THE END OF THE WELFARE STATE

Dr Pirie’s paper is based on a speech delivered to the Radical Society in January 1994.

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INTRODUCTION

The attention of policy–makers has recently turned increasingly to the welfare state. The process by which items find themselves on the agenda for reform is a varied one. It may happen because of attention devoted to them by the media. A few high profile cases might draw the attention of legislators to changes in popular sentiment. Or it may be that a series of events highlights deep–seated problems. The authors of this report incline to the last of these possibilities.

They focus on the fact that much of Britain's welfare state was designed in another era and for another era. It is by no means relevant to today's society and today's problems. When this nation gradually ceased to be a mass manufacturing economy, its uniform mass services ceased to be appropriate to the needs of its citizens.

They draw attention to a more serious structural problem which mere up–dating will not redress. It is that there is a pathology inherent within the welfare state we have created. It spends increasing amounts of money, diverting from economic growth and expansion the funds needed for investment and job–creation. Yet it manifestly fails to achieve its primary purpose: the provision of security and the elimination of poverty.

Welfare economics does appear to have created or to be in process of creating an under–class similar to that in the United States. That under–class is increasing detached from mainstream society: it exists apart from it and seems largely unable to enter it. The system which was supposed to help people back on their feet is succeeding only in keeping them prone. It corrals the poor into social ghettos from whose hopelessness and helplessness there is little likelihood of escape.

The pathology of the welfare state has extended to the middle classes. There are strong indications that they use it to advantage, stretching and sometimes breaking the law in order to qualify for its benefits. It has encouraged them to forego responsibilities toward elderly or dependent relatives and to expect the state to shoulder the burden in their place.

Attention has turned to welfare because of its huge costs, but the thrust of this work is that urgent attention is overdue for more significant reasons than cost. The authors argue that it is time for the welfare state to be transformed. Its assumptions must be changed, along with its methods. Private provision must be allowed to supplement or to replace universal state benefits.

Part of the radical impact of this report is that the authors argue for a new structure which can gradually be built out of the existing one. They present ways in which this can be achieved despite the financial constraints which contributing individuals and Treasury officials will impose. As such, this report sets forward a clear and intellectually coherent alternative to the welfare state, together with the means which can be used to bring it about. It thus presents a bold challenge to the conventional welfare thinking which has so visibly and lamentably failed to achieve its objectives.
The ideology and apparatus of state welfare, whatever its benevolent intentions, inevitably stifles the responsible, adaptive behaviour which freedom requires of those who would claim its precious benefits. Its bureaucratic structures strangle the natural, spontaneously developing cooperative institutions on which freedom depends — the family, the market, the legal system, and the local community foremost amongst them. Its tangled web of rules and obligations destroys the capacity of free men and women to choose freely for themselves and to pursue their individual interests rationally. Its illegitimate seizure of moral control abandons people to purposeless drifting, subservient dependency, and aimless incapacity to choose and act for themselves responsibly and freely (Segalman and Marsland, 1989).

Socialism has failed, and is being replaced. The Welfare State has failed at least as badly. We must set about replacing it with institutions more appropriate to a free people. We must liberate welfare from the shackles of the state, and provide for ourselves a system of welfare which liberates our capacity for responsible autonomy from the cramping oppression of the Nanny State.

The Government's record on welfare

There are some — on the right as much as on the left of British politics — who view the Government's record on welfare since 1979 as a disappointing failure. From this critical perspective, years which have seen a revolution in other spheres — in improvements in economic management, in privatization, in tax reform, and in controlling the illegitimate powers of trade unions — have brought nothing more than tinkering, administrative fine–tuning, and bureaucratic blundering in the field of welfare.

Even in housing, where personal home–ownership has been massively expanded, state tenancy (the tied cottage system of socialism) remains at a higher level in Britain than in some Eastern European states even before the collapse of communism. Reforms of social security, health, and education have left the state monopoly system largely intact, while exposing the Government to accusations of uncaring mean–mindedness and hard–hearted cost–cutting for its own sake.

I see the sense of such criticisms, but I am not persuaded of their validity. After all, the Welfare State is deeply entrenched in the British psyche. Its ideological power rests not only on the post–war, but also beyond that on nearly a century of cross–party tolerance of state welfare. Beyond that again, its stifling grip on social policy derives from politicised distortions of Christian ethical principles going back well into the nineteenth century.

In this context, welfare reform had to be cautious and gradual. I think much has been achieved. Since 1979 the Government has begun to reform some of the major sectors of the welfare system — education, housing, and health in particular. This, it seems to me, is to the Government’s credit and to the people’s advantage. Ministers deserve
support in their efforts to implement reform in the face of concerted resistance by vested interests, ideological collectivists, and the massed ranks of soi–disant social affairs experts in the media and among academics (Marsland, 1992).

In the 1970s, extraordinary as it now seems, social policy academics were still arguing that private home–ownership should be actually reduced to the meagre levels of private provision in health and education. Now even the Left dare not speak out against home–ownership, and council housing is generally regarded as residual, special provision.

Reform of education has proved much more difficult than was envisaged by radicals in the 1970s. Union power is more powerfully entrenched in the schools than in the steel industry or coal–mining. Educational ideas remain firmly controlled by egalitarians and play–way theorists. The institutions of reform themselves are still largely in the hands of unreconstructed collectivists (Marsland & Seaton, 1993; Marsland, 1992[3]).

Nonetheless, the Education Reform Act has at least shaken the system up. Competition and choice have been injected into it as a vaccination against bureaucratic inertia. Devolved management of schools is in place. The worst excesses of the politicised curriculum of the sixties and seventies have been challenged and limited. A beginning has even been made — mirabili dictu — on assessing the effectiveness of teaching and learning. Parental choice of schools is assured.

In health, a genuine and courageous start has been made on fundamental re–structuring. Of course reform is being fiercely resisted by those who stand to benefit from vested interests in the inertia of status quo bureaucracy and state monopoly. Of course critics are making the most, and more, out of every heart–rending story about supposed cuts, dying children, underpaid nurses, and decrepit hospitals.

But the die is cast. Reform is in place (Marsland, 1993). Independent hospitals are managing themselves. The internal market is bypassing the bureaucratic sclerosis of the biggest organisation in Europe except the Red Army. Doctors are waking up to costs and the advantages of competition. Patients are being initiated into the novel privilege of choice. Even the public are beginning to realise that most of the scare stories are nothing but middleclass trade unionists crying, “wolf” (Marsland, 1992).

Again, in relation to social security and the benefit system, some real, if modest, progress has been made. The essence of the several reforms in this sphere since 1979 has been targeting.

The more radical Right may scoff at the feasibility of thus rationalising an overblown hand–out culture which reproduces and multiplies itself automatically. And it has to be admitted that, despite a decade and a half of Conservative administrations committed to cutting the system down to size, the social security apparatus and its budget have continued to expand inexorably.

But continuing modest reforms have at least put the whole crazy system under question. Even the Labour Party and the professional poverty lobby have become more circumspect with their promises about minimum wages, improved benefit levels, and further extensions of rights to state support. Even socialists, it appears, have recognized at long last that the level of income and the standard of living of the
least well–off are shaped more by the health of the economy than by egalitarian sloganizing. If only our television pundits and our sentimentalizing bishops were vouchsafed the same modest level of understanding of economic realities.

Thus in most of the major spheres of welfare — housing, education, health, and social security, to which one ought to add pensions and local government — the Government has managed to call a halt, or at least a decisive pause, to collectivist ideas which had previously been entirely taken for granted for decades. It has made at least a start on turning the tide away from the straitjacket of state welfare towards freedom, choice and self–reliance.

The need for radical reform

Even if all these initiatives are successful, however, partial reform leaves the underlying concept of the Welfare State and the paternalist values which it enshrines entirely unchallenged. Fundamental critique of the whole concept remains apparently unacceptable in polite circles. It seems to be assumed that the curious combination of high taxes, state control, and rights without responsibilities which the Welfare State essentially comprises represents the pinnacle of human civilization.

There are, nevertheless, more than sufficient reasons for believing that radical reform of the Welfare State is essential (Ashford, 1993; Marsland, 1994).

(1) The whole concept of the welfare State is confused to the point of incoherence. Some view it modestly as a safety–net designed to help the temporarily unfortunate back into normal self–reliance. For others it is a transition stage on the way to a glorious socialist future. Others again apparently believe it comprises in and of itself a New Model Society which synthesises and transcends the best elements of capitalism and socialism. These three models are mutually incompatible. Incoherent oscillation between one and another confuses consumers and producers of welfare alike, and guarantees chaotic inefficiency (Seldon, 1990).

