Welfare Reform

Means-tested versus Universal Benefits

John Grieve Smith

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by John Grieve Smith

John Grieve Smith is a Fellow of Robinson College, Cambridge

Despite the wide ranging series of changes in social security that the Government have introduced, the area of so-called 'Welfare Reform' is one in which New Labour policies are to a large extent still dominated by the Thatcherite consensus. After two decades of attacking Tory Governments' increasing reliance on means-testing, New Labour is itself moving further and further down the same road, as the latest proposals in the Pre-Budget Report make plain. The proposed increases in the basic state pension and Minimum Income Guarantee will give welcome help to pensioners in the short run; but in the longer run, Gordon Brown's insistence on continuing to link pensions and other benefits to prices, rather than earnings, will make them an increasingly inadequate substitute for lost earnings when people retire, or are unemployed or sick. We are now at a cross-roads where a basic political decision has to be made: whether to restore and update the initial post-war policy of relying primarily on contributory or universal benefits, or to continue the shift towards means-testing, with the inevitable implication that other benefits will eventually be phased out altogether.

1. The Growth of Means-Testing

New Labour's Welfare Reform proposals have been dominated by the desire to keep down expenditure on benefits and avoid any increase in Income Tax. It has been a Treasury driven exercise throughout. Amid the welter of glossy documents, there has been no attempt to set out a consistent overall picture of the social security system when the 'reforms' are completed, together with their cost and how they would be financed. Their *New Contract for Welfare* notably failed to do this. This is in stark contrast, for example, to the Beveridge Report which set out its comprehensive proposals in some detail, including the proposed benefit and contribution rates together with estimates of the total cost and the cost to the Exchequer. One reason for not doing so today is that any longer term projections with benefits indexed to prices would show a continual rise in the numbers of people dependent on means-tested benefits and their increasing share of the total cost. The Government's tactics appear to be to argue at any one time in favour of targeting any extra money on the poor, but to avoid any discussion of the long-term future of universal benefits.

The shift in emphasis towards means-testing in recent decades has had the effect of doubling the proportion of benefit income which is means-tested from 16 per cent in 1979 to 32 per cent today.[1] How has this come about? The attraction of increased reliance on means-testing is that it enables any given minimum level of benefit for the poor, for example the Minimum Income Guarantee for pensioners, to be established at a lower cost than if all pensioners got the same benefit. The superficially attractive argument is that 'targeting' expenditure on the least well-off does more to combat poverty than spreading the same amount of money evenly across all pensioners, whatever their income. Why raise state pensions, say Ministers, and give everybody more money, including those already well off? They never seem to mention the fact that the better-off will be paying 40 per cent Income Tax on what they receive. This approach may seem reasonable on the surface but if continued for any length of time, it leads inevitably to the question: why not means-test all benefits? What is the point of maintaining universal benefits? We need to go back to basic principles and examine why the post-war social security system set up a benefit system which was intended to minimise the need for means-testing, and whether the arguments which then prevailed are still valid.

What's wrong with means-testing?

The first major disadvantage of means-tested benefits is the indignity, and feeling of second class citizenship, which comes with being subject to severe interrogation and scrutiny by those in authority before receiving any benefits. Such conditional benefits are then bestowed as a 'hand-out', with the implication that the recipient should have been able to do better for himself – that he or she is in effect a member of the 'undeserving poor' or 'underclass'. Moreover the network of means-tested benefits is becoming increasingly complicated, so that the ordinary citizen cannot possibly be aware of what amount of benefits, if any, he or she is entitled to. Were it not for the help given by Citizens' Advice Bureaux and other voluntary agencies, potential beneficiaries would be totally at the mercy of officialdom. It is not surprising that so many pensioners fail to apply for the benefits to which they are entitled. Up to 700,000 pensioners entitled to Income Support are not claiming these benefits.[2] At least in their case it should be a more or less once-and-for-all procedure. For those who become unemployed or sick, the circumstances are often more complicated and the scrutiny more frequent and severe. Means-tested benefits are also much more costly to administer than universal benefits. Administrative costs amount to 5 per cent of the value of benefits in the case of Income Support, whereas the corresponding figure for Retirement Pensions is only 1 per cent.[3]

