Adam Smith Institute
Omega Report

SOCIAL SECURITY POLICY

Adam Smith Institute

THE OMEGA FILE

SOCIAL SECURITY

From research conducted

for the Adam Smith Institute

FOREWORD

The Adam Smith Institute's **Omega Project** was conceived to fill a significant gap in the field of public policy research. Administrations entering office in democratic societies are often aware of the problems which they face, but lack a well-developed range of policy options. The process by which policy innovations are brought forward and examined is often wasteful of time, and unconducive to creative thought.

The **Omega Project** was designed to create and develop new policy initiatives, to research and analyze these new ideas, and to bring them forward for public discussion in ways which overcame the conventional shortcomings.

Twenty working parties were established more than one year ago to cover each major area of government concern. Each of these groups was structured to include individuals with high academic qualification, those with business experience, those trained in economics, those with an expert knowledge of policy analysis, and those with knowledge of parliamentary or legislative procedures. The project as a whole has thus involved the work of more than one hundred specialists for over a year.

Each working party had secretarial, research and editorial assistance made available to it, and each began its work with a detailed report on the area of its concern. Each group has explored in a systematic way the opportunities for developing choice and enterprise within the particular area of its concern.

The reports of these working parties, containing, as they do, several hundred new policy options, constitute the **Omega File**. All of them are to be made available for public discussion. The **Omega Project** represents the most complete review of the activity of government ever undertaken in Britain. It presents the most comprehensive range of policy initiatives which has ever been researched under one programme.

The Adam Smith Institute hopes that the alternative possible solutions which emerge from this process will enhance the nation's ability to deal with many of the serious problems which face it. The addition of researched initiatives to policy debate could also serve to encourage both innovation and criticism in public policy.

1. THE SOCIAL SECURITY SYSTEM

The social security system is 'the largest single [government] programme and in 1984-5 will account for about 29% of public expenditure'.[1] Expenditure on benefits in the current year is estimated to cost over £37 billion. Simply to administer the system costs nearly £1.5 billion.

Despite such massive expenditure - and other forms of support such as concessionary bus and rail fares, regional and industrial subsidies, subsidized state housing, rate support grants, and free education - poverty, however defined, still exists. Our benefit levels are among the lowest in Western Europe. A significant proportion of those entitled to claim them fail to do so. And yet, at the same time, billions of pounds are paid out to people who could not, under any criteria, be said to be in need.

The reasons for this failure lie in the very nature of the social security system itself.

The drawbacks of complexity

Although the number of benefits available is substantial[2] they can be grouped into three main categories:

> 'First, there are national insurance benefits which depend on the claimant's previous national insurance contributions... unemployment benefit, sickness benefit (including the new arrangements for statutory sick pay), invalidity benefit, maternity benefits, widow's benefits, and retirement pensions.
>
> 'Second, there are certain non-contributory benefits which depend not on contributions but on other conditions. Among the most important of these are child benefit, benefits for accidents at work and benefits for the disabled.
>
> 'Thirdly, there are the means tested benefits. Whether or not these are available to claimants depends on their income or other resources. The most important are supplementary benefit and housing benefits. There is also Family Income

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1. The Government's Expenditure Plans 1984/5 to 1986/7 (London: HMSO, Cmnd. 91413-II, 1984).

2. The DHSS administers 'over 30 benefits' (ibid), while the National Consumers' Council identified no fewer than forty-five means tested benefits (in addition to the flat rate ones available) it its study, Means Tested Benefits (London: National Consumer Council, 1977).

Supplement (FIS).'[1]

Confused goals. The origins of this comprehensive complexity lie in the clear lack of any single, defined set of objectives behind the social security system. From the beginning, in the early decades of the century, some benefits were tax funded, some 'insurance' funded, and some funded through a mixture of both.

The attempt by Sir William Beveridge to create a unified system based on the insurance principle failed in the face of the politician's understandable unwillingness to impose high charges on today' electorate to provide benefits for some future generation. Instead, current benefits were increased to buy current support while national insurance charges were kept down to avoid alienating taxpayers and voters. The National Insurance Fund, in which the money to finance future benefits was supposed to accumulate, was deprived of income and reduced to nothing more than 'a piece of arcane book-keeping'.[2]

As a result, national insurance contributions have long been little more than simply another form of taxation (and a peculiarly regressive form at that), while the level of benefits towards which the payments are supposed to go is determined in ways totally unrelated to any payments made towards them. While the illusion is maintained that contributors are paying to provide future benefits for themselves, the reality is that they are simply financing present payments to other people. Indeed, they are not even financing the whole of the burden; the National Insurance Fund has to be topped up out of general taxation because its income is insufficient to meet the payments theoretically made from it.

Political manipulation. To complicate matters even further, a whole new range of benefits has developed in response to the activities of political pressure groups who correctly identified that the system was not achieving its objective of eliminating poverty but found it more profitable to pursue the narrow interests of a readily identifiable section of society than the objectives of restructuring the system to defeat poverty as a whole. Thus, for example, single parent families now qualify for a variety of benefits because of their special status. Whether they are rich or poor does not matter.

Even greater complexity arises when quite unrelated considerations are superimposed. The level and method of payment of child benefit, for example, owes more to well organized pressure in the past that aimed at providing women with some income of their own, than it does to any seriously thought-out plan to help families in need.

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1. State Benefits 1984 (London: Labour Research Dept. 1984), p.2.

2. The Reform of Social Security (London: Institute of Fiscal Studies, 1984).

Conversely, of course, groups with a less readily identifiable political identity lose out. Single people, for example, pay the same national insurance contributions and higher taxes but cannot qualify for the many family-related benefits and are denied the opportunity to put their money towards a package of benefits more suited to their individual circumstances.

Lack of understanding. Complexity and lack of choice characterize the system. As a result, many do not claim the benefits for which they qualify (see Table 1). They may not know what they are entitled to or be deterred by the difficulty of making a claim. They may be badly advised by DHSS staff, themselves confused by or unaware of the entire range of different benefits they administer. Or they may simply find the forms and booklets designed to explain the system are totally incomprehensible.

Table 1
Estimated take-up of certain benefits

Percentage of those entitled who claim benefit	1979	1981
Supplementary benefit		
Pensioners	65	67
Non-pensioners	78	75
of which: sick and disabled	63	67
unemployed	81	75
one parent families not included under sick & disabled or unemployed	85	88
Total	70	71
One parent benefit	60	70

[Source: Government Expenditure White Paper, 1983-84, p. 86]

Administration. It requires a large administration. Over 85,000 people are employed to organize and distribute social security benefits, 10,000 of them simply to maintain the national insurance contribution records at a cost of £100 million a year. Overall, it costs around 5p for every £1 distributed; but the costs incurred in paying some items of supplementary benefit rise to several times that. By comparison, it costs well below 2p in administration for every £1 collected by the Inland Revenue.

1. It costs the Inland Revenue 1.73p to collect taxes alone but that figure drops to 1.23p when national insurance contributions are included. 126th Report of the Board of Inland Revenue Cmnd. 9305 (London: HMSO, 1984).

Duplication. It leads to substantial duplication. Not only do many claimants qualify for more than one benefit (see Table 2), where those benefits are means tested they may have to undergo more than one assessment of their needs by different groups of officials.

Table 2

Estimated number receiving certain contributory benefits plus supplementary benefit 1983/4

Retirement pension	1,435,000	15% of all receiving retirement pensions
Unemployment benefit	240,000	9% of all receiving unemployment benefit
Widows benefit and industrial death benefit	25,000	5% of all receiving widows & industrial death benefits
Invalidity benefit	55,000	8% of all receiving invalidity benefit

[Source: The Government's Expenditure Plans 1984/5 to 1986/7, p. 86]

Lack of innovation. The system inhibits competition and innovation. Because benefits are provided under a unitary system and payment for them is obligatory for taxpayers, there is virtually no opportunity to develop private provision over large areas of social welfare. The experimentation with new benefits or different packages of benefit that characterize other areas of insurance is almost non-existent. By its very existence the cost of 'free' state provision precludes all but the best employers and a small minority of wealthy individuals from seeking better benefits in the private sector, given the problem of paying twice - once through taxation, and once for the private service - that is implied.

Lack of discrimination. Worst of all, because so many benefits are paid equally to rich and poor alike, they cannot be generous enough to those in need and yet the means tested nature of the rest is such that taking a job may make an unemployed family little better off while a pay rise to a lower paid worker might actually make him poorer. The present benefit system in fact hurts the poor by squandering valuable resources on those who do not really need them.

The system has other, more detailed, drawbacks, too. Entitlement to some benefits is assessed over a short period while payment is made over a long one. The choice of untypical weeks can lead to over or under payment with the intelligent claimant manipulating the system to his own advantage. People with two jobs, one of them self-employed, can find themselves paying two sets of national insurance contributions but without qualifying for any extra benefit. The different levels at which income tax and national insurance contributions are imposed means that families too poor to pay tax (perhaps, indeed, in receipt of Family Income Supplement) may yet be having national insurance contributions deducted. Such examples abound.

The principles for reform

Past proposals to reform the system have either been rejected as too radical or have been implemented in such a way as to increase the existing complexity even further. In our view, the time for radical change is long overdue. We propose four principles on which reform should be based.

(a) that help should only go to those in need of it;

(b) that such help should be, as far as possible, in the form of financial support such as to enable the recipient to maintain a basic standard of living for himself and his family, but to exercise individual choice in the exact way in which the benefit is spent;

(c) that there should be an incentive towards taking work, however poorly paid, and towards improving earnings; and

(d) that circumstances that are capable of being provided for by insurance should be covered through properly funded, privately provided, compulsory insurance, with the state paying the premiums of those who cannot afford to provide for themselves.

In putting forward the following scheme based on those principles we are conscious that there will be significant consequences, the total affects of which we can only guess at.

First, there will be clear effects on the pattern of income distribution. Even if the new system is no more generous to the poor than the present one, the replacement of benefit by tax reductions will be far from neutral for the rest of society. There will, of course, be many for whom the gains and losses will be broadly equal, and the poor should be much better off. But there may be a few in the higher income groups who gain and those in the middle groups who lose.