(2) The early stages of state welfare provision in the period up to 1990 made some limited sense, given the persisting poverty and social disruption arising out of industrialization and urbanization. Even the elaboration and bureaucratic institutionalization of the Welfare State in the 1940s could be made to seem at least half–way plausible in the context of post–war reconstruction and the innocently utopian idealism it generated (Marsland, 1992 [2]). Since then, however, the standard of living and the quality of life of the whole population have been improved out of all recognition by straightforward economic progress. There ought to be far less need for welfare than in the past, and yet we consistently spend more and more on its provision (Hill, 1989).

(3) We cannot afford to squander an increasing proportion of our hard–earned GNP on state welfare. If economic progress is to be continued, direct and indirect taxes alike will have to be reduced substantially, particularly for those on lower incomes, to provide incentives for productive effort. Combine this with the anticipated multiplier effects of demographic change on the state’s already extravagant expenditure on health care and pensions, and with the crucial importance of keeping relative wage costs to the minimum in competitive global markets, and the necessity for a real and radical reduction in the scale and cost of the Welfare State is palpable (Pliatzky, 1982).
(4) However generous its resources, the Welfare State does not and cannot produce its intended outcomes. A large proportion of the taxes extracted expensively from the prosperous majority is re-cycled even more expensively to the same people. The more street-wise among the self-sufficient majority cunningly siphon off still more money into their own pockets from resources intended for the disadvantaged minority. Those who really need help often don't get it at all, of get too little, of have it provided in tawdry, demeaning conditions and in ways which turn them into dependent caricatures of their potentially creative, self-reliant selves.

(5) Finally, and worst of all, the Welfare State inflicts damaging levels of moral and psychological harm on its supposed beneficiaries. It has seduced people away from their natural independence of spirit and their traditional commitment to hard work, honesty, and high standards. It has made of its primary clients — perfectly normal, capable men and women before the state got to work on them — an underclass of welfare dependents fit for nothing better than passive consumption of and ever-expanding diet of “bread and circuses”. It is rapidly destroying the family — the main arena of genuine welfare in a free society, and thereby crippling children for life more reliably than “dark satanic mills” ever did. It is turning estates and neighbourhoods right across Britain into factories of crime and arbitrary violence fuelled by an increasing flow of drugs and alcohol (Murray, 1984 and 1990; Dennis, 1993; Segalman & Marsland, 1989)

A strategy for reforming welfare

Reform, then, is essential. In my view, simultaneous change on two fronts is required.

First, the prosperous majority should be encouraged to opt into independent provision of all those services which are called “welfare” but in reality can be insured or saved for.

Second, the small, temporary, and changing minority who genuinely cannot manage self-reliance should be provided with effective assistance in a quite different spirit from the sentimental, rights-oriented approach to which we have become habituated.

The bulk of welfare provision — including pensions, employment protection, sickness and invalidity insurance, education, and health care — could be transferred quite rapidly out of the state sector into the private and voluntary basis. Tax reductions, specific tax incentives, and large-scale buying out of established entitlements could bring it off once and for all within ten or fifteen years. Detailed practical plans for reform along these lines are presented elsewhere in the report.

With the large majority of the population served by their own savings and insurance programmes, an effective programme of special assistance will need to be organized for the minority of people who are temporarily incapable of self-help.

Help should be based on needs, not rights. All assistance should be temporary and conditional. To avoid disincentive effects assistance should be set at the minimum necessary level (Parker, 1982). It should normally take the form of loans rather than grants. Above all, some degree of self-help should be required in return for assistance. For example, workfare should be instituted for the unemployed, and training schemes, where appropriate, for young lone parents (Howell, 1982).
The system should be administered on a local basis by staff familiar with the neighbourhood and its people, and authorised to treat individuals and families with discretion appropriate to their circumstances, attitudes, and behaviour. There should be no more anonymous giros through the post, or straggling queues of “claimants” at Post Office counters.

The fundamental mission would be to shift people out of state dependency and back into the normal self-provisioning system as rapidly as possible (Segalman, 19867). This is essential if we are to reverse and prevent the major destructive effect of the Welfare State as currently organized — its moral and psychological impact on the character of free people.

The swelling underclass

The most damaging effect of the Welfare State is its impact on the character, motivations, and behaviour of the individual men and women subjected to its comprehensive expropriation of their capacity for free and independent action for self-reliance, for enterprising initiative, and for moral autonomy. By nationalizing care and by expropriating personal responsibility, the Welfare State creates and reproduces dependency.

This process affects every level of society and every sphere of social life. Welfare by right and on demand inevitably destroys what free and civilized societies have always defined as the fundamental characteristic of human beings — the capacity to make rational normal choices as a basis for independent action. (Green, 1993).

The Evidence is clear. However benevolent the intentions underlying it, collectivist welfare damages the economy, cripples the dynamism of enterprise culture, fails to help those who most need help, and worst of all positively harms those it is most meant to help — by creating out of temporary unfortunates among our fellow-citizens an underclass of welfare dependents. Still worse, it is characterized by the fractured families which inappropriate welfare encourages and multiplies, generating a permanent and expanding underclass (Murray, 1984 and 1990).

If we are to halt and reverse this tide of decay, radical reform of welfare is essential. Unless we cut the Welfare State back to size by contracting out the prosperous majority and by handling welfare issues separately, its damaging effects will worsen still further as its expansionary growth continues at an accelerating rate.

Education, health care, and employment provide examples of the danger apparent right across the expansive board of state welfare that — unless radical reform is entered on urgently — the Welfare State will continue its inexorable growth. If this is not prevented by intelligent, courageous policy development, the destructive damage to individuals, the family, and the national psyche caused by state welfare will worsen rapidly.

The contexts of reform

Ordinary people understand that welfare expenditure is excessive. They do not want higher taxes. They are aware of fraud in the benefit system, and angry about it. They know only too well that the quality of education, health care, and other state services
has not improved in parallel with standards in other aspects of their lives which they provide for or from the private sector. They are beginning to understand that self-reliance is a more dependable source of real welfare than the blundering bureaucracy of the state.

A much more serious obstacle to reform comes in the shape of our intellectuals. Most of our social scientific academics, most social policy researchers, and a large proportion of social affairs correspondents in the media remain collectivist, egalitarian, anti-capitalist, and enamoured of state welfare.

The debate about welfare reform which is just now getting under way concerns on one of the most important general policy decisions of the century. Its outcome will affect for good or ill the whole future of us all. In this crucial debate, the intellectuals are — sensu stricto — prejudiced. Their commitment to state welfare is pre-ordained and irreversible, entirely regardless of evidence about its effectiveness of its impacts.

The intellectuals are also influential. Sadly this proposition is not one which is readily believed by ministers, by politicians, by businessmen, or by most ordinary men and women. Nonetheless, it is true. Public understanding of welfare in Britain is largely defined and controlled by the defunct theories of academics and other intellectuals. From the universities, these mistaken ideas are passed on to the media, and on again from the media to the politicians, and hence to the public.

This vicious process, which magnifies error, multiplies misunderstanding, and perpetuates folly, cannot be reversed simply by ignoring it in the hope that nonsense — about welfare, as about the market — will vanish of its own accord. Its powerful and damaging influence will continue until utopian dreams are replaced by realistic analysis, and wish-fulfilment by honest facts.

Conclusion: culture, freedom, and responsibility

Over and above its other deficiencies, the Welfare State is a major source of social divisiveness, something which the proponents of state welfare attribute mistakenly to the market. Since its inception, the Welfare State has gravely weakened the family, the local community, voluntary organization and the market. Right across the board of all those intermediate institutions which comprise the intimate bonds of civil society, which stand protectively between the atomised individual and the all-powerful bureaucratic state, which define and sustain our belief in ourselves as belonging together, the impact of the Welfare State is entirely negative (Green, 1993). Far from providing a source of social solidarity, the Welfare State corrupts and destroys all those long-established institutions which comprise the whole basis of our genuine unity (Shils, 1982).

With them it destroys also — is still destroying day by day as you read this sentence — the only reliable sources of genuine welfare there are: the family, the neighbourhood, friendship, feelings of duty, and ethical obligations (Green, 1984; Harris and Seldon, 1987). The Welfare State has been constructed on the basis of spurious “rights”. The natural and proper basis of genuine welfare, by contrast, is provided by responsibilities. We must free ourselves of the shackles of the old mentality, and retrieve our responsibilities as free men and women for self-reliance and for helping those who seek and need our assistance (Hayek, 1988).
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Climate of questioning

Forty years after Beveridge, there is a growing belief in the UK that the system as a whole is in need of deep reform. Though living standards, housing, and the quality of public education and health might be far better today than Beveridge could dream of, they remain well below what we know is possible. Our welfare system is clearly failing to eliminate those giant evils of need, sickness, squalor, ignorance, and idleness.