The other major drawbacks of means-testing stem from its effects on those whose economic circumstances put them, or could put them, marginally above the level at which they would be eligible for such benefits – much of Tony Blair's 'Middle England'. Those who save small amounts of capital or accumulate a small occupational or private pension will receive correspondingly less from the state when they retire and may be little, or no better off, than those who have saved nothing. To qualify for the new Minimum Income Guarantee pensioners must from April 2001 have savings of less than £12,000, and to qualify for the full support, savings of less than £6,000. This creates understandable resentment, and reduces the incentive to make provision for one's old age. To mitigate this, Gordon Brown has put forward proposals for a new Pension Credit to ease the problem of those with relatively small amounts of capital or low second pensions; but however complex the provisions, this difficulty will not go away as long as the basic pension remains below the level of means-tested benefit.

Under the Pension Credit Scheme to come into effect in 2003, the

Minimum Income Guarantee would only take into account *income* from savings and not *capital*. The MIG means test would be adjusted so that pensioners with small incomes from saving would get 60p more than at present for every £1 of their savings incomes, up to a maximum of £12 for a savings income of £20 a week,[4]. Thus someone with £20 a week savings income would get £15 a week from the MIG (on top of the basic pension of £77) instead of £3 under the present rules. This would, however, only leave a person with a savings income of £20 a week £12 better off than someone who had no such income. Then for every extra £1 savings income over £20 a week the amount received from the MIG would decline by 40p in the pound until pensioners received nothing extra when their savings income reached the comparatively low maximum of £60 a week. Thus while the Pension Credit would make the Minimum Income Guarantee a little more generous for those with a restricted band of savings incomes, it would leave what is in effect a tax rate of 40 per cent on low occupational pensions and income from savings; and mean that half of pensioner households would face a means test.

Correspondingly for those at work, the rate at which the various means-tested benefits are reduced as they earn more means that they are subject to the equivalent of an income tax or 'withdrawal rate' which would be regarded as intolerable for those on higher incomes. It is ironic that in order to avoid raising rates of Income Tax above 40 per cent on the 2 million or so who pay the higher rate, nearly 1 million people at the bottom of the ladder pay effective rates of 'tax' of 60 per cent or more if their earnings increase. Recent changes have reduced the number of low earning families subject to withdrawal rates of 90 per cent or more from 130,000 to 30,000 by stretching out the income range over which benefits are withdrawn, but at a cost of increasing the total number of people subject to withdrawal rates of 60 per cent or more from 760,000 to 950,000.[5]

Means-tested benefits not only involve strong disincentives for saving, but also an element of second-class citizenship in which people get financial help by the grace and favour of the rest of the community. As means-testing becomes the predominant source of benefits, the more affluent members of society no longer have a stake in the system, and political support for it is eroded. The argument against relying on means-testing were strongly put in the Report of the Commission on Social Justice set up by John Smith, which concluded that the aim should be 'to reduce dependence on means-tested benefits to the absolute minimum.'

In an effort to make means-testing more acceptable Gordon Brown has been moving towards integrating the tax and benefits systems: e.g. by the Inland Revenue managing the Working Families Tax Credit scheme. This has the laudable objective of reducing any stigma involved, and giving those on benefits greater stability by moving where possible from a weekly to an annual basis of assessment. But the prospect of the Inland Revenue becoming increasingly involved in operating welfare systems raises major issues which have not yet been properly discussed. It would certainly signal the end of state social insurance and the beginning of an era in which state benefits were virtually all subject to an income assessment.