Secondly, the transition to a system with a large element of insurance-based provision in it, particularly for pensions, must be more expensive at first than the present tax funded system. Existing demands must be catered for while future claimants are building up their entitlement in personal insurance funds. That extra cost will fall on all those not in receipt of benefit and will amount to a significant shift from consumption to savings. It is to be hoped that sensible investment of those savings by the insurance companies and other financial institutions will lead to greater economic growth in the future than might otherwise have taken place, thereby reducing or eliminating the projected problems of the decades 2020-2040 when a smaller working population is foreseen as having to maintain an increasing population of pensioners.

Thirdly, the clearly identifiable savings that will arise from our proposals come from a substantial and progressive reduction in administrative costs. We have no doubt that the superior efficiency of the private market will lead to reduced costs, greater choice, and superior benefits elsewhere but no advance estimate of their size or nature is possible.

A PROGRAMME FOR ELIMINATING POVERTY

The simplest way to ensure that those (and only those) in genuine need will receive assistance is to fix a minimum income level per person (or different minima for different categories of people such as the elderly, the disabled or the single parent family who are thought to have different levels of need - or for different areas if some are considered more expensive to live in than others) and pay everyone with incomes below that the necessary amount to bring them up to the level.

In a sense, this is what supplementary benefit payments seek to do. Unfortunately, however, so many other separate benefits, both flat-rate and means tested are superimposed on top that it is at best a very imperfect weapon in the fight to eliminate poverty. Table 3 below lists the most important benefits and the numbers of people in receipt of them.

It is our view that all these benefits should be replaced by a single system combining the payment of income tax and the distribution of benefit based on a single assessment of need or ability to pay. In broad terms, such a system would assess an individual's or a family's needs and make payments to them if they were below the determined level or deduct taxes from them if they were above, with a sliding scale provision in the detailed arrangements at the margin to ensure that there was some incentive in favour of taking up employment and working towards higher wages.

The purpose of any such reform must be to ensure that no-one falls below an agreed standard of living. Any minimum income guarantee that is proposed would therefore have to take into account local and even seasonal variations in housing, food, transport, and so on. To set the appropriate figures and keep them updated would probably be the work of an independent panel.

Revisions would reflect changes (upward or downward) in the costs of the commodities that are thought essential to provide a minimum standard of living, rather than general movements in prices or incomes, and from time to time new 'essentials' would enter the equation and outmoded items would drop out.

Table 3
Estimated costs of benefits and the numbers receiving them (1984/5)

'Contributory' benefits	Cost (£,000)	Numbers (,000s)
Retirement pension	15,348}	9,260
Earnings related component	87}	
Christmas bonus	104}	
Widows benefits, etc	798	430
Unemployment benefit	1,538	970
Sickness benefit	246	150
Invalidity benefit	1,928	740
Death grant	18	
Industrial disability benefit	377	180
Industrial death benefit	57	30
Other industrial injury benefit	5	5
Maternity allowance	191	140
Guardian's allowance, etc	5	5
(Total 'contributory' benefits)	(20,699)	
'Non-contributory' benefits		
Retirement pensions	38}	35
Christmas bonus	6}	
War pensions	544	305
Attendance allowance	571	490
Invalid care allowance	11	10
Invalidity pension, etc	201	225
Mobility allowance	356	350
Supplementary pensions	792	1,520
Supplementary benefits	5,365	2,790
Child benefit	4,291	12,455
One parent family benefit	122	570
Family income supplement	131	205
Maternity grant	18	-
(Total 'Non contributory' benefits)	(12,446)	
Housing benefits		
Rent rebate	2,045	3,315
Rent allowance	416	790
(Total housing benefit)	(2,461)	
Total	35,606	

Above the level of zero earnings, benefits would still be payable, but their size would be gradually reduced. This would mean that there was always an incentive for individuals to seek employment, or better-paid employment, although nobody would fall below the minimum living standard. (See Fig. 1)

Rationalizing tax payments. A number of unified tax and benefit schemes have been suggested in the past, from modest ones covering limited measures of income support to fully fledged systems of negative income tax that would incorporate virtually all social security support.[1] It is the latter comprehensive approach that we are proposing.

Instead of collecting income from those above the poverty line (and some below it too) by means of national insurance at 9% and income tax at 30%, we recommend a single income tax structure. Increasing the basic rate of income tax to 40% would produce roughly the same income as is currently produced from employees. Those with higher incomes would be a little worse off, most would be very little affected, but those on lower incomes would gain. A single person earning less than £2,000 and a married man earning less than £3,150 would pay nothing under the new scheme, whereas they currently have to pay 9% of their earnings if they receive more than around £1,800. We also suggest the abolition of the employers' element of the national insurance contribution, which is not in fact an insurance contribution in any meaningful sense, but merely a tax on jobs and an administrative headache for the very people - small businesses - that are most likely to generate new jobs if given the opportunity and incentive.

Advantages of rationalization. While we deal in detail with our suggested alternatives to it at a later point, it is appropriate to outline some of the consequences of the abolition of national insurance contributions here. In the first place, it will end the illusion that these taxes on employment are a form of contribution towards future benefits. Secondly, not only will it simplify the tax system and allow savings of at least £100 million in the maintenance of contribution records, but it will remove a significant bureaucratic burden on businesses, especially small ones. While deducting contributions may not impose much extra work on large companies where the payroll is computerized, the same is certainly not the case in small firms where pay is handled manually. Extra, unnecessary paperwork is just one more disincentive to taking on extra workers. And it cannot be repeated often enough that unemployment would disappear if every self-employed small businessman took on only one extra employee.

Abolition would remove a regressive element from the tax system. Contributions are imposed only on incomes below a

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1. Varieties of such schemes have been proposed by people of all shades of political opinion, from Milton Friedman to the late Jim Conway, General Secretary of the Engineering Union who described it as 'a weapon for socialism'!

certain level. The effect is that the rate of tax, in total, on higher incomes is actually lower than that imposed on middle and lower income earners! Worse, such contributions fall due after a certain income threshold is reached - the lower earnings limit - but are then levied on the entire income, creating an effective marginal tax rate of many hundred percent. This is a serious disincentive to part-time workers increasing their earnings if they were just below the threshold at which contributions become liable. Abolition would similarly remove an equally serious disincentive to employers increasing their pay or hours.

A side benefit of the change would be the ending of the invidious difference between the rates of contribution paid by the self-employed and the employed and the different benefits to which each are entitled. The apparently higher contributions and lower benefits 'enjoyed' by the self-employed has long been a source of discontent and its elimination is long overdue.

No administrative difficulty

Unifying the various systems of assessing need would not pose qualitative problems of administration. At present the annual tax return provides for the taxpayer claiming tax relief for a variety of reasons such as dependent relatives, the need for a housekeeper, or blindness. We see no difficulty in expanding it to include all the equivalent information required to assess need.

For the vast majority of people, one such assessment per year would be sufficient, since the size of their families, the scope of their responsibilities, and the nature of their handicaps will not change. For most of the rest, changes would be unlikely to be frequent: birth, death, or serious accident being the likeliest.

While there would undoubtedly be some extra cost to the Inland Revenue in collecting and processing this additional information, it would be more than compensated for by the substantial reduction in work undertaken by the DHSS and (if housing benefits are incorporated into the scheme) the local authorities.

Given these two changes there should, in principle, be no administrative difficulty in issuing a new form of tax code. Those, the big majority, with incomes above the level of the guaranteed income and incentive threshold would pay tax at the appropriate rate or rates. Those with incomes below the (GI&I) level would receive benefit, again at an established rate.

For those in employment, the tax system would work in the same way as at present. For those without a job or earning less than the GI&I threshold, payment could be paid in a variety of ways, as benefits presently are: through employers, by pay books, giro cheques, or credit transfers to the claimant's bank account. The practical problems would be no different to those which currently arise, such as payment cheques or pay books being 'stolen' and black economy earnings not being declared. Inasmuch as the problems already exist, the changes we propose would make matters no worse. Indeed, by eliminating payments to a great many who do not need them and paying others through the income tax system at their place of work the opportunity for dishonesty will be diminished.

Nonetheless, our system does offer an opportunity to reduce such fraud and eliminate a major source of trouble experienced by those changing jobs - the delay in obtaining a tax code. Since everyone will be issued with a code as part of the payment of welfare, such delays will disappear. If the period before school leavers qualify for benefit is retained as part of the system, ample time will be available for processing new applications.

We see no reason why, with the advances in modern technology, it should not now be possible to issue every person's coding in the form of a GI&I 'bank card', using the magnetic strip to carry their coding or assessed needs. Such a card could be handed to an employer for use in calculating the tax or benefit due and could be used through the banking system or a network of tax office or post office automated cash tellers for the payment of benefits to all those not working. With proper supervision of employers by the Inland Revenue, the opportunity for fraud would be reduced to the undeclared income from the black economy employment which the present system finds it equally impossible to counter. It may be possible to combine this system with a 'medicare' card which guarantees free health treatment to those in need, with one card serving both purposes.[1]

SOLVING THE PROBLEMS

While in outline such a system seems simple and would allow considerable savings in administration, it is not without its problems.

The cost of incentives

The most difficult, and the most costly problem to solve, is the provision of some incentive to people in receipt of benefit to take work if it is available or to increase their pay if they are already working. Under the existing social security system, the incentives are small. A memorandum from the Treasury to the House of Commons Treasury and Civil Service Conditions shows that a married couple with no children and living on the dole would be receiving 80.5% of the money they would get if the husband took a job at half the average wage (i.e. £91.20 a week). With two children the family would get 88.8% of that wage by staying on

1. See our report on Health Policy (London: Adam Smith Institute, 1984).

the dole. As far as families in work are concerned, the Treasury estimates that there are 160,000 in the position where the combined marginal rate of tax and benefit withdrawal is high and may exceed 89%.

The Institute of Fiscal Studies argue that the position is even worse and that, for some families at least, a pay increase can actually make people worse off. The example they give is illustrated in Table 4 below.

Table 4
How a couple with two children* are affected by taxes and benefits (1983/4, November 1983 benefits)

	Gross income (£ p.w.)				
	50	80	100	120	200
Plus:					
Child benefit	13.00	13.00	13.00	13.00	13.00
Housing benefit	22.55	17.60	13.89	8.29	-
Family income supplement	20.50	7.50	-	-	-
Free school meals	5.00	5.00	-	-	-
Less:					
Tax	-	-7.88	-13.88	-19.88	-43.88
National insurance	-4.50	-7.20	-9.00	-10.80	-18.00
Net income	108.55	108.02	104.01	110.61	151.12

* Rent £20 p.w., rates £7 p.w.