That is disappointing, considering that the UK welfare budget is now roughly £80 billion per year, one-third of all public expenditure, one-quarter of GDP. Welfare spending has grown sevenfold in real terms since the Second World War. It is now over three times what it was in 1979 — and is projected to grow much faster than the economy as a whole, reaching £96 billion by the end of the decade (even if unemployment falls and public spending policies remain tight). Politicians and academics of both left and right are now openly describing the present system as “financially unsustainable”.

Changing cultures

Can a system that was initiated before the start of the First World War and largely redesigned at the end of the Second really be effective in tackling today’s problems? Social patterns have changed enormously since the 1940s.

Knowing more today about the power of incentives, we can well ask whether we are actually breeding more problems for ourselves. Are we not subsidizing, and so encouraging, the very things we seek to eliminate? By providing money to everyone in disagreeable circumstances, are we simply making such conditions more bearable and so reducing the incentive for self-support? Are we tempting people at the margin to adjust their affairs in order to qualify for this support? And is the existence of that option not ethically corrosive?

Nor do we take for granted today the Beveridge generation’s faith in central organization: that state control of industry would end duplication in production, and eliminate the costs of advertising and profit, or that central control of health and education would produce an equality of outcome.

Today we recognize that the profit motive is a spur to better performance; that competition dilutes market power; that having a variety of suppliers and products enables people to choose those particular goods and services which best suit their individual needs; that producers’ desire to win and keep customers drives them to innovate and improve.

The shoddy state of the nationalized industries made inevitable their reform along market principles, and eventual privatization. State health and education clearly
suffered the same problems, though their outright privatization was still unthinkable in the mid–1980s. For them was designed the internal–market concept, by which they were kept in state ownership, while quasi–market forces were unleashed within them.

With those important services well on the way to competition, some policy analysts now wonder whether other human services, such as the assessment and delivery of welfare benefits, pensions, and even police services, should be entrusted to single suppliers or whether some measure of variety and competition is possible.

These questions would have seemed shocking just a few years ago; but now they are being asked more and more openly. Nor is it just a short–term panic among ministers trying to grapple with recession and budget deficits; even non–government (or anti–government) bodies such as the Joseph Rowntree Foundation and the Labour Party’s Commission on Social Justice have also been thinking about these questions too, with the long term in view.

**Fundamental Questions**

There may well be agreement that we should re–think this part of the government apparatus, look afresh at what the welfare state exists to do, assess whether its present programmes are actually achieving those objectives, and if not, devise some better mechanisms. But there is much less agreement about what sort of reform would be appropriate.

Some argue that no enormous structural change is needed, that a little more public spending would cure most of the problems, and that this is affordable. Others believe that the incentive structures of our welfare system are almost wholly perverse and that throwing more money at it will merely amplify the perversity of its results.

In fact, the problems of the welfare state are both philosophical and practical. It may be that no solution will be fully satisfactory: certainly, none will work unless it runs with the grain of human nature, and uses the power of incentives and of market structures, instead of ignoring or trying to suppress them, as many present–day welfare programmes seek to do.

**Philosophical issues**

Several broad strategies can be employed in a state welfare system. Unfortunately none of them is perfect and (as we now know) their side–effects can be very perverse and difficult to deal with. First, we can provide essential goods and services to everyone, as with health and education. Thus everyone is assured of at least some access to these services; indeed, if there is little or no choice of provider, a rough equality of treatment can be imposed.

Unfortunately, such monopoly provision kills off the benefits of choice and competition. And most of the output of these state services, by definition, is consumed by the middle–class millions rather than the needy few. If a minority of the population were too poor to afford proper food, we would not think of setting up state kitchens to provide a free but nourishing standard menu for us all; so why provide free healthcare, or free education?
Universal benefits

Next, we can provide for people's essential needs by paying ourselves universal cash benefits so that everyone can afford at least a range of basic goods and services. We might confine these benefits to people who qualify in some way (just as today, all mothers qualify for child benefit, and most unemployed people qualify for unemployment/job–seekers benefit); or if we are being really radical we might propose paying a general (or “basic income”) benefit to everyone, rich and poor.

Cash benefits at least allow people to purchase the package of goods and services which they think best suits their own needs. But universal benefits also suffer many problems. Again, most of the money is going to people who do not need it. We must impose high levels of taxation if we are to pay for benefits so widely distributed. But the higher the benefits, and the higher the tax to pay for them, the lower is the incentive on people to drag themselves off benefit and into employment: the phenomenon of the poverty trap.

Indeed, this is a real problem right now. When we look at the taxes people pay and the benefits they receive (the “tax/benefit ratio”), it is clear that the “why work?” question has become bigger and bigger since the 1960s — even during the Thatcher years, when people commonly assume that benefits were eroded.

Paying the poor

Third, a welfare system can provide benefits (in cash or in kind) only to those who need help, and let the middle classes pay for their own essentials clothes, food, housing, education, healthcare, and so on. Thus we have the idea of the “negative income tax”, a general benefit which is paid to all those on the lowest incomes, but which tapers off to zero as people’s income rises.

There are still problems. While this tight focus reduces the cost to taxpayers, the loss of benefit when people do try to improve their circumstances is a major disincentive, amounting to a high marginal tax rate on the very poorest.

Selection of beneficiaries

The next strategy is selectivity, whereby benefits are given on a case–by–case scrutiny. The aim is to concentrate resources again on the most needy, while denying state support to those who are capable of supporting themselves (wholly or partially) but choose not to because they know they can advantage of the system. Thus support is focused while costs are kept down, so incentives remain reasonably positive. But while we might praise charitable bodies for discriminating between beneficiaries on the basis of their apparent motives, it is much harder for state agencies to be so selective particularly when legislation grants people welfare benefits as of right, whatever motives they might have.

Categorization of beneficiaries

A fifth strategy is categorization, in which benefits are restricted to particular groups of people. For example, Beveridge could be fairly sure that when he was helping old
people, he was for the most part helping poor people, because most older people were also poor. But with the diverse lifestyles that are common today, such categorization is less and less useful as a means of targeting social benefits.

**Practical problems of reform**

Every welfare mechanism, in other words, will involve us in an uncomfortable trade–off between objectives, particularly between cost, focus, and incentives. So how does the present system work in practice?

Today we imprison people in squalor, thanks to the poverty trap. People who accept work can find themselves losing a whole raft of social benefits, both cash benefits and in–kind services, making them much worse off as a result. Marginal tax rates of over 100% hardly count as positive incentives.

The Department of Social Security administers a truly bewildering array of benefits. The list includes income support, housing benefit, council tax benefit, child benefit, one–parent benefit, family credit, unemployment benefit, two sorts of retirement pension, (and the Christmas bonus), widows' benefit, war pensions, statutory sick pay, sickness benefit, invalidity benefit, severe disablement allowance, maternity benefits, invalid care allowance, disability living and working allowances, the attendance allowance, the social fund, the industrial injuries scheme, and more.

Some benefits depend on past National Insurance Contributions; others do not. Some benefits are means–tested; others are not Some are taxed; others are not. Some are cash; others are in–kind; some are given as a gift; others as loans.

**Bad value for money**

Complexity makes administrative costs high. And universality makes some of those costs pointless. Is there not a certain absurdity about a system which takes money out of the pockets of middle–class families, sends it up to the Benefits Agency, pockets an administrative fee averaging 30p per week, and then pays the residue back as child benefit to the same families?

Future projections of the cost of the largest state benefit, the retirement pension (which is now costing around £26,000 million) are alarming, with more and more pensioners being supported by a dwindling proportion of working taxpayers. Income support costs another £13,000 million. And most of the other benefit costs are increasing at an alarming rate.

**Dependence on politicians**

Politicians, not markets, drive the welfare state. And political decision–making reflects voting power, not need. Hence the curious persistence of universal benefits, free health and education, and state–run pensions; though they are disguised as programmes to help the poor, their greatest beneficiaries are the middle classes. Since middle–class voters far outnumber the rest, why should any politician want to change things?
Any reform will produce some winners and some losers. But the losers will be vociferous opponents of such reform; while the winners are unlikely to march through the streets in delight. Politicians, naturally enough, opt for the quiet life. However much they recognize the justice of reform, they frequently regard it as impossible to achieve politically.

We no longer live like the Beveridge generation. Then, women rarely worked, men rarely changed jobs, people normally married and normally worked full–time. Today, men and women work, change jobs frequently, take voluntary breaks between jobs, often work part–time instead of full–time, work part–time in two or more jobs at once, live together without being married, divorce and re–marr, and have large pensions or savings of their own. With such diversity of lifestyles it is often very hard to know who is actually in need of support and who is just taking advantage of it. Is our support really getting to those who need it, or is much of it being wasted?

A centralized system is an impersonal system. The money we disburse through the welfare state is seen as “government” money, so that people regard cheating the system as less wicked than cheating a person, and turn a blind eye to cheating.