Welfare to Work

Increased reliance on means-testing is allied to an increasingly authoritarian streak in Government policy which seeks to dictate to those on benefit: for example, effectively suggesting that all lone mothers should be at work and leave their children, however young, to be looked after by someone else. New Labour's authoritarian attitude to welfare is most evident in its approach to unemployment. Its policies tend to be based on the assumption that unemployment is due to people being unable or unwilling to take the job available – rather than to a shortage of jobs or inadequate demand for labour. This is in sharp conflict with the facts: post-war experience shows quite clearly that unemployment is primarily determined by the strength of demand for labour. The pattern of regional unemployment makes the same point. People in the areas of high unemployment are not more reluctant to work than people elsewhere: they are victims of a job shortage. A recent study suggests that it would take another 1.75 million jobs for the proportion of those of working age to be in employment in the North of the country as in the South.[6]

During the first 25 years or so after World War II, when demand was high and unemployment low, 'cash hand-outs' did not lead to 'dependency', despite a benefit regime which New Labour now rejects. The subsequent rise in the number of people on unemployment, sickness and disability benefits was a direct consequence of the oil crisis in the 1970s leading to the Thatcher regime's policy of fighting inflation and breaking the power of the unions by deflationary measures and a steep rise in unemployment. Even though the demand for labour partially recovered in the 1980s and 1990s, it has not yet regained earlier post-war levels. The fall in unemployment in New Labour's first three years of office was a consequence of an uncovenanted upswing in demand, rather than any of the New Deals or the Working Family Tax Credit. Experience shows that when more jobs are available, people take them. The irony is that the movement in demand – the key element in Labour's economic success – was something that they had deliberately placed outside the government's control, by giving the Bank of England a free hand in determining monetary policy, and explicitly stating that the Treasury would not use budgetary policy to regulate demand. This has not inhibited ministers from claiming credit for the reduction in unemployment – as, of course, do American Presidents who are in a similar position!

Measures to improve training and education for those out of work are important, but they are of little use unless there are sufficient jobs available. Similarly it may be desirable to reduce the positive disincentive to work when people stand to lose a high proportion of the various benefits which they are drawing, as they begin to earn wages. But it should be remembered that in the post-war years when the unemployed automatically lost *all* their benefit when they got a job, it was not suggested that people were unemployed because they preferred to be on the dole. Any reasonable benefit system should be predicated on the assumption that people want to work rather than be unemployed. After all, unemployment benefit has always been subject to the condition that people are genuinely seeking work.

It seems strange that a Labour Government should go out of its way to encourage the belief that the unemployed are unwilling to work. It is sad that they, of all people, should revert to a Poor Law mentality and repeatedly suggest that the unemployed are effectively there through their own fault and must be brow-beaten or coerced back into a job – whoever expected to see front page headlines such as 'Brown tells unemployed "Go get a job"'[7] and 'Wake-up call for workshy'[8]. It is not something which families whose lives have been blighted by unemployment will easily forgive. Ministers' constant references to rooting out 'fraud' display a similar caste of mind, suggesting that many of the unemployed are just idle lay-abouts. Of course, there are some people who cheat the system, just as there are some company directors who fiddle their expenses. But we have yet to hear any minister take a similar stance with the higher echelons of management.

2. New Labour's Inheritance

The Victorian concept of pauperism and the undeserving poor was epitomised in the New Poor Law of 1834 which 'rested upon the assumption that destitution was due to personal failing. It followed that destitution should always be relative in a way which would encourage self-reliance on the part of the pauper and deter others from seeking relief. In short, poor relief should be so unpleasant and so degrading that people would turn to their families for support, or, if they were able-bodied, take the work which it was assumed was available.'[9] Although the degrading features of the poor law and the workhouse were ameliorated in the 20th century, means testing still aroused bitter resentment. This was most acute in the 1930s when the rising cost of unemployment benefit led the National Government to restrict entitlement to unemployment insurance benefits and made large numbers of the unemployed dependent on means-tested relief from the local Public Assistance Committees (which had taken over the administration of the poor law in 1929). The unpopularity of the Household Means Test to which they were subjected was a major factor in the widespread support for the system of mainly contributory benefits proposed in the 1942 Beveridge Report on *Social Insurance and Allied Services*, which laid the foundations for the post-war system of social security.