[Source: The Reform of Social Security (London: I.F.S., 1984), p. 56]

As some of these estimates exclude the cost of travel to work and none includes other expenses involved in taking a job or the cost of other benefits that might be lost (such as free prescriptions), the position is undoubtedly even worse!

Inasmuch as the present system contains little (and perhaps a negative) incentive to work, it could be argued that the new system we propose need not give any either. Reducing benefit pound for pound with increased earnings has the merit of simplicity and is the least expensive method of operating. It also concentrates resources exclusively on those who are in genuine need. Our aim, however, is to encourage people to look after themselves if at all possible. To provide no incentive to those who are the worst off in society would be contrary to that objective.

Figure 1
Graphical representation of GI&I scheme

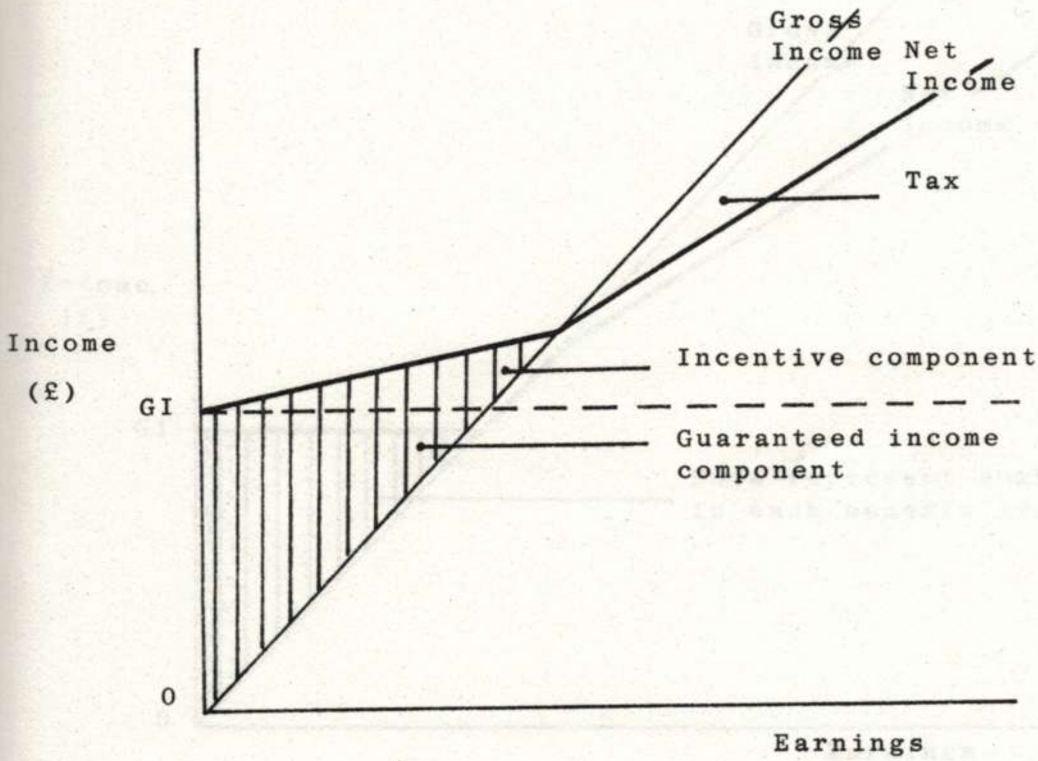


Figure 2a
No incentives: beneficiaries bunch at zero income and maximum benefit requirement

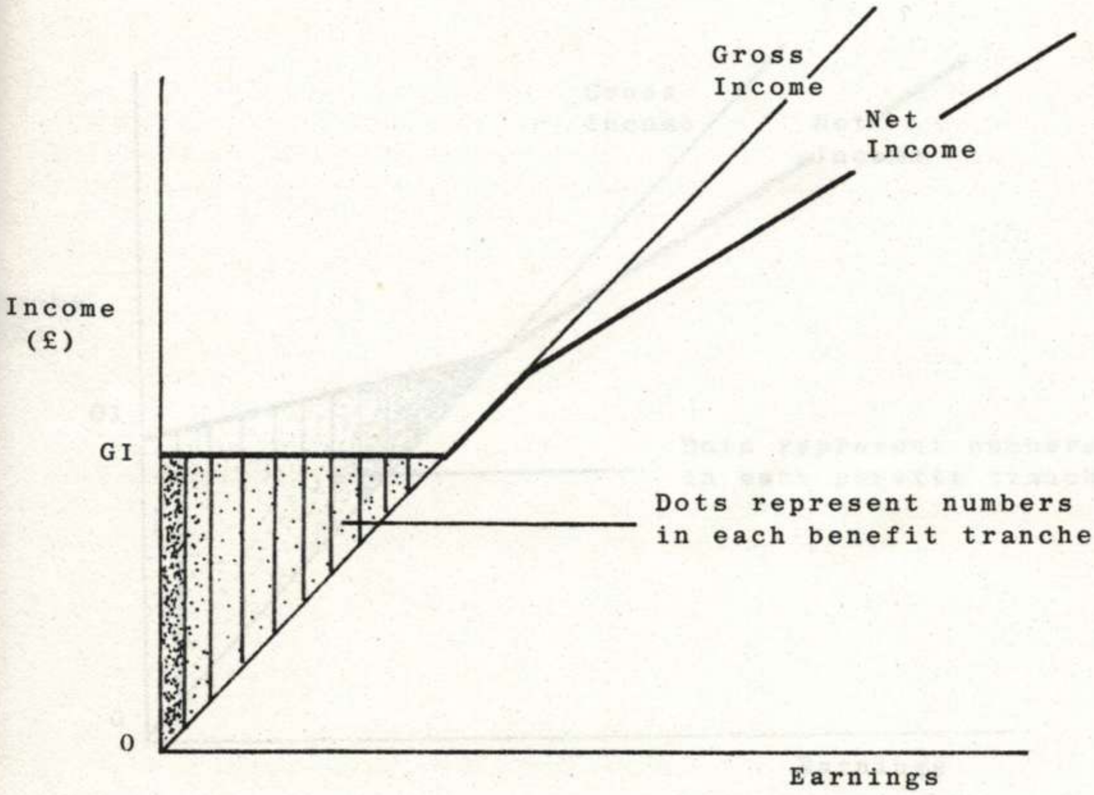
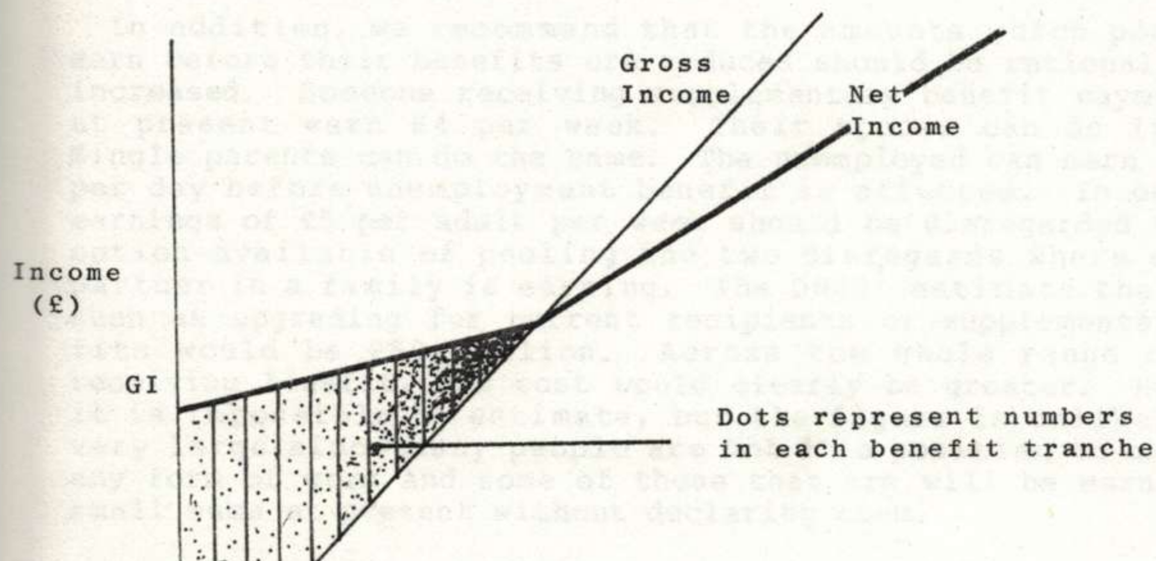


Figure 2b
With incentives: beneficiaries bunch at higher incomes and lower benefit requirements



Nonetheless, reducing benefit at a slower rate than incomes rise means that some benefit is given to those who, strictly speaking, do not need it. The bigger the incentive, the more people will benefit in this way and the greater the cost of the new system. We are, therefore, compelled to recommend that, initially, the incentive be a modest one of 10% (i.e. for every £1 earned benefit would be reduced by 90p).

In addition, we recommend that the amounts which people can earn before their benefits are reduced should be rationalized and increased. Someone receiving supplementary benefit payments can at present earn £4 per week. Their spouse can do likewise. Single parents can do the same. The unemployed can earn up to £2 per day before unemployment benefit is affected. In our view, earnings of £5 per adult per week should be disregarded with the option available of pooling the two disregards where only one partner in a family is earning. The DHSS[1] estimate the cost of such an upgrading for current recipients of supplementary benefits would be £50 million. Across the whole range of those receiving benefit, the cost would clearly be greater. How much, it is impossible to estimate, but the figure is unlikely to be very large since many people are not in a position to undertake any form of work and some of those that are will be earning such small sums at present without declaring them.

The principle involved in our proposals can be seen in Table 5 below, using as a basis a family with two children with an assessed guaranteed income need of £90, roughly the present value of the benefits they would receive if they were dependent on supplementary benefits. For comparison, the net income figures from Table 4 are included. The table is for illustrative purposes, and does not imply our commitment to particular values of guaranteed income and incentive payments.