It is also a fair question whether our net effect is to subsidize the things that we are trying to alleviate or reduce. If teenage pregnancies, single parenthood, divorce, unemployment and profligacy are so bad, do we simply increase them by cushioning their effect? And do we meanwhile strangle the opposite values by taxing people who save, people who maintain stable relationships, and people who do everything they can to keep themselves in work?

State service provision

A large and costly portion of the welfare state is devoted, not to giving people the money they need to acquire essential goods and services, but to providing them. Health and education are obvious examples. But too often, like all monopolists, the state has ended up providing sub–standard services at high cost.

Were a private business to take our cash and give us a shoddy service, we would rightly demand our money back. And if we did not get it we could even sue. But state services have for a long time taken our money — by force, through taxation — and not even told us what services we are entitled to in return. Only now are we starting to demand that specification, and to impose some penalty if the standard is not met, through the Citizen’s Charter initiative.

So at last there are two sides to our contract with government. But even Charter enthusiasts regard it as only a second–best option. By far the best way to improve value for money in public services is to expose them to competition. A market–based welfare system, like a market economy, would aim to capture the benefits of customer choice and competitive supply. It would give people the money (or vouchers) they need to become effective consumers in the marketplace, and allow them to make their own decisions about what particular mixture of services they think most appropriate for their own tastes and circumstances.
Making self-provision possible

Welfare systems are supposed to redistribute resources from those who are healthy, young, and in work, to those who are sick, elderly, or unemployed. But about three-quarters of state welfare spending is not really welfare redistribution at all. It takes from individuals at some points in their lives, and gives back to the same individuals at other times. In other words, the state is one-quarter welfare agency, three-quarters savings bank. Its clients have no choice about how much they will deposit or what rate of return they will receive on their money. Indeed, it is not even invested on their behalf. This is not a bank which would survive long in the High Street.

A better system would return that money to the control of the customers themselves. It would empower people to save when they are young, healthy, and in work; so that they can provide for themselves when they are old, infirm, or out of work.

This could be done by replacing much of the existing state benefit structure with a system of personal pension and income-replacement funds. People would be expected to contribute into these funds when they could; and they would be entitled to draw benefits from them when necessary.

Private-sector bodies, including insurers and friendly societies, could provide such funds; and they would work along proper insurance and savings principles. The role of the state would be as a welfare agent, topping up the funds of those whose own funds were inadequate to their needs; or paying the premiums of those who for one reason or another could not contribute themselves; or even managing the application of the benefits on behalf of those who were unable to manage.

There need be no state bureaucracy apart from this. People would choose their own fund providers, and competition would tend to bid up the quality and efficiency of that provision. People would not have to accept off-the-peg welfare any longer: they could select from a variety of plans which as long as they provided an acceptable minimum of cover — could provide flexible benefits tailored to suit the lifestyle and preferences of those concerned.

Separating insurance and welfare

Most of our task in reforming the welfare state will centre around this massive state insurance and savings programme, which benefits the middle classes more than others, but which disguises itself as state welfare. The fact that most people are perfectly capable of seeing themselves through bad times as well as good, drawing on savings and insurance of their own, suggests that many more could do exactly the same — if we swept away the burden and the disincentives of the present system.

What, however, of those people whose needs are correctly categorized as welfare needs, including people who will never be able to provide for themselves? In simple terms, welfare provides benefits based on needs, regardless of contributions; while insurance provides benefits based on contributions, regardless of need. But our welfare state tries to combine the two.

A number of benefits (such as income support or support for the mentally or physically handicapped) are installed principally for welfare motives and operate on
welfare principles. Others (such as unemployment and disability benefit) cover inherently insurable risks, and are linked (though not always perfectly) to past contributions. A few (such as the retirement pension) were originally designed along welfare principles (since old people were almost always poor people), though today are predominantly and insurance programme; though in this case as with most benefits (including the health service) welfare and insurance concepts are combined in the same programme.

The two principles, however, are always in fundamental conflict, and the result, as far as the UK welfare state is concerned, is bad welfare and bad insurance. Politicians do not worry much about this confusion. Insurance programmes which benefit their own middle–class voters can be driven through under the guise of welfare. So any reform is difficult politically. But if we were trying to design a market–based welfare state afresh, we would surely try to separate out the welfare and insurance principles: running insurance programmes competitively, along insurance lines; with welfare payments going directly from the state to those in need.

**Benefit according to need**

Universal benefits, which aim to protect the welfare needs of the few by delivering benefits to everyone, do not easily commend themselves to market economists. By definition, most of the money goes to those who do not really need it. Still, they are easy and cheap to administer, because no checking up is required. They are nevertheless very costly if they are to put any reasonable sum into the hands of the neediest recipients. Because they must be costly if they are to do the job, they require much higher taxes to finance them. That in turn puts up marginal tax rates, deepening the poverty trap even further.

Concentrating the state’s welfare help on those who really need it is clearly preferable, provided once again that we can get over the incentive problem: that people may not risk improving their own circumstances because they would lose the security of receiving regular state benefits if they took a job, or sought a better job.

There is a general acceptance of the idea that people with their own savings or other assets or good incomes, should take care of themselves. Indeed, we should be encouraging precisely that self–provision. Our welfare help should be concentrated on those who cannot provide for themselves independently.

The existing system does follow this principle, of course, though it applies it in a very confused way, and with a complexity which generates much hostility. There are in face several dozen different tests within the present system; each benefit, almost, being subject to different qualification criteria.

A better concept would be to have a single test which would distinguish a person’s eligibility for a whole range of benefits, or for some comprehensive benefit along negative income tax lines. This sort of general income support might be less reflective of particular needs than the present battery of specific programmes from housing benefit on down. But equally it would allow people to manage their own budget as they chose.

Within the present system, all means tests produce disincentives — a disincentive against saving, and an incentive to draw down one’s assets in order to quality for
benefit. Much of this is because benefits are seen as simply “other people's money”. In a personalized system where individuals were drawing on their own income–replacement funds, the direction of the incentives may be quite otherwise.

The waste inherent in universal benefits might be reduced by other methods, such as using the tax system to “claw back” the benefits given to wealthier people. Thus every mother might receive child benefit, but wealthier parents would find some (or even all) of it being taxed away. There is still an administrative loss each time the money is taken in taxation, disbursed, then taxed again; but at least some waste is avoided.

There is a need for care, however. Ingenious families will arrange their affairs so that the spouse receiving the benefits is also the lower earner, enabling them to keep the benefit even though they may be quite well off as a family. It should still be possible to keep the money going only to those who genuinely need help by linking tax and benefit rules so that those taxed as families receive family–based benefits.

**Competing providers**

Even if we are not contemplating any deep structural reforms, considerable saving and innovation may be possible through *contracting out* the administration of a number of state benefits.

Many parts of the civil service are already obliged to check whether other suppliers could do some of their tasks more cost–effectively. There is no issue of principle at stake in extending it to benefit assessments and administration. Indeed, a number of local authorities have already taken the initiative, and are now employing outside service companies and advisers to handle assessments, claims, and payment of various benefits.

There may be advantage in widening the net of potential suppliers to non–commercial sources of supply, such as local charities and friendly societies. Being more locally based, they would be less distant when help was actually needed, and better placed than a government agency to assess who was genuinely in need of help, and how best to help those same people.

The idea is not even new or radical. Friendly societies were given the role of “approved societies” in the 1911 National Insurance Act. Beveridge proposed that they should be “responsible agents” in the administration of sickness benefits, but this recommendation was dropped; and thus began their post–war decline.

**Service users as managers**

Another way of getting positive incentives into the welfare system is to devolve as much of its management down as far as possible towards those who use the service.

Transferring the responsibility for social housing away from local authorities and into the management of social landlords (such as the housing associations) is one example. We could go further and put most of all of the management power into the hands of the tenants themselves.
Devolved management of this sort means that decisions can be made quickly and cost-effectively because they are made more locally. For example, that essential repairs are dealt with speedily, without requisitions having to make their way laboriously up and down some distant management structure. Since service users themselves usually have a better idea of local needs and resources than any distant manager, such self-management can help provide a less costly and more responsive service.

Personal responsibility is also encouraged. Tenant managers in the UK and elsewhere, for example, have been able to turn around the local culture, and to reduce drugs and vandalism far more surely and effectively than their official landlords ever could. And by allowing people to manage their own local services, we give them an important foundation of experience which can help them move out of the social service net.

The same principle is appearing in health and education, thanks to internal markets and the Citizen’s Charter. More local management in hospitals has been taken right down to ward level.

**Human services**

When the welfare state delivers its product in the form of actual services, reform is difficult because of the number of people who are dependent on them and therefore very worried about the possibility of change. The National Health Service, for example, remains Europe’s largest employer, and roughly 90% of the UK population are wholly dependent on its provision.