The Beveridge Report

The Beveridge Report reflected the wartime atmosphere of solidarity of the British people and the ideal of common citizenship. This was apparent not only in its objective of minimising the need for means testing but also in the proposals for flat rate benefits paid for by flat rate contributions (irrespective of an individual's earnings) from both employees and employers. But although contributions were to be levied at a flat rate, the fact that the remaining 50 per cent of the cost was to be paid for by the Exchequer[10] meant that there was an element of redistribution in the scheme, as the burden of taxation fell more heavily on the rich than the poor. The benefits were to be set at the minimum level adequate for subsistence. These would be supplemented by National Assistance, which was intended to cover a much more limited field than the existing means tested facilities - mainly people who had not made the necessary qualifying contributions, who failed to fulfil conditions for benefit, or had abnormal needs. The Beveridge Committee considered the perennial problem of how to deal with the varying level of rents paid by applicants in different localities but settled for a uniform notional rent component in the universal nationwide level of benefits. An integral part of the Beveridge approach was the introduction of family allowances for children, irrespective of whether the parents were drawing benefits or not. One powerful argument for this approach was that if children's allowances were paid only to those drawing benefits, it would increase the potential problem of people suffering a drop in income if they found work.

Under the Beveridge proposals, single working women were treated the same as single men for unemployment benefit and pension purposes. But married working women would receive a lower rate of benefit on the assumption that they were dependent on their husbands. Correspondingly married men on benefit received an additional allowance for dependent (non-working) wives. Two major social changes in the intervening years have been the rise in employment among married women and in the number of unmarried couples. Men and women are now formally treated in the same way; but the fact that someone with a broken contribution record may not qualify for a full pension hits women more than men.

The Beveridge Report illustrated the fact that concern over the effects on the pension bill of people living longer is nothing new. It drew attention to the forecast rise in the number of men over 65 and women over 60 from 12 per cent of the population in 1941 to 17 per cent in 1961. But this was not taken as a reason to curtail the provision of what were regarded as adequate pensions. Beveridge's comments on these projections are, if anything, even more appropriate today. The Report said:

'There is no reason .... to doubt the power of large numbers of people to go on working with advantage to the community and happiness to themselves after reaching the minimum pensionable age .... The natural presumption for the increasing length of total life is that the length of years during which working capacity lasts will also rise .... A people ageing in years need not be old in spirit'.[11]

Beveridge distinguished 'social insurance' organised by the state, from voluntary or private insurance, by the fact that membership was compulsory and risks were pooled across the nation: 'each individual should stand in on the same terms; none should claim to pay less because he is healthier or has more regular employment.' One of the questions we have to ask in reviewing the future of social insurance today is how far increasing reliance on private insurance is putting the vulnerable at greater risk. New developments in gene testing may precipitate fresh thinking on this issue. If those of us most likely to be healthy or ill, or live longer or shorter lives can be identified by insurers, a new era of private insurance will open up, with companies charging differential rates for life insurance, annuities, and health insurance to different groups, and in some cases not being prepared to insure people at all. This would very quickly bring the concept of *social* insurance back into prominence.

Post-war legislation

The 1946 National Insurance Act embodied the basic principles of the Beveridge Report. As far as pensioners were concerned, it was, however, more generous in that the new pension rates came into effect from the start, rather than after a transition period. In the same year universal family allowances were introduced. This was followed by the 1948 National Assistance Act which set up the National Assistance Board to provide additional, means-tested help for those in need. The number of people on national assistance rose from 1 million at the end of 1948 to just under 1.8 million by the end of 1954, and stood at around 2 million when the Board was abolished in 1966[12]

The initial post-war system remained virtually unchanged for the best part of 30 years. The first change of principle was the introduction of earnings related supplements to pensions in 1961 and at the same time a move from flat rate to graduated contributions. This was the first step along the road to SERPS: the State Earnings Related Pension Scheme set up in 1976, 20 years after the Crossman Plan first proposed that the state should offer a universal alternative to employer run occupational pension schemes. A further step along the road to relating benefits to previous earnings came in 1966 when earnings related supplements became payable for the first six months of entitlement to unemployment and sickness benefit. The move towards earnings related benefits, however, fell a victim to the changing political and economic atmosphere of the 1980s.