Table 5
Old and new benefit structures

Gross income (£)	0	50	80	100	120
Benefit received (£)	90	54	27	9	-
Tax deducted (@ 40%) (£)	-	-	-	-	4
Net income under proposed system (£)	90	104	107	109	116
Net income in present system (£)	*(90)*	*108.55*	*108.02*	*104.01*	*110.61*

<u>Exaggerated costs</u>. The worry about the cost of this incentive arrangement can be seen from Figure 1. Everyone agrees that the triangle representing guaranteed income would be justified as a weapon against poverty, but the size of the triangle above it -

1. <u>Second Report of the House of Commons Committee of Public Accounts</u> (London: HMSO, 1983) Appendix 2.

representing only work incentives is daunting.

In our judgement, however, this familiar graphical representation of the problem is misleading because it ignores the numbers of people claiming benefit. The very purpose of the incentive element is to push people rightward on the graph - that is, to where they earn incomes (or larger incomes) and so the benefit payment required to each is actually reduced. If the incentive effect is strong, beneficiaries will bunch in the top corner of the triangle, actually requiring only a small total volume of payments (Fig. 2).

Indexing benefits. Once the minimum standard of living has been set and has been expressed in terms of the guaranteed income necessary to secure it, there arises the problem of when and how to change it.

Defining poverty in relative, rather than absolute terms has been a source of growing cost - the real value of benefits has more than doubled in the last three decades - and thus of higher taxes and public concern. If benefits are tied to average earnings, rather than prices, there is an inherent tendency for them to leap far beyond the amount required to purchase what most people would regard as 'necessary' items.

In political and administrative terms, the easiest solution is to index benefits in terms of the price level. This would assure current standards and would increase the incentive effects of employment as average earnings continued to grow faster than prices.

However, attitudes about what constitutes 'necessary' items in a household budget do change. A television, for example, is now considered a necessity rather than a luxury, and in cases such as those of old and single people where depression is a threat, there may be no doubt about the question. These changing attitudes clearly have to be taken into the equation. Similarly, once the range of 'necessary' commodities is decided, it must be remembered that its price may not follow the general price index. It is an index based on the necessities of housing, food, heating, and so on that is required for a basic standard of living to be assured.

Cost-based benefits

The other significant problem relates to benefits which are calculated in relation to the actual costs incurred by the claimant rather than those given automatically up to some predetermined maximum. The most important of these are housing benefits and the supplementary benefit single payments.

While the existing housing benefit regulations (specifically No. 17) provide for a limitation on such payments where the cost of the accommodation is judged to be excessive, the power is little used. In principle, we are unhappy with such cost-based benefits because of the open-endedness of the commitment, because they distort the market, and because they restrict or eliminate choice. In the case of housing, they act to reinforce existing disparities between families. Those in the best and most expensive houses get the greatest help; those in the meanest and cheapest get the least. In our view, a more uniform or flat-rate benefit would therefore have the merit of restoring a measure of choice to poorer tenants. Some would be able to use the improved purchasing power to move up market, others might choose to move down market to release money for other purposes they considered more important.

In the case of rates, cost-based rebates also act to encourage political irresponsibility. Where the rates are paid by the state, regardless of their level, there is absolutely no incentive to vote, let alone vote responsibly. There are estimated to be 6.25 million people in receipt of rate rebates; which is high by any standards.

In the case of supplementary benefit single payments, the system acts to encourage imprudence. If the state will provide for emergencies, there is no need for the individual to do so himself. Not only that, but it is costly to administer with each claim having to be considered individually and subject to a cumbersome appeal structure.

For all these reasons, therefore, we suggest that the new system should contain no provision for cost-based benefits but that, instead, an average amount should be included in the total of assessed need to cover rent, rates, and some savings or insurance for emergencies. Given the widely varying levels of house costs in different parts of the United Kingdom, we recognize that it will be necessary to provide for different levels of this element of need for different areas.

Insurable risks

While our system would cover everyone in need, whatever the reasons for their situation, there are a number of circumstances which we believe could and should be provided for privately through personal or company insurance, many of them currently included in the (misnamed) national insurance scheme.

These insurable events can be broadly grouped into four categories:

(a) those which individuals can generally provide for themselves either because liability is foreseeable and can be planned for or is readily insurable (an example of the former is childbirth, of the latter, death);

(b) those that an employer or self-employed person can - and often already does - provide for through insurance (such as industrial injury, permanent disability, or death);

(c) those that the individuals can provide for themselves over a longer period (such as pensions and survivers' benefits); and

(d) those that companies could provide or insure for but only in the longer period when a new market has developed (unemployment pay is such a case).

We see considerable potential gains from a move towards such genuine private insurance. Instead of a single state package providing the same benefits at the same level for everyone, there would be an opportunity for variety and innovation, and for benefits better tailored to the individual needs of the person or the company. Insurance premiums would vary according to risk, so that employers in dangerous occupations or those exposing themselves to heavy risks would have to face the real potential costs. Such differentiation might, indeed, provide a valuable impetus towards greater safety both through the pressure on companies of high premiums and on employers and individuals from the insurance companies seeking to minimize their potential liabilities. The competitive environment within which insurance companies have to operate would also ensure cheaper and more efficient administration of the new system.

__Industrial insurance__. We therefore recommend that companies and the self-employed be obliged to insure themselves and their workers to a fixed minimum standard for industrial injuries and their consequences. As the establishment of responsibility for industrial accidents can often be the cause of lengthy disputes and litigation, we envisage that the government, perhaps through the Health and Safety Executive, should assume the responsibility of ensuring that the legal minimum of insurance cover is in fact being provided and should undertake a supervisory role in ensuring that any claims are dealt with fairly and speedily.

Regarding the contingencies that can in principle be insured privately by individuals, the ultimate aim would be to make such insurance compulsory, just as motorists are required by law to insure their vehicles against potential liabilities. Initially, however, it may be necessary to allow a private market to grow where one does not exist at the moment, and to boost this growth, we suggest that encouragement be given through tax relief on premiums to private individuals who wish to take out their own insurance cover against events that might otherwise cause them to make a claim on the basic welfare system. Such private cover relieves the state of many potential liabilities, and so could bring net reductions in costs to the taxpayer in spite of the rebate payments. It would certainly provide an incentive to go private that presently cannot exist because of the costs to most people of 'paying twice' and the fact that, in the absence of private cover for risks such as sickness or disablement, an entitlement to state benefit would exist anyway.

If funeral expenses are seen as a difficulty requiring state help - which is doubtful - we would suggest that every individual under the age of fifty should be obliged to take out insurance to cover funeral expenses. For those over the age of fifty when the scheme is introduced, we would envisage the present minimal benefit continuing to be available.

Unemployment would be a difficult risk for the individual to insure against, but not so much so for employers. The redundancy arrangements currently in force constitute a crude form of unemployment benefit though they have the obvious drawback of not being transferable between employers.[1] It should not, therefore, prove impossible to devise a system which obliges companies to provide at least a minimum level of payment for workers it ceases to employ with the entitlement, and the money related to it, being transferable between companies as employees move. Clearly, such a system would have to be phased in as employers could not be expected to assume a commitment that had not been provided for but we believe that steps should be taken to introduce such cover over the shortest time possible, even if that means that entitlement would initially be limited in its duration. The number of unemployed people receiving unemployment benefit is now down to below 40% because entitlement under the national insurance system has expired. There would, therefore, be no difference in principle in a privately operated system having limited entitlement related to length of service, except that the costs would fall on the highest-risk industries rather than on taxpayers in general.

BUDGET CONSIDERATIONS

The above proposals impose significant financial burdens on employers in financing new or expanded insurance liabilities. We have, however, already recommended that the employers' portion of the national insurance contributions be abolished as part of our general reforms. This would reduce the total of taxes on employment by approximately £6 billion. The national insurance surcharge has long been accepted as a tax on jobs; but of course, the basic national insurance contributions on which that surcharge was superimposed are a tax on jobs also. Its total abolition should therefore act as a powerful stimulus towards economic growth and increasing employment.

Universal benefits

The savings that are possible by concentrating universal benefits on needy families alone are very substantial and easily offset the proposed reductions in payroll taxes. Child benefit, for example, presently costs over £4 billion on its own, and approxi-

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1. Unless the worker is employed by a local authority when (typically of the 'public' service) his entitlement to redundancy is cumulative, no matter how many times he changes job!

mately 75% of this goes to families who cannot be said to be in need of it. On the moral plane, it seems impossible to justify the levying of higher taxes on everyone, including young single people, childless couples, and working pensioners, in order to pay benefits to well-off families. The elimination of benefits such as these, except as part of a guaranteed income package to those in need, would free sizeable sums that could be spent on the elimination of real hardship and the encouragement of new employment opportunities for all.

Administrative savings

A system such as the one proposed would show significant savings in administration and hence in administrative costs. All the existing varieties of assessment would be reduced to one - and that organized jointly with the Inland Revenue. Payments would be greatly reduced in number and variety, with further progressive reductions as the full reforms developed in practice. We have already commented on the widely differing costs of collecting taxes and paying benefits. It is to be hoped that the new simplified system would bring costs down towards the low Inland Revenue level, rather than raise them significantly towards the DHSS levels. Yet further savings could come from unification of the systems of detecting fraud and wrong payments.

The dramatic simplification proposed should yield administrative savings of at least 25% and perhaps more, a large part of that amount coming from scrapping the system of maintaining contribution records. In the long term, the savings should be substantially greater as Inland Revenue computerization simplifies the administration even further.

Incentive savings

To try to calculate in detail the full implications of the radical reforms we are proposing is quite impossible. The time when the system is introduced and the levels of assessed need adopted will clearly determine initial costs, and too many other variable factors exist which will affect that cost in both the short term and the long term.

In very broad terms, the unification of the employees' national insurance contributions with his income tax payments would have very little effect on total income. The scrapping of the employers' contributions would cost around £6 billion (net of the savings that arise through compelling companies to insure against industrial accidents and for at least short-term unemployment). On the other hand, the savings from ceasing to pay benefits to those who do not need them could save as much as £16 billion.[1]

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1. This figure is gross of any expenditure involved in transferring pensions away from the 'chain-letter' principle and towards

Some of this would need to be disbursed on incentive payments aimed at poverty and unemployment traps. Increased take-up of benefits would also eat into the figures. Even so, it seems far from unreasonable to expect that the net changes would lead to a sizeable reduction in cost to the taxpayer and that the objective of eliminating poverty would in fact be more fully achieved.