Nevertheless, healthcare is already privately insurable, and a thoroughgoing market–based welfare system would probably treat it just like any other insurable benefit. That is, people would be required to have a minimum standard of insurance for their health, just as today they must have a minimum standard of insurance for their cars. If people wanted to pay extra and have a more comprehensive service, they could. But if people could not afford the premiums of the minimum standard of cover, the state would pay on their behalf.

In other words, the insurance element could operate on sound insurance principles, and the actual service provision could be made by competing suppliers, with all the benefits that competition brings to service users. Meanwhile the welfare element would be clearly separated, its cost identifiable, with proper welfare principles guiding its provision.

**Care for the elderly and disabled**

National and local government face a rapidly growing demand for day care and nursing–home care, mainly from the increasing numbers of elderly persons. Again, some companies are now offering long–term care insurance. Given the existence of free state care and our high rates of taxation, few people regard the cost of the product as worth the benefit. If we used the tax system to encourage people to provide for their own long–term care in retirement — perhaps simply integrating it into the current pensions tax reliefs — the rising cost to the taxpayer could be trimmed and competition could bring people more secure and better–quality provision.
Political decision–making

As a practical project, reforming the welfare state such as to capture the power of market principles is no easy matter. A radical overhaul might well rationalize the system and lead to a clearly fairer and more efficient outcome; but the piecemeal and reactive nature of political decisions makes it unlikely that any comprehensive reform can be achieved in one step.

Norman Fowler MP, when Secretary of State for Health and Social Security, discovered this with his own radical review of welfare spending in the early 1980s. Through the introduction of income support and family credit he made positive moves towards a workable and high–incentive negative income tax scheme. He did much less well at subsuming other benefits within this overall approach: the complaints of the potential losers were too loud for him to endure. The system thus remains something of a patchwork quilt.

It is much more likely that any change will come from the reform (and possibly quite radical reform) of individual programmes rather than the imposition of any “big idea”. It could well be a systematic programme, with a vision at the end of it; but the most successful strategy is likely to be one which works through the welfare state programme by programme and builds up a comprehensive reform out of more modest changes.

Objective–led reforms

In other words, there are many ways in which one can introduce market principles and positive economic incentives into the welfare state. We can keep the tax–funded system of state benefits, but re–cast some of the existing structures so that the economic incentives are made to work in a more positive way.

The problem can be tackled benefit by benefit, or in terms of a package of related benefits, or in terms of the system as a whole. The change can be made optional and voluntary, or introduce an element of compulsion. One can make changes right away, or introduce them over a long period of time.

Alternatively, one could aim to produce more fundamental changes, which handle most national insurance benefits as genuine insurance risks, and which give individuals charge of their own contributions and benefits through the establishment of personal income–replacement funds.

Probably, as in past attempts to reform the welfare state, politics rather than common-sense will decide what can and can not be done. But if we are to reform the system, we should be starting with an understanding of the enormous power of personal economic incentives — for good and ill — and a vision of how to use them positively in the defeat of poverty. Armed with that, one can then move systematically through the whole range of social benefits, one by one, working out in each case the best option that is consistent with sound working principles.

Forty years after Beveridge, it must be clear that politicians are not actually very good at providing welfare. They certainly perform badly as an insurance company, and their performance as pension fund managers is nothing short of scandalous.
Has the time not come to take the welfare state out of politics? To liberate those who are trapped into dependence on the government whether they need and want it or not, to empower people to make their own provision for the contingencies they face through their lifetimes?

If we devolve the decisions to the people, and confine the state to its proper role as a welfare agent — then we will be able to overpower those giant evils of want, disease, ignorance, squalor, and idleness, and create a social insurance system of which Beveridge himself would have been proud.
3. REFORMING THE WELFARE STATE
by Dr Madsen Pine, President of the Adam Smith Institute

Increasing cost

The bad news about the welfare state is that there is a problem. The survey commissioned by the Rowntree Trust blithely reported that Britain could happily continue to fund its welfare programmes well into the new millennium, despite the adverse demographic changes which are taking place. Alas, their definition of affording something is not one which everyone agrees with. Their report spoke of only a 5% increase in the proportion of GNP needed in taxation. This translates as doubling VAT from 17.5% to 35%, or of putting 20p onto income tax.

This is not affordable at all. The tax increases imposed by Kenneth Clarke's budget are already threatening to limit the economic recovery. It seems we now have to remind a Conservative Chancellor that every penny he takes and spends is a penny less for us to invest in British industry, and a penny less to spend on its goods and services. There can be little serious doubt that the swingeing increases postulated in the Rowntree study would cripple our economy and wipe out its ability to create wealth and jobs in the future.

The latest Social Trends report highlights the growing problem. Spending on Income Support has risen by 20% in a year to £14.5 billion. Of the poorest households, 70% of their money comes from Social Security benefits, and 1 in 3 is unemployed. The total budget for Social Security is over £80 billion, and represents one-third of all public spending. Basic pensions account for about a third of the total at £26 billion, with Unemployment at £8 billion, Housing Benefit at £7 billion, Child Benefit at £6 billion, and Invalidity Benefit at £6 billion. These are big numbers, and they conceal some surprises.

Poor targeting

Two thirds of all Child Benefit goes to the richest two-thirds in the country. It is, in Social Security jargon, a poorly targeted benefit. At a time when general health has been improving, the numbers claiming Invalidity Benefit have doubled in the last 10 years and trebled in the last 15. The total cost of Social Security is three times what it was in 1979.

There is more bad news. Despite all the increased spending, there seems to be as much poverty as ever. Whatever we are doing with Social Security, we are not solving the problem of social deprivation. In other words we are getting poor value for a great deal of money. There is a complex array of benefits governed by arcane rules. There is no adequate policing of the system, and many applicants seemed to be directed towards the benefits which are easier to claim, rather than the ones most appropriate to their circumstance. We are, in Milton Friedman's words, “throwing dollars at a barn door in the hope that some of them go through the knot holes.”
Fraudulent

The system is awash with fraud. Many people start with the assumption that a certain proportion of social security money is being wasted on undeserving cases. Further research can bring them rapidly to the view that millions of persons on every housing estate in the land are avidly swindling the state in a variety of ingenious ways. Fraud is far higher than the Department’s official claim. From their own experience most people know a friend or relative who is swindling the state. Fraud seems endemic to the whole system.

There is still more bad news, in that the system itself is fraudulent. It talks glibly of insurance and a social security fund, but there is none. It is run as a straight transfer system. Money from today’s contributors goes straight into the pockets of today’s claimants. This is one reason why a crisis is looming. As long as there are enough fit workers to fund it, the obligations can be met. As the population ages the number of burdens will rise faster than the number of shoulders. The morality of Social Security is that of the chain letter. You only benefit if people in the future are even bigger mugs than you were.

The central problem

There is one central problem which lies at the heart of the system. No one has solved it, yet all advanced countries face it. It is this:

“Anything you do to relieve distress will instigate more of the behaviour which caused the distress.”

By relieving distress we make it more tolerable, and we make it less necessary to avoid the condition. If we see that unemployment causes poverty and misery and we give money to the unemployed, we will find that unemployment is less to be avoided than it was, and there will be more of it. If we give money to unmarried mothers to relieve the poverty in which their children are brought up, we make unmarried motherhood more acceptable than it was, and we will get more of it. This problem lies at the heart of every welfare policy, and no–one has yet proposed a satisfactory solution.

Some people respond by calling for welfare to be withdrawn, but this is not acceptable in a modem society. We want to relieve the distress caused by unemployment, disability, lone parenthood, and we cannot simply turn aside from it. Yet we should be aware of the likely effect of our intervention. In making these circumstances less distressing, we make them more acceptable, and we make people less strenuous in their efforts to avoid them.

The old societies were fine if you were fortunate. Families looked after their members; the young supported the old; people relied much more on themselves and their relatives than on the state. This was good if you kept in work and family. It was the social casualties who suffered. If you were thrown out of work, became sick, were abandoned by your spouse, the result was destitution. It was to combat that destitution that welfare programmes were gradually extended. Out of laudable motives we have created a monster which threatens to destroy us.
This is enough bad news. Pessimism does not come naturally to the Adam Smith Institute. We solve problems, not wallow in them. We can propose the outline principles which will govern a reformed welfare state, and show them to be principles which can command wide support in the nation, can carry bipartisan, cross-party support, and can even arouse the interest of Treasury officials.

For the foreseeable future, and perhaps always, there will be a need to transfer wealth from those who are young, fit and in work, to those who are elderly, sick or unemployed. Welfare reform has to be based on the simple principle that the best person to support someone who is elderly, sick or unemployed is that same person when young, fit and in work. In other words, where we today transfer across society from some groups to others, an efficient welfare system would transfer within a group across time. People would pay in provision when they were able to do so, and draw upon those provisions when circumstances made it necessary. They would be supporting themselves.