The Conservative reaction

The Thatcherite desire to cut back the role of the state coincided with increasing expenditure on benefits as unemployment rose to levels unprecedented since World War II. Unemployment doubled between 1979 and 1981, reaching 3 million in 1982 and remaining there until 1987. The desire to reduce expenditure led both to an extension of means testing and a retreat from earnings related benefits. What was then a distinctive Tory attitude was a major theme in Tony Barber's 1970 Budget when he said 'We intend to adopt a more selective approach to the social services .... Instead of the present indiscriminate subsides, help will go where it is most needed,' – a theme reiterated by Alistair Darling today. In the same year Keith Joseph introduced the Family Income Supplement, a means-tested benefit designed to help those with children without having to raise the general level of family allowances or extend them to the first child. The supplement was reduced by 50p for every £1 of earnings above the maximum qualifying level. In addition wage earners would begin paying Income Tax and social insurance contributions, increasing the effective withdrawal rate to 85 per cent. They could also lose rate and rent rebates. This sparked off intensified discussion of the so-called 'poverty trap'.

The Family Income Supplement was not quite the first scheme to break new ground in subsidising low wages. The Labour Government had gone a small step down this road in introducing rate and rent rebates in 1967. Previously benefits had either been directed at those not in work or had been paid irrespective of income like family allowances. But the FIS set successive governments more firmly on this path, culminating in New Labour's scheme for Working Families Tax Credits.

A further watershed in the history of post-war social security pension was the decision in Geoffrey Howe's first Budget in 1979 to break the link which had been effectively established between benefits and earnings, and instead uprate benefits only with price increases. In the immediate post-war years of low inflation, benefits were neither linked to prices nor earnings, but were up-rated on an *ad hoc* basis. Between 1948 and 1964 insurance benefits were raised six times and means-tested benefits ten times.[13] But the 1974 Labour Government announced that it would index pensions and long-term benefits for the sick and disabled to increases in earnings or prices, whichever was the greater – while unemployment and short-term sickness benefit would only be uprated with prices. The subsequent abolition of the earnings link started a process of whittling away the value of pensions and other benefits in relation to the earnings they were replacing. The basic state pension was equivalent to around 20 per cent of average earnings in the early 1980s, but is now worth only 15 per cent of average earnings and, if it continues to be indexed to prices, will only be worth 7 per cent of average earnings by 2050.[14]

The over-riding objective of the Thatcher Governments' social (and other) policies in the 1980s was to reduce the cost of benefits and cut taxes on income. Targeting benefits on the poor and indexing benefits only to prices was one way of doing this. Encouraging private provision of pensions by the introduction of the Personal Pension Scheme in 1988 and the down grading of SERPS was another. New Labour has gone one step further replacing SERPS with a State Second Pension Scheme. This will initially be a transition measure, but (if still in existence) will eventually become a second flat rate pension indexed to prices for those in a particular income bracket, and which people can contract out of.

3. Welfare Reform

Despite its criticism while in opposition, New Labour has adopted virtually the same philosophy as its Conservative predecessors, whilst taking a rather more generous view of the level of means-tested benefits which should be available to the least well-off. In the case of pensions, they have introduced the more generous Minimum Income Guarantee to replace the former Income Support scheme, but have notably failed to index the basic state pension to earnings. The Government have also consolidated Conservative means-tested benefits for helping families with low incomes by introducing the Working Families Tax Credit to replace the Family Credit introduced by Norman Fowler in 1984.

The Working Families Tax Credit

The Working Families Tax Credit is implicitly based on two highly debatable assumptions. The first is that it is preferable to help working families by means-tested benefits rather than by raising universal child benefits. The second is that the government should be prepared to subsidise low wages to increase employment. The alternative to the WFTC would be to raise (and tax) child benefit. When Family Allowances (as they were then called) were first introduced at the end of World War II, the cost of bringing up children was seen as the extra cost of providing accommodation, food and clothing. Today, the major part of the cost is the loss of earnings if one of the parents stays at home to look after the children, or the cost of child-care if they do not. In either case, the level of Child Benefit does not attempt to cover this. We should be considering tackling this problem in two ways. The first is the Government paying a substantially higher level of (taxable) benefit to all parents, with a higher rate for children of pre-school age, leaving parents a free choice as to whether they go out to work or look after their children themselves. An enhanced, universal child benefit would not only be a major weapon in the fight to reduce family poverty, but would also improve the balance between those with children and those without at all levels of income. In addition the Government should review the cost and extent of child care provision by local authorities, in all forms: pre and after-school clubs, playgroups and nursery classes, and holiday activities.