That cost might well, however, be reduced even further by some of the side-effects our changes would create. Removing the barrier created by the threshold at which national insurance contributions become due might well lead to increased employment and higher wages among part-time employees. Eliminating the poverty and employment traps would provide enough encouragement to persuade many people to improve their position. Such effects are impossible to quantify but they are bound to have a beneficial effect on costs and on attitudes.

All in all, we are confident that the changes we have put forward would eliminate poverty much more effectively, and do so at lower cost than the present system which is failing to do so. And it would provide an encouragement, sadly lacking in the present system, for people to improve their lot.

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an individuated and fully funded arrangement (see the section on pensions below). The figure also assumes that other pension-type benefits are concentrated among those in genuine need.

2. THE BASIC STATE PENSION

PROBLEMS

The main criticisms of the state basic pension system fall into three main categories: doubts about the future funding of pensions; the moral shortcomings of the present system; and unfairness in the scales of benefits and contributions. Many of these criticisms will, of course, apply equally to all the other parts of the national insurance arrangements.

Future funding of basic pensions

1. The foremost concern about the future of state pensions is that **political pressure always tends to bankrupt the system.** The pay-as-you-go system invites political manipulation, the temptation being for governments to gain popularity by increasing benefits. This increase can be financed through the general increase in taxation or through inflation, neither of which is obvious but each of which puts extra strain on the productive sector of the economy. Alternatively, it can be financed through increasing national insurance contributions, with taxpayers' acquiescence being secured by promises of even greater benefits in the future. But finding the money to pay for those benefits will be the task of some other government next century, so the promise is a cheap and convenient one to present-day politicians. Hence the natural tendency for the system to run out of control and to make spiralling demands on taxpayers.

2. Another source of concern abut future funding is **demographic change.** While the retirement age has remained unchanged, those over it have tended to live longer, forming an increasing portion of the population. Other factors, such as the tendency of people to start work later in life, and unexpectedly high levels of unemployment, have increased the burden by reducing the proportion of contributors.

3. The increasing difficulty of financing pensions leads many people to doubt whether the future generation will in fact honour the obligations which we have imposed on them without their consent. It is certainly a source of some discomfort to any pensioner that the size of his retirement income depends not on his own past efforts to secure it, but **only on a moral obligation** felt by future governments. For this reason, the pay-as-you-go system has been uncharitably, but perhaps accurately, likened to a chain letter, with its attendant morality and its likelihood of future collapse.

Moral shortcomings of the state system

4. Even if the state pensions system were completely secure, it would still fail to stand against the assault of the powerful

argument that it completely precludes any personal choice. There is no possibility of an individual tailoring his contributions or benefit structure to his individual needs: he has to take the ready-made state offering.

5. The pension and social benefits system suffers from the **confusion of welfare and insurance principles**, with frequently absurd results. For example, the same basic pension is payable to everyone, regardless of how high their past incomes may have been: even those with sizeable assets are entitled to a basic pension. Insurance principles pay everyone a pension until death, no matter when that might be; but then welfare principles continue to pay benefits to survivors without requiring larger contributions. There are many instances of such confusion, so that benefits are not linked to contributions in any consistent or equitable way.

It is perhaps better to recognise that national insurance is not really insurance at all; it is a tax which is used to promote a large range of social or political objectives, including income redistribution . But many of these objectives it serves poorly or perversely because it is so confused.

6. The notion of the **employer contribution** to national insurance is equally mythical, and should therefore be resisted on moral grounds. The national insurance contribution paid by business simply reduces the amount which an employer has available to spend on wages, and therefore reduces wage rates (or employment levels) accordingly. The contribution is thus a payroll tax and not a gift to the employee for insurance purposes, as is commonly supposed.

The payroll tax has a particularly depressive effect on wages and employment in smaller firms, which are less able to absorb the administrative overhead. This depressive effect on small business expansion eats into future economic growth and therefore into the security of the pensions system itself.

Benefit and contribution structure

7. Confusion of welfare and insurance principles has also led to national insurance taxes **deepening the poverty trap**. The tax is not payable by individuals with an income of less than £32.50 per week, an attempt to ease the burden of the very poor. But beyond that level, the whole earnings become liable to the tax. A worker at the lower earnings limit, in return for an extra £1 of earnings, pays taxes just over £3.00 per week, a tax rate of 300 per cent! In order to be just as well off as he was when he earned only £32.50 per week, his gross salary must increase to £35.70, that is, by about 10%. It is surprising, in view of the attention given to the work disincentives of supplementary benefits, that the effects of the minimum earnings limit have been so rarely pointed out.

8. Just as there is a disincentive effect at the bottom of the contribution range, there is **regressivity of the tax** at the top. For above the maximum earnings limit, national insurance contributions are not paid, presumably an attempt to incorporate some of the insurance principle into contributions rates. But this means that the tax represents a declining proportion of income for the higher earners. A worker at the upper level of £235 per week pays contributions equal to 9% of income, whereas one earning twice that amount pays taxes equal to only 4.5%. Since regressive taxes have been widely avoided elsewhere, it is odd that they should persist so obviously here.

9. The treatment of particular categories of person, particularly women, is anomalous under the state basic pension scheme. The most obvious inequality is that the retirement age is lower for women, even though they tend to live longer. Another inequality occurs in the treatment of widows and widowers. There are particularly generous terms for most widows, who receive benefits to support themselves and their children, and are then entitled to a pension until death. Yet this extra benefit to survivors does not require any higher contributions, as insurance principles would require. Widowers, by contrast, do not receive benefits merely because they survive a wife.

10. The state pension system represents **very poor value for money**. If we look at an individual entering the workforce, we can compare the contributions he can expect to make over his lifetime with the level of benefits he can expect to draw on retirement. From this information, we can compare the implicit rate of return on his payments with that he could expect to achieve in an ordinary investment.

Take for example, an individual much like the average, who enters the system at age 20 and pays contributions continuously until age 65. Having reached retirement, his life expectancy is about another fourteen years, as calculated by the government actuary. Only a portion of total national insurance contributions go to retirement and widow's pensions, of course - between 73% and 81% - the rest goes on other benefits. So we will attribute this portion of his lifetime contributions to his pensions, and balancing this against his expected pension receipts, we can estimate the yield on his contributions. It forms this pattern:

Table 6

Salary	Single man %pa	Married man %pa
2/3 National average	+0.3	+2.3
National average	-0.3	+1.9
Upper earnings limit	-0.7	+1.4

If the individual could invest his contributions at higher rates than these, which the individual in our example will not find too difficult, he would be better off **out** of the state scheme. Other individuals will of course do better in the state system, but these rough figures give a useful notion of what poor value state pensions represent to many people.

REFORM

The shortcomings of the present basic pension scheme force us to search for more secure, flexible and equitable alternatives. The prospect of a funding crisis in thirty years' time (when demographic factors are at their worst), is certainly the most common reason for wishing to undertake the search: but no less powerful is the severe lack of personal choice in the system, its insulation from any improving competitive forces, and its large transfers of income between population groups which seem to be unjustifiable on insurance or welfare grounds. Yet the prospects of any reform of the system are impeded by severe difficulties.

The economic strain of reform Any attempt to make the system more secure by moving to a funded basis, where contributions are invested in order to pay future benefits, faces problems because of the huge current costs of the present system.

Under the present pay-as-you-go system, current basic pension rights of £14,700m per year (in 1983-4), and total national insurance benefits of £20,000 million are paid directly out of **current contributions**. If we decided to move immediately to a funded system, and started to use these contributions to build up funds to meet future benefits, then there would be no income to maintain the current obligations. These obligations would diminish to zero over the years as the beneficiaries died, but nevertheless, the financing burden is certainly much more than any government would be willing to bear.

We can overcome this difficulty by controlling the rate at which current contributions are diverted into funds. If only part of the total of contributions goes to build up a fund, then the financing problem is reduced to that extent, although the transition to a fully funded system is obviously more protracted.

An unexpected bonus. The transition burden should not be overestimated, however. Because the state system gives poor returns, an individual going into a private pension alternative would have to contribute less to achieve the same growth. To achieve a 2% per annum real rate of return, roughly equivalent to that offered by the state system, the average-income married individual in our earlier example would have to contribute only about 12% of earnings, significantly less than current and projected average total contributions. A small levy on those going private might therefore ease the burden of paying current state pensions, while leaving them no worse or better off than they would have been in the state sector.

A proposed solution for basic pensions reform

Our proposed reform of the state basic pensions system comprises the following elements.

Personal retirement accounts. An individual will be allowed to contract out of the state basic pension system provided that he sets up his own funded alternative in the shape of a personal retirement account (PRA). These accounts will be private (thus benefiting from the stimulus of competition) and will probably be offered by insurance companies, banks, and perhaps even building societies: it might even be possible for employers to offer them to their workforce.

Personal retirement accounts will have to be approved by the government and will be required to meet basic criteria about investment and benefit structures, in order to guarantee complete security to the contributor. Any payments which an individual makes into his account will be used to build up a fund and cannot be withdrawn until retirement, and then only according to fixed rules. The age of retirement would be flexible, as would be the period of contributions, subject to a set minimum.

The personal retirement account will be a personal and portable asset. Individuals will receive regular statements of their balances, like a bank account. It will therefore be difficult for future governments to expropriate, just as private bank accounts today are difficult for governments to expropriate. It will be the property of the individual and his heirs, no matter if he changes jobs or even leaves the country. An individual, giving advance notice, would be able to move his account to another approved institution if he wished.

Minimum contribution rate. Although we might wish to ensure that each personal retirement account should pay a minimum pension, this would be, in practice, rather difficult to guarantee. The exact amount of the pension paid would depend upon the success the investments of the managing institution over the life of the individual's contributions. Freedom of choice suggests that individuals should be given some latitude to opt for riskier investments in the hope of receiving higher eventual benefits. Although this of course admits the possibility that some will eventually receive lower benefits. Like bank accounts, the personal retirement accounts can be expected to pay slightly different rates of return on investments.