**The basis of a funded system**

This clearly implies a funded system. In place of today’s instant transfers from contributors to claimants would be managed funds held by individuals or families. These would be Personal Lifetime Accounts, or PLAs for short. They will constitute a person's investment in their own future, but they will do much more. They will form a huge capital pool which will be handled by fund managers and ultimately be available as investment capital for British industry. The present system has no such funds, no such pool, and no such contribution to the economic growth of the nation.

Many of the drawbacks of today's system will be eliminated. The tendency to fraud, for example, will be much diminished if it is no longer the state they are defrauding, or even other contributors. People will be defrauding themselves, since it is their own fund they will be drawing benefits from. The complexity will be much diminished if people draw from a single source the benefits they will need in the event of well-defined circumstances.

Part of the contributions which today go from employees and employers into the hands of the state will go instead into PLAs chosen by people from a variety seeking their custom. The fund managers will invest most of these sums in capital growth accounts to cover the “savings” benefits such as pensions. A part they will assign to insurance companies to cover the “insurance” benefits for circumstances which strike hard but infrequently. The one company will handle both types of benefit.

**Paying twice?**

There is a central question to be addressed, and it is a serious one. It seems that one generation has, in effect; to pay twice. They have to fund today’s beneficiaries, while at the same time paying into funds which will meet their own future needs. It is a real problem, and it is the one to which the Treasury officials will pay closest attention. It can be solved, however, even though the solutions are rarely neat and clean ones. The basis of its solution is that private funds, the PLAs, will offer a much better deal because of capital growth. They will far exceed the benefits which any future government could afford to pay out.
Just as the private sector proved it was far superior at running the privatized industries and utilities, so is it also far better at running insurance schemes and managing funds. The private sector polices them better, without attracting Labour charges of attacking the poor. It is more efficient in its methods, uses less staff, takes less time, and treats its clients as what they are: namely customers. Private sector firms running these funds will give their public a much better package of benefits than the government can manage to offer. This means it will take less to support equivalent benefits.

People moving over to these PLA funds will not need to be refunded the contributions they are making to state welfare, only from some of them. It only takes a part of the total contribution stream which is made on behalf of each employee over a working life to fund the benefits they will receive. The rest is, in a sense, surplus. It is not needed to finance the benefit which the individual who pays it will receive. In the case of young workers just joining the labour force this “surplus” will be very substantial indeed. It can be used to fund the existing claimants who have built up no funds because they were not given the opportunity to do so.

Phased transition

The other instrument which makes the switch possible is phased introduction. We can, if we choose, allow some age groups to make the transition first, then gradually extend the range of the population covered. In this way we can move at a rate acceptable to Treasury finances. Their worst nightmare is an opt–out system in which all of the young and fit promptly opt out, leaving the Treasury to pick up the bill for the elderly and sick, with insufficient contributions coming in to support them. To avoid that nightmare we only excuse them from some of the payment when they opt–out, and we could let them do it gradually, systematically extending the age range of those who go that way.

Of course there is still a state role. What about those not fortunate enough to pay enough in to these funds? The answer is that the state does it for them, redistributing income from the fortunate to the unfortunate, only in a far more efficient and less costly way than it does at present. It will pay into these PLA funds for people who cannot do it themselves. The state might legitimately insist that those who follow this route guarantee that they have cover at least as good as the state provides for the various benefit. Again, the Treasury will be determined to stop people opting out of some of the payment; only to fall back upon state welfare later. The state might also insist that companies managing these funds indemnify each other as most travel agents do, to ensure that if any of them go bust, their benefits will be picked up by the others.

We envisage that the Personal Lifetime Accounts will cover the present mish–mash of assorted state benefits. People will draw upon them in the event of unemployment, sickness, retirement and admission into care homes. They might even cover funeral expenses. The private firms would cover some of these needs by insurance, some by savings fund. Each person’s account would include an insurance element to cover needs greater than most people would have saved for, but which only affect a small part of the population.

The Rowntree study said that most people use state welfare as “a form of savings,” paying contributions at some time of their lives and drawing benefits at others. If this
is true, how very much more efficient if those savings are contained in funds invested for capital growth, and if they are managed and policed by the private sector instead of by a cumbersome government bureaucracy in a programme gone out of control.

The salient point to keep in mind is that most people support themselves quite adequately for most of their lives. Indeed, most manage to improve their living standards systematically. In such a reform as is described here, they would be easily able to pay contributions while working to fund for future contingencies. They already do it in a sense via the agency of government, but with the added costs of rampant waste superimposed.

As the traveller was told upon asking directions in Mississippi, “You can’t get there from here.” There is little point in setting out how an efficient and humane welfare system would work if there is no conceivable means by which the present system could be converted to it. It is not enough to say what ought to be. The policy engineer has to say how it ought to be. He has to get the grease of the real world on his hands.

A policy for change

The answer to the question “How do you get there from here?” is systematically. It has to be done programme–by–programme, one at a time. There will never be a consolidated Bill to overhaul our system of social welfare and replace it by a new system. This is apocalyptic thinking. It does not happen in this world. In the world of small majorities, of political cowardice and of public choice theory leading everyone to guard their own pet benefits, progress comes piecemeal.

The first phase will involve the consolidation of some state benefits so that they could alternate more readily with private sector equivalents. These are the insurable benefits in which opting out will gradually be extended by the offer of tax concessions to those who do. This will cover such areas as jobseeker’s assurance and incapacity benefit. Once these have been restructured, the government can begin to allow some groups to opt for private alternative schemes. This after all, formed the basis of the successful privatization of the State Earnings Related Benefit Scheme. By offering tax concessions and leaving private firms to develop attractive alternatives, a situation was created which led 70% to make the decision to go private.

Private insurance firms have been asked whether they could cover a jobseeker’s assurance which gave 80% of salary for the first 6 months, and then cut away sharply to income support. They reply affirmatively. Given that most people will never be unemployed and will be making payments throughout their working lives, the insurance element is not difficult to provide.

Basic pension reform

The second phase will involve private alternatives to the Basic Pension Scheme. It can be left in place for those who prefer to depend on it, in order to honour the government’s manifesto pledge, but given the likely buying power of the basic pension today’s new workers can expect when they retire, many will choose more attractive private alternatives. Similar measures will allow people to choose privately—funded long–term retirement care.
One by one the state programmes can have private ones set alongside them as alternates. The transition from unfunded, pay–as–you–go state system to a fully funded private system can be made gradually. People will choose the private alternatives in increasing numbers when this becomes possible because the private schemes will be so much more attractive. As more and more programmes are added, the Personal Lifetime Accounts steadily assume greater importance to the future of their holders.

The piecemeal changeover from one system to the other can be achieved systematically in such a way that there is no sudden point at which the welfare state is replaced by personal private provision. It will happen gradually by the free choice of citizens. Services which are now provided by government will be provided instead by private firms which spring up to meet the new demand. People who are paying money to the government at present will pay money to private firms instead, and they will get a better deal in consequence. Instead of people depending upon the state for their own future needs, most will choose to depend upon themselves.

The privatized welfare state will end the psychology of dependence. Most people will provide for themselves and their families, and will be proud and pleased to do so. They will, through the state, help those who cannot manage such provision for themselves. Our successors will live with a system that is more efficient, more humane, and which lacks the pathology of the present welfare state. Their reaction will be one of puzzled bemusement that society tolerated for so long the outrages perpetrated daily in the name of universal benefits.
Kenneth Clarke's first budget of November 1993 had few obvious underlying policy principles, and his attack on the public–sector deficit has not convinced many commentators that he is in general an enemy of public spending. He is on record as saying that 40% is an acceptable slice of GNP for the state to take and spend. Even if this is a lower percentage than in most European countries, it is still much higher than in Europe's main competitor countries, the USA, Japan and the emerging markets.

After the Budget, however, Michael Portillo said: “Sustained lower taxation can be achieved only through improved competitiveness, which requires a fall in public spending as a proportion of national income. We must reduce the proportion of national income that is spent by the government.”

It is no coincidence that successful economies have low levels of public spending. State spending is itself seldom economically well allocated, and is often spent wastefully even when the objects of spending are legitimate. And there is a double whammy: high state spending means high levels of taxation, reducing the incentive to work for citizens. If the state is taking even 40% of GNP, taxation on the margin for wealth–creating entrepreneurs and managers is at least 55% (50% direct taxation and at least 10% on the balance consumed). Incentive is severely reduced at these levels of taxation; no one can one pretend otherwise. While the middle classes are being held back at one end of the income scale, at the other end universal welfare benefits are sapping the will to work of all those in or near the poverty trap.

The Delors solution

Across Europe, there is a new acceptance that something must be done to improve competitiveness, but little understanding that the state can help most by standing back. Mr Delors is as usual trying to help by spending more; he will probably be stopped but the fashionable nostrum of work–sharing seems likely to be the EC's only coherent response to the crisis of low growth, lack of competitiveness and high unemployment.

Work–sharing is virtuous up to a point: evidently, if Worker A earning 30,000 euros is prepared to let worker B earn 10,000 of it rather than draw dole of the same amount, then the state is better off. But it is not likely that productivity will improve as a result — if anything the opposite is true. Even if workers are individually willing to share work (why should they be?), labour rigidity will usually prevent this kind of change or will attach such a high cost to it that the fiscal benefits are lost. On the margin, however, if employers are able to use part–time workers, they can often do so efficiently. If newly flexible labour markets are matched by a tougher dole regime, then progress can be made. To some extent this has been the pattern in the UK, and the new unemployment benefit rules will be very helpful.

Work–sharing and dole restrictions will have some impact on public spending, but on their own are insufficient Unemployment benefit is partly cyclical in any event. If
there is to be a significant reduction in the state's share of GDP, there is eventually no alternative but to reduce state involvement in the main headings of health, pensions, and education.

Market–based systems

Conceptually, perhaps philosophically, there is by now little doubt that the best way of providing such benefits is through a market–based system operating as independently as possible from central government, with a safety net for those who fall out of the system. All three benefits (health care, education and pensions) are in unlimited demand and have somehow to be rationed. Currently this is done by the state for the overwhelming majority of provision, with only a minority of people being rich enough to purchase in better levels of service: about 10% in education, less than 15% for health care, and perhaps no more than 25% making voluntary contributions to secure extra pension benefits.

The now–abandoned full voucher scheme would have introduced zero–base purchasing for education and would have encouraged the development of a range of competitive schools across a whole spectrum of different types and qualities of provision. Opting–out may eventually have some of the same effect, and it seems that the Government may yet return to the voucher system for at least some parts of the educational system. But there seems to be no thought of moving provision right out of the public sector.

In pensions, opting–out does remove cost from the public sector; but there is no plan to go further. The Chancellor has recently gone out of his way to reassert his belief in universal benefit. He did not, however, give any justification for compelling mature and economically–active citizens to pay tax towards their retirement benefit when they would prefer not to. The current scandal about over–selling of personal pensions is unfortunate, but should be seen just as a growing pain, reflecting absence of knowledge on the part of the consumer after 50 years of enforced inactivity as well as lack of transparency in commission structures.

In health care, the state has done nothing to reduce its involvement, while attempting to introduce a form of managed market. On the contrary, private health care scheme are at a fiscal disadvantage compared with, for instance, private pension schemes. Except for the elderly, contributions to private health care schemes come out of taxed income.

The availability of a safety net of benefits for the incapable and unlucky is, of course, one of the redeeming features of our sometimes nasty civilization. But the completely unnecessary extension of this principle on ideological grounds to attempt to compel equality of provision across the population simply serves to remove choice and dull incentive. It flies in the face of human nature and economic development, and is wasteful even in delivering benefit to the very people for whom it exists in the first place.

It is time to begin to plan the wholesale removal of pensions, perhaps followed by health and education, from the public sector. It is not that difficult to imagine how a privatized system would work: education would still be compulsory, with the state maintaining standards through inspection and a core curriculum. In health and pensions there could be compulsory private insurance to give a minimum level of
benefit from regulated providers. The role of the state would be to maintain standards, and safety–net provision could be achieved through means–tested state payment of insurance premiums, or in the case of education, payment of fees for a standard level of provision.

It is not the purpose of this study to take on ideological objections to private provision, such as the danger that an underclass will become ever more mired in inadequate schools and clinics while the majority of the population does better than at present. There is such a danger but the problem has to be taken head on; there is no way of avoiding the existence of a range of quality. Yes, richer people will get better services than poorer ones. It is the case now, and it will always be the case except under Communism, where it was Party members who cornered the best supply for themselves.

Our task is to find the system which will deliver the most benefit at the least cost, and it is up to society to decide how much wealth to transfer from rich to poor. The reason for privatization is precisely that it will deliver the maximum amount of benefit in the most efficient way — and means–testing will ensure that the transfers are effective. The state must decide how much to spend on transfers. Once the idea of private provision is accepted, it is indeed easy to see how it can work. What is more difficult is to see how to get there from here, and the remainder of this study will take the case of pensions, which in some ways is the most intractable.

The misconception

The big problem with pensions is the perception that a fund is required, and that the state, while pretending to run a fund, is fraudulently operating a “pay–as–you–go” system which will increasingly penalize younger workers as the population ages. This idea merits close examination, beginning with the reason for “funds” in pension provision.

General insurance companies (i.e. non–life companies) do not have a fund in the same way as a life insurance company. Most non–life insurance is for a short period, and any given policy–holder may change to another insurer at any moment. Most claims occur during the currency of the policy, or shortly after. The companies do have reserves, of premiums received and not paid back out in claims, but there is normally no need or attempt to build up a fund to cover a long–term future outflow of claim payments. Insurance companies deal with potentially large risks by using reinsurance.

A pensions insurance policy, on the other hand, is normally for a long period. The insurer knows that the insured will contribute for many years, but it is highly probable that a pension will have to be paid, and the liability may last until 60 years or more in the future. The insurance company cannot guarantee that it will attract future customers to pay in while the insured’s pension is being paid out, and therefore the company quite reasonably establishes a fund, to guarantee the pension. Although the contributions are paid in to the fund, and are not normally held separately, the total of the fund is enough to cover the company’s total liability to future payments.

Interestingly, at the moment when a person retires, the insurance company itself notionally converts the “lump sum” that has been earned under the retirement policy (usually an endowment) into an “annuity”, i.e. a promise to pay so much per year as a pension. Usually the annuity is for life, but sometimes it is for a fixed term, and then
as a financial instrument it is indistinguishable from the stream of interest payments on a bond. In aggregate, a large enough number of “life” annuities is effectively also for a fixed term, since at any one time life expectancy averages out to a constant term of years.

Use of derivatives

It would be possible for an insurance company (and also pension funds) to use the financial markets to “securitize” their assets and liabilities, i.e. the streams of income represented by contributions, and the streams of expenditure represented by pension payments. They do not do this, because of the “fund” concept, instead, they invest the fund into equities and properties which give them streams of return through dividends and rentals (to pay the pensions), while maintaining capital value.

It is possible that life insurance companies and pension funds could nowadays get better financial results for their shareholders and policyholders by making more use of financial and equity derivatives in addition to the equity and property sectors. The similarity of pensions cash flows to capital markets instruments is of relevance to government, in considering the privatization of the state pension scheme.

The government’s case is different from that of the pensions industry, because it does know that it will have future contributors to pay in while pensions are being paid out to today’s contributors. A difficulty arises only because of demographic changes; there will be an inadequate number of contributors to pay outgoings some time early next century unless changes are made. Some commentators raise their hands in mock horror at the government’s failure to establish a real “fund” to save up today’s contributions for future pensions, but given the arbitrary basis on which the state pension is fixed, and the government’s degree of control over contributions, the government does not need to run a “fund” large enough to cover future outgoings. There is in fact a “National Insurance Fund”, but it is designed only to cover fluctuations in cash-flow within a fiscal year.

For most of the 1980s, the state pension scheme was just about in balance, on an annual basis. That is to say, contributions matched outgoings, on the government’s own split of national insurance contributions between the various objects of the scheme such as pensions, unemployment, disability etc. Owing mostly to the recession, the Treasury has had to make a “topping-up” contribution to the scheme this year (as it had to in the early ’80s), but current projections suggest that the scheme will be back in balance on a cash basis within 3 or 4 years.

A private life insurance company with a stable level of business whose premium income was equal to its pension and other outgoings would be fantastically profitable, because it would have large amounts of investment income from its fund. Most life assurance companies are in fact growing strongly, so that premiums are often higher than outgoings, and their accounts will then demonstrate very good cash-flow, with investment income pushing up fund values while still permitting good profits. This shows of course that the “pay–as–you–go” system is a very expensive way of providing for one’s retirement and that the consumer (citizen) would be far better off with a private scheme.
Up-rating

Not only is the “pay-as-you-go” system inefficient in itself as a way of providing pensions, because it ignores the advantages of capital growth through investment, but there is a further aspect of the existing state scheme which makes it a particularly poor bargain for its members, especially the younger ones. Owing to the aforementioned demographic problems, the Government has resorted to a device which reduces benefits in real terms, while contributions continue to increase.