Perhaps the best way to ensure that individuals have an adequate pension on maturity of their account at retirement is to require a minimum rate of contributions. This is easy to police: the institutions offering the accounts themselves can check the contributions, and evidence of the amounts can also be required annually on the individual's tax form. Thus, an individual who desires a higher pension can contribute more than the minimum, but nobody can contribute less.

Investment portfolios. Arrangements already exist to protect policyholders in insurance plans, and some extension of this principle to the personal retirement accounts should be relatively simple. It may be that the government should require some part of the fund's investments to be in indexed securities, providing a safety net in case other investments give a poor return. But the sophisticated investment markets and expertise available in Britain should make excessive intervention unnecessary.

Benefit payments. Once an individual reaches retirement, he will have accumulated a large sum in his retirement account, and this will be used to finance retirement benefits. Again, an element of choice can be introduced here which is not available on the existing state system. For example, the individual could simply **use the interest** on the fund to live on, and leave the fund to his children. Alternatively, he could use the fund to **purchase an annuity** to guarantee him a specific income for the rest of his life (the annuity could be adjusted, if necessary, to continue payments to a surviving spouse). Or again, the individual could **vary the amount** he draws from the fund, letting his interest mount up and using it for emergencies or later on in retirement.

Another advantage of the fact that the fund is the personal property of the individual, is that expected benefits cannot be lost by a disqualifying act, as they might be in the state system. An individual who works beyond retirement age, for example, still owns his fund and can draw income from it. Changes in marital status leave the fund unaffected.

Survivors benefit. The survivors insurance function can also be served through personal retirement accounts. If a husband and wife each had individual accounts, of course, there would be no difficulty, since the fund accumulated by the deceased individual would be transferred to the spouse, to be drawn on immediately if required, and the survivor is thus guaranteed an individual pension in any case.

Alternatively, we can recognise that survivors benefits are simply term life insurance, and we could give married couples the option to have only one retirement account between them, but insist on the purchase of a life insurance supplement, probably arranged through the account with any recognized insurance company. On death, an individual's survivors receive not only the amount of the insurance, but any savings in the couple's retirement account. These in turn can be invested to support survivors during their lifetime.

As the amount in an individual's retirement account grows, of course, the amount of insurance required to support survivors will diminish to zero, but once again there would be no objection to an individual taking out a larger policy if he thought it desirable.

Past contributions record. The contributions which an individual has made to the state system, if any, before opening his personal retirement account can be transferred with interest into the account, so that on retirement, the individual's basic pension comes only from one source. Perhaps the most convenient method is for the contracting-out individual to be given a government bond, redeemable at retirement age, reflecting the benefits which his past contributions record would have guaranteed.

Once the bond is issued and the personal retirement account is set up, therefore, the individual leaves the government's books entirely, and no further national insurance bureaucracy is needed to deal with him.

Welfare payments. The welfare role of government is, in this system, confined to meeting the retirement account premiums of those unable to pay the minimum. Individuals unable to meet the payments because of inadequate income (temporary or long-term) receive cash or vouchers up to the amount of the recognized minimum contribution to private accounts. This again has the advantage that it is a simple and clear system, and that it separates the insurance and welfare functions in a rational way. It also gives poorer individuals the same choice enjoyed by others to decide where their account is invested and how benefits should be paid.

Controlling the rate of exit. If individuals were allowed to take the entire retirement element of their national insurance taxes out of the state system and into a private account, it is probable that there would be a large exodus, particularly from younger workers who have most to gain by setting up a fund. This would pose a great strain in terms of lost contributions, since benefit reductions would not appear for many decades. One method is to control the rate of exit by allowing only a **portion** of the tax to be saved, a portion which could be adjusted as necessary, possibly being made much larger for older workers to encourage them to leave the state system.

Thus, an individual opting out of the state system receives a tax rebate in recognition of the fact that he will not be drawing pension benefits in old age. Although these may be modest, taking them up will still be thought of as advantageous by some people who value the extra security of a funded arrangement, the prospects of higher growth, the immunity from disqualification, and the flexibility of benefit payment systems. Some quota system may be required while governments learn the size of the tax rebate which attracts an acceptable number out of the pay-as-you-go arrangement.

This being said, it is an attractive prospect to place all new members of the workforce directly into private pension accounts, and they themselves are likely to find it attractive also. We suggest that this should be the main vehicle for the transfer, with tax concessions being used to increase the flow to an affordable level.

Other reforms. A transition to private arrangements will not be attractive to certain groups of people who presently do very well out of the state basic pension arrangements. A series of interim reforms to make the state system approximate more closely to a genuine insurance system would therefore help to speed up the transition.

Advantages of the reform

Reform, in the shape of allowing people to contract out of the basic pension system and into funded personal retirement accounts, has many advantages. It removes the political pressure to bankrupt the system, because it links individual benefits more closely to individual payments. It prevents the uncertainty that a future generation might suddenly renege on its obligations to current beneficiaries.

Furthermore, the private system allows a wide measure of choice in terms of the contributions pattern, the size of the eventual pension, and the method in which the pension is drawn. It establishes a personal asset which is more immune from government expropriation than the rights accruing under a pay-as-you-go system.

Confusion and absurdity caused by the present mixture of insurance and welfare principles is avoided. The system is fundamentally an insurance system, with eventual benefits reflecting contributions more closely than at present. Yet the welfare element, in terms of support payments to those unable to meet retirement account premiums, is still present, and indeed its operation is clearer.

This welfare element can be used to avoid the poverty trap disincentive of the current system. The poor would be helped in other ways: for example, since poor people tend to enter the workforce earlier, and even to die earlier, they pay longer for less in the present system. In a private funded arrangement, they would receive more. Moreover, single people, who tend to be poorer than married couples, would on average receive larger benefits than they could expect under the present system, and would not be cross-subsidizing the relatively better-off marrieds.

Objections answered

The economic benefits of funding. Some critics doubt that there are significant economic benefits to be gained from moving to a funded system.

However, a principal benefit should be that the investment funds themselves should be able to grow quickly and increase the total of capital investment in the economy. The investment funds backing a system of private retirement accounts would be sizeable indeed, and would allow significant injections of capital into the productive areas of the economy. This in turn would help boost employment and output.

The security of the new system from the ravages of political changes is also an economic benefit to those inside it. The value of present pay-as-you-go benefits to individuals must be discounted because of the possibility of eventual collapse of the system.

A pay-as-you-go system is also constrained by the growth of real incomes. It cannot grow faster if taxes do not rise. But an investment fund can grow at the real rate of interest, which can be much more rapid.

Doubts about performance. Some people doubt that the real rate of interest will always be higher than the growth of incomes or even prices. Critics point to negative real rates of return on investments over the high-inflation years from 1970.

It is certainly true that in recent years, real rates of return on many investments have been negative. Yet this must be something of a sad admission for an investment manager to make, since even a basket of goods would have **kept pace** with inflation.

Poor rates of return have been largely a phenomenon of recent years when inflation has been high, and therefore the overall picture is clouded. Since personal retirement funds will be invested over a period of several decades, it is the long-term pattern of interest rates which is important, and this if far more encouraging.

Furthermore, the causes of high inflation, and the lessons of how it ravages the economy, have now been learnt. Governments will be less willing to inflate in the future; where they see it happening, investment managers can switch to less risky investments; and beneficiaries themselves will form a lobby to keep inflation under control.

However, some forms of automatic protection can be built into the system. Part of the investment portfolio of the retirement funds, for example, can be held in indexed securities as a requirement, although obviously a great deal of latitude to invest in items which might substantially outperform inflation is desirable. Regarding withdrawals from an individuals' fund at retirement age, annuity payments can be indexed, or the individual can take the risk of leaving the funds to grow, hopefully faster than inflation, and take occasional interest payments for subsistence.

State pensions overheads. Another objection is that the overheads of the state pension system, at around four per cent, are low and could only with difficulty be matched by private institutions.

This is something that cannot be decided until it is tested. The private sector may come up with a large number of new proposals for **reducing** the cost of overheads. In addition, the forces of competition would tend to keep overheads low.

It may well be that the present overheads of the state system are very low in any event. But this saving is borne at the cost of having a system which is completely without choice and which is not definitely secure. The advantages of the private alternative would justify the additional cost - if such exists. Again, this can only be judged in practice.

Would policing the system be expensive? The final argument is that the administration involved in making the new system work would be expensive.

If standards are set in terms of the minimum contribution and not in terms of the minimum pension guaranteed by any fund, the administration should be relatively straightforward. It is easy to check that all individuals are paying at least the minimum amount into a fund; the funds themselves can check, and annual tax returns can include the information. The range of investments which can be held by the institutions offering private accounts can likewise be checked without much difficulty.

Each individual leaving the state system and opting for a private alternative disappears entirely from the government's books and thus allows countervailing savings in administration. Furthermore, the private system reduces the prospect that some individuals will end up without an adequate contributions record orwill for other reasons be forced to draw upon supplementary benefit, enabling further administrative savings to be enjoyed.

3. THE EARNINGS-RELATED PENSIONS SYSTEM

PROBLEMS

The earnings-related pensions system admits the same general classes of criticism as does the basic pension system; moral, financial, and distributive.

Moral concerns

The fundamental moral criticism of the system is easily expressed, but nonetheless powerful. It is the question whether general tax revenues should be used to provide people already on higher incomes with higher retirement pensions than others.

Future funding

The recent adoption of the present earnings-related pension system embarked us on a completely new level of pay-as-you-go funding. There are already individuals drawing earnings related benefits, although no state fund has been built up to provide them. The state earnings-related pension system therefore suffers from the familiar charges that it is a hostage to political pressure, that future taxpayers may reject the obligation when the full costs begin to be borne, and that it is fundamentally insecure.

The complexity of the earnings-related scheme may mask its true cost, and it is quite possible that at maturity, its burden on the working population could be twice what it is today. For example, a person's entitlement under the system is based on the best twenty years of his or her contributions. If an individual does not pay the contributory taxes for more than twenty years in a lifetime - for example, because of periods of unemployment or sickness - his or her pension rights are undiminished. But it clearly requires a higher number of contributors to support each pensioner if this is common. Therefore, and especially in periods of high unemployment, the support ratio of contributors to beneficiaries could easily dip too low to maintain the system without tax increases.

A related problem is that the balance between expected total benefits and expected income from contributions remains inexact. It is difficult to estimate in advance how large a person's best twenty years of contributions are likely to be, and to compare them to his anticipated average contributions. It is likewise impossible to make a future estimate of these magnitudes for the whole population. The balance between the system's total contributions (the sum of the averages) and its outpayments (based on the best years) is therefore impossible to determine. Once again there is the risk that slight changes in demography or the economy could impose severe costs on the system.

Income redistribution

The state system begins with the assumption that women should receive pensions in their own right: often these will be small because married women usually have only partial contribution records. But a widow is entitled not only to this but also to a widow's pension on the basis of her husband's contribution record. This seems unusually generous; and once again, the generosity does not extend to widowers. The system once again contains a major transfer from single youngsters to older women.

The self-employed also complain about their treatment under the earnings-related system. They pay national insurance taxes in proportion to income between certain limits, but receive no extra pension for it. Although it can be argued that self-employed contributions, in total, roughly reflect total benefits overall, this is not obvious, and the system may conspire to take taxes from the self-employed population to be spent on employees, which seems hard to justify.

Transferability

The problem of transferability in contracted-out private pension schemes has received much attention. It arises because approximately 90% of occupational schemes are **final salary** schemes: that is, an individual's pension is fixed as a certain percentage of his or her salary on retirement.

This ensures that those retiring do not face a sudden drop in income on retirement, but can cause hardship for those who transfer from one job to another. The reason is that a final salary scheme is essentially a group arrangement, admitting no simple relationship between an individual's contributions and eventual rights. New employees enter the scheme with low pension rights at first, in return for the benefit of a higher ultimate pension on retirement. Those who changed jobs frequently, however, find themselves always in the 'starting-out' position, with a series of rather low pension rights.

The **economic effects** of poor transferability are considerable. Less than a quarter of employees complete more than 30 years' service with the same employer, and over half the population appears to move jobs before 20 years' service is up. As British society becomes increasingly mobile, as old-fashioned giant industries are replaced by smaller firms, and as occasional self-employment becomes more common, this problem of job transfer will become more pronounced. But even today it appears that a comparatively small segment of the population can expect to retire on anything like the full pension achievable under present final-salary systems.

In economic terms, this must be seen as a major disincentive to job mobility, tending to lock individuals into old jobs and thwarting the development of new products and services. The present system of financing occupational pensions is showing itself to be unsuited to a mobile economy that responds to changes in technology and demand.

The **choice** issue should not be underestimated. Many individuals find that their pensions rights would suffer disastrously if they changed jobs, and so decide to continue until retirement, the choice of moving having been effectively closed to them. It is doubtful whether employees - usually senior employees - who have to stay in jobs they might be tired of, will really contribute greatly to the prosperity of any company or to the economy as a whole. The effect of this stifled initiative of a senior level cannot easily be measured, but could be significant.

Although it is possible for groups to contract out of the earnings-related pension in a way not available under the basic pension system, it is clear that free choice is highly curtailed.

EARNINGS-RELATED PENSIONS REFORM

Different problems plague the state and private components of the earnings-related pension system. The major concern in the state sector is whether taxpayers can continue to support the large and growing cost of earnings-related benefits. In the private sector, the main concern has been the poor transferability of most company schemes. Different strategies are needed for each type of problem.

Temporary reforms to state earnings-related pensions

One approach to the problems of the state earnings-related pension scheme (SERPS), not in our opinion the best, is to attempt to preserve its fundamental character as an earnings-related scheme while reducing its cost. In this context there are three principle piecemeal reforms.

(1) The 'best twenty years' rule is an arbitrary one, totally unpredictable in its effects. The total costs to the system in future years are impossible to predict because the size of the best twenty years' contributions in the future cannot be guessed. Calculations based on lifetime average qualifying earnings would be more manageable, easier to predict, and less arbitrary.

(2) The different pensionable ages for men and women are an historical curiosity in these days of sexual equality, and given the fact that women tend to live longer in any case, represents a substantial transfer of resources from men to women. A universal pensionable age of 65 is suggested in the first instance, possibly rising thereafter as it is doing in the United States.

(3) Subject to these rules, it is suggested that a widow (or

widower) should take either the pension deriving from his or her own contributions, or those of the deceased spouse.

Scholars from the Institute for Fiscal Studies calculate that these reforms, though seemingly minor, could reduce the costs of the state earnings-related pension system by half in the long run.

More substantial reforms

Although these partial reforms would reduce some of the costs of SERPS, its burden remains substantial and is still potentially unmanageable to future taxpayers. Equally important, the reforms do not tackle the moral shortcomings of the system, such as its lack of choice, its compulsory element, and its subsidy from taxpayers to people who are already better off. A durable solution to these problems would require either ending or phasing out the system.

Ending the system. In our opinion, the best course is to admit that SERPS was an ill-designed scheme of questionable virtue, and that it should be abandoned as a costly mistake. All future commitments under the system would thus be ended, although commitments already made would be honoured, so that the pension expectations of those who have already contributed into the system would be met in proportion to their contributions thus far. The administration of these obligations could be disposed of immediately with a bond redeemable on retirement.

Since SERPS is recent in origin, and since the pension expectations under it are mostly modest, the effect of this approach on beneficiaries would be minor in most cases. Although politicians will undoubtedly prefer to meet the existing commitments in full, even a partial honouring could be contemplated without undue hardship being caused.

In any event, ending future SERPS commitments is the quickest means of reducing its costs and supporting taxes, and thus of freeing taxpayers' income to devote to private alternatives or to spending as they see fit. It will in addition greatly ease the later stages of the transition of the basic pension to private arrangements.

Alternative provision? In our view, however, it is not clear that those leaving SERPS, or finding themselves without an earnings-related pension if the system is abandoned, should be **required** to have private cover. The government has no obvious right to insist that everyone has earnings-related retirement income whether they want it or not. Some individuals might prefer the extra spending capacity during their working lives and accept a lower retirement pension; others might like to save in their own way, or build up a business, rather than be forced to contribute to a private earnings-related pension scheme. Provided individuals do not become a public charge (which the basic pension should ensure), then there seems to be no case for further compulsion, although encouragement of additional retirement saving through tax concessions might be justified.

Contracting into occupational schemes

The SERPS legislation allows groups of employees to contract out of the system and into approved company pension arrangements. This is encouraged by a reduction in the joint rate of national insurance contributions, by government-financed compensation against the effects of inflation, and by tax concessions. The tax inducement is powerful; although the entire pension (which includes an element of capital repayment) is taxed as income, contributions to approved plans and all returns on their investments are exempted, and up to 150% of salary can be taken at retirement in the form of a tax-free lump sum.

Taxation questions. Whenever tax concessions are admitted, as they are in the provision of private pension schemes, there exists the possibility of their being used for large-scale tax evasion. To prevent this is the main work of the Superannuation Funds Office (SFO) and the multitude of regulations it operates. The considerable cost of this monitoring raises the question of whether the present tax concessions are the most efficient method of encouraging private pension provision.

An obvious possibility lies in shifting the concession from contributions to benefits. Thus, individuals could contribute unrestricted amounts from their taxed income, while all benefits (or benefits up to some simple limit) would be tax free. Monitoring costs would be reduced to near zero and flexibility would be increased. However, the economic and incentive issues involved in such proposals as this are complex, and further research is needed before this sort of simplification could be contemplated.

The nature of private pension schemes

Almost all private occupational pensions offered by employers are **final salary** schemes, where benefits are based on the employee's final salary with the company and not on past contributions. The legislation to encourage contracting-out has discriminated in favour of these schemes, and they have been attractive to employers because of the assumption that employees will tend to remain longer with the company in order to qualify for higher benefits. Managers and long-serving employees, similarly, have been attracted to setting up and belonging to final salary schemes because the benefits are high and are identifiable in advance.

But high and identifiable benefits to those who stay are made possible only at the expense of lower benefits to those who transfer out of the company scheme. Thus, an individual who changes jobs can often find himself or herself with pension rights that are painfully small.

It has taken some years for this drawback of final salary schemes to be recognized. Those who transfer jobs and find themselves with low benefits have little power to complain, even if they realize the problem at all until later in life. But other problems are now becoming equally pressing. For example, by setting pensions in terms of future final salaries, the employer faces the risky question of what his future obligations will be, and the employee faces the risk that the employer will miscalculate the answer; and membership of a company pension plan is now almost invariably a condition of employment, a coercive monopoly which might help to keep up the income of final salary schemes, but which can hardly be welcomed. Accordingly, people find themselves compelled to join pension plans even though they may have no control over their risks or structure.

Other schemes. The arrangement usually seen as the alternative to the final salary (or the related average salary) scheme is the **money purchase** plan. This begins not by deciding the size of the pension to be paid, but the size of the contributions. These are invested and benefits are paid from the resulting fund: if the investments have been good, benefits will be higher, and if they have been poor, benefits will be lower.

These schemes have disadvantages: clearly, the exact size of the pension depends directly on the fund's investment returns, so is unpredictable, particularly in inflationary episodes; they usually mean a sizeable drop in income on retirement; and older-style schemes have been rather inflexible in structure, although this problem is not necessarily inherent. Yet despite these difficulties, money purchase arrangements do ease the transferability problem. They make it easier to attribute the resources of an investment pool between the members, so that people can leave without loss, and they do not require compulsory membership of new recruits to keep their income up. In today's world, where technological changes are making mobility imperative, or where employment turnover is rapid for other reasons, they are consequently attractive, particularly to younger workers.

Government actions and misallocation of resources. Directly and indirectly, governments have unintentionally caused the rise of final salary schemes with their attendant problems in today's highly mobile labour market. For example, government attempts at economic expansion in the early 1970s generated a high and unexpected inflation, pushing real investment returns below zero and causing hardship to those whose pensions depended on investment plans. More directly, the rules governing contracted-out schemes serve to encourage final salary arrangements, and the condoning of scheme membership as a compulsory condition of employment has imported the pay-as-you-go morality from the public sector into the private.