For some years now, the Government has annually uprated benefits according to growth in prices (it quite reasonably calls this inflation-linking or indexing) while contributions automatically continue to be calculated as a percentage of earnings. But growth in earnings annually outstrips growth in prices: sometimes this discrepancy has been quite large, sometimes small, but it is almost always there. On the Government’s own figures, the long-term difference is expected to be one and a half per cent per year, and this is the figure used by the Government Actuary as a basis for all his pension scheme projections.

Earnings growth can of course legitimately exceed the rate of price inflation, because of increased productivity stemming from investment or innovation — there is no other legitimate long-term reason — but the consequence of the Government’s policy will be penal for future generations if present policy is continued. One and a half per cent per year may not sound much, but by the year 2040 (retirement year for today’s 19-year-olds) the existing policy will have reduced the rate of state pension for a man on average earnings to 22% of earnings (currently the figure is about 32%), while he would still be paying the present 19.4% on almost all of his earnings.

Given that the state “pay-as-you-go” scheme is such a bad bargain, how could it be privatized? Putting aside doctrinal questions, the practical difficulty in the way of privatizing the state pension scheme is said to be the lack of a fund. What private company would take on the current liability without any assets to match it? Government has of course spent the past contributions that should have built up to pay for future retirees’ pensions. The answer is simple: securitize the future contribution flows, sell them to the bond markets, and then offer the resulting package — capital fund plus pensions liabilities — to the pensions industry.

Alternatively, the government could package up contributors with pensioners, and sell the packages to the industry. Allowance would have to be made in pricing for the insurers’ administration costs and profit, but life assurance companies and pension funds might want to buy even perfectly-balanced portfolios, because of the on-selling possibilities of having “captive” customers and the economies of scale.

Asset versus liability

The state pension scheme is thought of almost universally as representing a liability. In fact, the opposite is the case: it represents a considerable asset. To illustrate the intrinsic value of the existing scheme, here are some examples of individual cases, all relating to single men on average earnings and who have not “opted out” of SERPS, in order to keep the numbers simple — the arguments apply also to single women and to married couples, and to those who have opted out, but the numbers are different.
Certain financial assumptions are necessary:

— that benefits continue to be uprated in line with prices (the Government’s policy since 1980)

— that earnings increase at one and a half per cent above prices (the Government Actuary’s assumption)

— that the real rate of return obtainable on financial assets is 3% — that pensions absorb 73% of National Insurance contributions (the Government Actuary’s figure)

— tax is ignored — all figures are calculated at constant prices

For a male at 65, who has paid all his contributions, and is about to receive his pension, the cost will be about £60,000: this is represents a capital liability of the scheme, on the “pay–as–you–go” system.

For a male of 40, the contributions he will pay in the 25 years remaining, accumulated at 3% pa, will total over £100,000 at age 65. To provide his pension, a fund of about £70,000 will be required. This represents 70% of his total fund, so that 30% is not required. To put it another way, 30% of his contributions could have been used for another purpose. The value of those contributions today (i.e. discounted to the present at 3%) is about £15,000. This represents an asset of the “pay–as–you–go” scheme, on the assumptions made.

For a male of 18, a similar calculation results in a fund at retirement of nearly £300,000, of which only 25% is needed for the pension, leaving a surplus at present value (today) of about £57,000. How many 18–year–olds would accept the proposition that they should pay contributions towards their pensions that are 75% wasted?

The value

There are currently about 13.5 million male contributors in the state scheme. By performing similar calculations to the examples given across the age spectrum, and applying the current values to the present age distribution of the male population, it is easy to work out what the present surplus asset value of the future contribution streams of the state pension scheme would be if its membership consisted of 13.5 million single males, and the answer is approximately £230 bn.

Of course the actual numbers are quite different from these, and it would be a very complex matter to calculate the actual current surplus “asset value” of the scheme. For instance, women will not carry so much of a surplus as men (they live longer and contribute less). Married couples, also, are probably not as “valuable” as single men (quite contrary to basic values; this arithmetic is by no means politically correct). The existence of many “opted–out” individuals is also a complicating factor; and there are others.

As well as the asset represented by scheme members who are still contributing, it is also necessary to value the liability represented by existing retirees. This is in itself a complex business, but a rough estimate based on the Government Actuary’s figures, and assuming that pensions continue to be uprated in line with prices, suggests that the current male pensioners would be very unlikely to represent a liability of more than £150 bn.
If the state scheme contained as contributors only single men, therefore, its net current asset value would be about £90 bn. That is to say, if the private sector were offered the scheme, with the given assumptions intact, then this is the price it could afford to pay to take on the future benefit promises together with the proffered contribution flows. To put it another way, £90 bn is the measure of the present value of the future economic inefficiency of the existing scheme. In practice it is not likely that existing financial institutions would buy part or all of the scheme as it stands; as noted above, it would probably be necessary to split the “necessary” contribution flows away from the “unnecessary” contribution flows, in one way or another, and to sell the latter in order to finance existing benefit flows.

Of course, the state scheme does not contain only single men, and it is not easy to work out whether the true net asset value is higher or lower than £90 bn. Married women who have not contributed still receive pension, and this increases the liability; on the other hand, married and single women who have contributed will tend to add to the asset value, although at a lesser rate than the men because of their greater life expectancy.

According to the Government Actuary’s figures, a very high proportion of women in the 25–50 year–old range are economically active and contributing, so that on balance the asset value based upon single males could well be higher than the estimate of £230 bn. But it must be emphasized that the figures given here are not intended to do more than suggest that the state pension scheme could be an asset if it were in private hands. They are certainly not intended to give any firm guidance as to the size of that asset.

In addition to the existing scheme, with its retirees and contributing members, there are also the future “cohorts” of people entering the scheme. Nominally, entry is at age 16, although in the figures above only those of 18 and over have been included. Not all 16–18 year–old’s are economically active. However, each year, numbers of people first enter the state scheme as contributors as they enter employment. Each one of these individuals represents a stream of future contributions, and a pensions promise, similar to those of the sample 18–year–old given above. If 500,000 individuals enter the scheme in a given year, and they are all assumed to be 18 years old, then this would represent a surplus “asset value” of about (25–30 bn. That is to say, the private sector in one way or another would pay (25–30 bn in respect of each year’s intake for the right to receive such contributions and pay out such benefits.

If it were once accepted that Government should privatize the state pension scheme, then this analysis shows that it could be done effectively, and almost certainty profitably. Financially speaking, there are innumerable ways in which the process could take place, and a very wide range of institutions and organizations that might wish to participate. For instance:

— existing company pension schemes could be invited to buy out the state contributions and pensions of their employees;

— individuals could be invited to “buy–out” their state pensions obligation for a capital sum, on condition that they provided themselves with equivalent benefits through the market;
— the “surplus” contribution streams could be separated from the “necessary” contribution streams and offered as pure financial assets, as if they were securitized mortgages; then the resulting capital sums could be offered with sections of the existing benefit liability, having suddenly become funded.

— insurance companies could be invited to bid for certain types of contributor or pensioner, or for random packages of them; it will be particularly attractive to the insurance industry to have, so to speak, captive customers, who will be inclined to place other types of business with their existing pensions insurer; and this will be reflected in the price the companies are prepared to pay.

These are just some examples. It is easy to imagine many more, but it is not the purpose of this paper to explore the ways and means of privatization, only to show its feasibility.

Although the figures given above are based on present policy, the Government is not committed forever to its current stance on uprating. Increasingly this will come to be seen by younger members of the scheme, and by new entrants, as iniquitous. It is probably a good thing that the state pension will tend to shrink in relation to earnings over the years to come, but not so good that the contributions will shrink less, if at all.

Privatization provides an opportunity to improve the situation. The approximate figures given above show there is plenty of scope for improving benefit promises out of existing contribution levels. For instance, the Government could postulate declining contribution rates for the younger people entering the scheme, while still having a very saleable asset each year. As with ways and means, there are innumerable possibilities, which need to be studied in detail.

In summary, privatization of the state pensions scheme according to the principles outlined above could probably make the Government a once–for–all profit of many tens of billions of pounds, and give it a substantial continuing income on the same scale, while transmuting what is effectively an income tax into private pension contributions. The public finances will benefit in every imaginable way, and a notable step forward will have been taken in the process of dismantling an intrusive state which limits opportunity.
Diagram One

The horizontal dotted line shows the level of National Insurance Contributions. The solid curved line which starts at 25% shows the proportion actually needed to secure pensions as good as those promised by the state.
Diagram Two

Present National Insurance Contributions are divided into two parts. That which is necessary to secure benefits at levels promised by the state is transferred out to Lifetime Personal Accounts (LPAs). Fund managers invest part of this capital growth to provide for such things as pensions. The other part they put into insurance schemes. Meanwhile the surplus part of the contribution stream is securitized into new financial instruments and sold. The cash from these asset sales is used to fund the outstanding liabilities to unfunded beneficiaries.