Without these distorting effects, it is probable that completely portable money purchase pensions would be dominant, and the transferability problem would not exist. In our opinion, a durable pensions system requires institutional barriers against inflation and the other distorting practices of governments, and these would in turn probably lead to the running down of final salary schemes and the emergence of contribution-based alternatives. This would, however, be a major restructuring, whatever its long term merits, and it is worth considering other options before deciding if such a change is necessary.

Reforming private pension schemes

There are many alternative suggestions for reform, ranging from the modest adjustment of present schemes to major changes in the basis of pension provision.

One of the main difficulties is the number of people who are forced to join schemes they do not really want. One suggestion is that membership of a company pension scheme should no longer be a condition of employment, whereupon three main possibilities arise.

(1) Firstly, the individual can opt not to join the company scheme, but remain a member of SERPS. Employee and employer contributions would therefore be made into the state system in the normal way.

Employers object that this would mean them paying two different contribution rates, one to their own fund's members and one which night be quite different, to SERPS members. But this seems only a slight inconvenience to the employer, and to employees it is clear that different rates of contribution paid by the employer will earn different ultimate rates of benefit.

(2) A second possibility is that those who do not join a company scheme should be required to open their own self-employed-type scheme, with contributions coming from the employer and the employee.

This is an attractive option, since it promotes the spread of personal and portable pension arrangements on a money purchase funding basis. Employers would presumably pay contributions equal to those paid to their own fund's members, so there would be no questions of equity. But employers would have to face the prospect of making contributions to a large number of different personal pension plans. This need not be so daunting, given that most individuals will invest in plans offered by one of a relatively small number of financial institutions. Furthermore, the employer is spared the administrative burden of paying pensions to a large number of individuals who have left the company years before, if they all have their own transferable pension arrangements.

(3) If the compulsion to have some kind of state or private

earnings-related pension provision were abolished, individuals could refuse to join any scheme at all. They would probably insist on higher rates of pay to compensate for the employer's contributions in support of members of the occupational fund.

All of these options imply a reduction in the income of occupational pension funds, because new entrants to the company are no longer contributing to the fund. This might place a severe strain on some arrangements and could require sizeable funding shifts. But despite these radical implications, an option not to join in the first place does not help the individual who joins and then decides that he would be better out of the fund.

More durable solutions

If we are to consider changes which are likely to cause an alteration in the funding basis of company pension schemes, more radical proposals still may be of greater benefit to the individual.

Replacing final salary schemes. It could be time to admit that final salary arrangements, deliberately and unwittingly encouraged by past governments, by employers, by managers and decision-makers approaching retirement, and by the impact of inflation, are actually of little attraction to most individuals in today's highly mobile society. The pressures are now great to end the past inequity which has been so studiously overlooked by the pensions industry. Money purchase schemes now available have adapted themselves substantially since the harsh lessons of the 1970s. Today, methods of spreading investments are better, and investment managers are better able to anticipate inflation and to avoid its worst effects. Money purchase arrangements have become far more flexible than they used to be.

A sudden change from final salary schemes to some other arrangement would not be easy. A fund with long-term and risky investments is difficult to attribute between its members, although some such breakdown is obviously necessary if shares are to be completely transferable. But there are various radical ways in which the funding basis of present pensions plans could be altered to help the early leaver, and these have been widely discussed.

Dual schemes: a route to reform. In our opinion, a lengthy period of institutional distortions, due directly and indirectly to government policy, has promoted the spread of pension schemes which are no longer suitable for people in today's highly mobile labour market. But to remove those institutional distortions without causing undue strain on the present system would be a long and perhaps impossible task.

However, we suggest that dual schemes may in fact be the key to a return to a more equitable and rational funding basis, and that it would be relatively simple to redress the balance part way, whereupon more adventurous reforms might be more possible. Two possibilities will illustrate the potential.

(1) Our preferred option as an initial step is to separate the lump sum and retirement pension elements, keeping the pension on its existing basis but putting the lump sum payment on contributions-based arrangements.

This would have the additional advantage of removing a large portion of the administrative costs imposed by the Superannuation Funds Office, much of whose work is devoted to ensuring that the tax free capital sum is limited and cannot be used in place of the (taxed) pension. Our suggestion is that occupational pensions should be divided into two separate pots. The tax free lump sum would be financed by investments on contributions up to a limited proportion of earnings. This would be a money purchase arrangement, and if the investments were successful over the years, the size of the lump sum would be greater. However, the lump sum is relatively less important than the overall pension, and so individuals would be prepared to take the risk that poor investment returns would reduce the size of their lump sum.

Meanwhile, the pension itself would remain on existing lines for the present, although a money purchase funding approach would no doubt be attractive to many groups. Since the final pension would be taxed, there seems no point in restricting the proportion of income which can be put towards the pension. If the pension is split in this way, in other words, there is little or no need for monitoring to prevent tax abuses, and there needs to be **no limit** on the amounts people subscribe towards their pension. It is probable that many people would choose to subscribe more than the present limits, which has the subsidiary advantage of increasing the income of funds, making it easier to transfer from final salary to money purchase funding bases.

This option would therefore greatly reduce the administrative burden of pension schemes on the government. It would also be a first step to introducing a completely portable element into occupational pension schemes. Whether the public demanded further transferability would be easy to judge when the scheme had been in operation for a few years.

(2) Another means of combining the benefits of the two different funding approaches would be to encourage individuals to open a personal self-employed-type pension plan in addition to any contributions they make to their current corporate plan. One way of encouraging this would be to open up competition among the financial institutions. Banks, building societies, insurance companies and others could be empowered to accept segregated funds from individuals, specifically devoted to retirement provision and not repayable until retirement.

This development is, of course, made largely unnecessary if personal retirement accounts of unlimited size emerge to replace the basic state pension. In any event, individuals could contribute to this (money purchase) fund and draw it as income at retirement without further restriction.

Objections answered

A number of objections to reform of occupational pensions have been raised, many of them coming from the pensions industry itself. However, it does seem possible to meet most of these main arguments and to design a reform which answers them.

Historical objections. A decade ago, money purchase arrangements were far more common. It is argued that the change towards final salary schemes represents a real need, and that they should therefore be retained if at all possible.

Undoubtedly, both financing methods have their advantages and disadvantages, but the disadvantages of the final salary arrangement are perhaps less obvious. It has taken many years for the problem of transferability to be recognized as a great one; and many individuals have remained members of a final salary scheme for years before the problem of changing jobs became plain to them. The disadvantages of money purchase schemes, however, are more clear: a pension that is not fixed in advance but depends upon investment performance, a pension not linked to salary on retirement, and a pension that could suffer if investment return is low.

But as pension schemes have gone one way, the economy has gone the other. In a static economy where there is little or no job transfer, final salary schemes would work well; but job mobility is increasing, and the problems of such schemes are only now becoming obvious.

Performance of money purchase schemes. Inflation has also helped to kill off money purchase schemes, because inflation tends to make investments unprofitable and therefore reduces pensions based on them. This makes the ultimate pension available under money purchase arrangements indeterminate.

However, this argument carries real weight only when an individual is locked into a particular scheme. Whether inflation is zero or is high, some investment portfolios will yield greater returns than others. If the individual has the opportunity to switch from one plan to another with a better performance, then he can avoid those which are not performing well during an inflationary period. And there will be a pressure on all funds to ensure that their portfolio is well protected against the ravages of inflation.

Large differences. Another objection to any kind of individual retirement account is that over the period of a lifetime, the investments in the fund may yield major differences. Thus, the principle of equal pensions for equal contributions is eroded.

This is true, but is not necessarily a disadvantage. On the contrary, it encourages savers to seek out those schemes which offer the best long-run returns, and it encourages competition among the investment managers themselves. The differences already exist, in life insurance contracts and in the various occupational schemes themselves. But again, these differences allow individuals to make the choice between riskier plans with potentially large gains and safer plans with more modest ones.

Furthermore, experience from the individual retirement accounts which are growing in popularity in the United States shows that different returns are not a problem. Individuals are <u>not</u> highly risk-adverse regarding their pension investments.

<u>**Administration**</u>. The opportunity of an individual to opt out of an employer's scheme and start his own is seen as posing an administrative burden on the employer. This especially would be the case if, for example, the employer was expected to make payments of joint contributions to the individual's new plan, for then an employer could be faced with making thousands of contributions to different schemes.

The employer making contributions directly into the employee's personal scheme would certainly pose some initial computing problem, but after that it would decline. And the employer would be saved the considerable administrative burden of paying pension rights to individuals who worked temporarily for the company many years ago.

But there is no reason to go down this route in any case. If the obligation is on the employee to make his own payments, then the employer faces no burden apart from separating out the contributions of those who remain members of his scheme, and making appropriate tax adjustments.

<u>**Monitoring compliance**</u>. If individuals are to be **required** to have an occupational or personal earnings-related pension scheme, then it raises the question of how compliance is monitored.

This should in practice be comparatively simple. Those in occupational schemes are easily checked. Those in individual schemes can be required to produce evidence, annually, of their membership of an approved plan and the amount they have contributed to it. This information can be supplied to the Inland Revenue directly by the individual, or through his employer as a routine operation, or by the institution operating the personal scheme.

<u>**Economies of scale**</u>. Another objection is that the economies of scale in funding benefits on a group basis would be lessened if individuals were free to opt out and make their own arrangements. This would lead to higher costs and to less advantageous terms for life cover.

There is no reason why this should necessarily be so for the insured money purchaser. Certainly, if opting out is allowed, then occupational groups may become smaller, but this does not necessarily have much effect on performance. Also, the individual who opts out might actually gain from any difference, because he might be leaving a small company plan to start a self-employed-type of personal plan which has many thousands of members.

Public sector employees.

Civil servants and others are covered by an unfunded 'contracted out' earnings-related scheme. This is another difficulty for reform.

Certainly, this is a major problem, and it requires separate treatment. Probably the most effective reform would be to transfer this system to a funded one over the course of many years. Alternatively, these employees could be allowed to start personal plans, although the rate of exit would have to be controlled to avoid the threat of immediate funding crisis. This would at least reduce the problems of those who change jobs in and out of the public sector, and therefore has much to commend it. A useful step would be to offer civil servants immediate cash payment options in lieu of future indexation, so that the problem for the future is reduced.

The problem of public sector employees does not therefore thwart any reform of the rest of the system. But it is a serious problem which requires a reform of its own.