A special factor in the rise in poverty among children has been the increase in the number of single parents. Since 1979 the percentage of children in households with only one parent has doubled, and nearly two-thirds of children of single parents are in poverty. This reflects the fact that most lone parents are either not working or are in badly paid jobs: but even where lone parents are working, their income is on average only equivalent to three-fifths of couples with children. The Government is trying to assist low income families by the introduction of the Child Care Tax Credit for those who go out to work. But this seems fundamentally misconceived. Lone parents taking part in a recent piece of research commissioned by the DSS commented that 'they were unhappy "passing over" their children to a registered carer they did not know. This was especially the case for those who received help from their family or friends with childcare. For them it was a shortcoming that payment could not go to someone who knew their children and whom they trusted'[15] Why should the state help with the cost of paying strangers to look after our children, but not their mothers or other members of the family? Higher child benefits and improved child care facilities would be a better alternative.

The second debatable assumption is that it is preferable to subsidise low wages rather than to set the minimum wage at an adequate level – a prime example being the Government's proposal in the last Budget to introduce an 'employment tax credit' for single people and couples without children from 2003. This approach reflects the belief that as employment increases, the level of wages that employers can afford to pay additional workers goes down because unit costs rise as output increases – and hence if the marginal workers are to get jobs their pay must be kept down. This tacit assumption (in economic jargon, the doctrine of '*decreasing returns*') is one of the commonest fallacies in contemporary economics. As every manager knows, in most fields of industrial activity, the reverse is true – costs per unit decline as output increases. This is because overheads or fixed costs remain broadly the same, and the output per head of the additional workers is similar to that of the existing labour force. This is true in a typical factory or in service trades, like hotels. The fact that the marginal workers may be less skilled or qualified is generally of much less significance. Provided the demand for their output is increasing, it generally pays employers to take on more staff on at least the current level of pay. It was sensible to set the minimum wage at a relatively low level to start with to avoid starting a new spiral of wage demands; but as time goes by it should be gradually increased to a higher level, and then kept in line with the rise in average wages. Such increases should not be regarded as an impediment to reducing unemployment: there is clear evidence that the introduction of the minimum wage has had no such effect.[16]

The Treasury estimate that nearly 400,000 of the 1.5 million families who should be eligible for WFTC are not actually claiming it.[17] Rather than putting more working families on means-tested benefits, and hence making them subject to higher marginal rates of what is effectively income tax, the best way of tackling family poverty would be to raise Child Benefits, improve the availability of child care facilities and raise the minimum wage. The minimum wage should be set at a level which makes it unnecessary to subsidise recipients without children by such devices as the proposed employment tax credit.

Pensions

Pensions, which account for by far the largest part of expenditure on benefits, are the main field in which the general public have become aware of the shift towards means-testing. Ministers have emphasised the virtues of targeting and taken the line that it does not matter whether benefits are universal or means-tested – it is how much the poor get that counts. Alistair Darling, the Secretary of State for Social Security made this claim in his evidence to the House of Commons Social Security Committee during its recent inquiry into the Contributory Principle: 'we believe that the welfare state needs to be focused on outcomes rather than on the means of delivery .... If you increase the basic state pension by whatever amount you want, it does not help the poorest pensioners ....' But people who have paid their social security contributions and taxes all their working lives expect a decent pension as of right, not as a form of state charity after an orgy of form-filling and cross-examination. It is no wonder that nearly three-quarters of a million pensioners do not claim the benefits to which they are entitled. If targeting is the criterion, a rise in the basic pension to the level of the Minimum Income Guarantee would be the most effective way of making sure that all pensioners in poverty get the benefits they need.

Reducing the dependence of pensioners on means-tested benefits is partly a matter of increasing the basic state pension, but it also raises two other issues. One is the treatment of people who do not qualify for a full pension because they have not paid enough contributions. The other (closely related) point is the position of married women who are at present getting only a dependant's allowance on the basis of their husbands' contributions – an allowance which assumes (realistically) that a couple can live more cheaply than two single people. As Holly Sutherland has proposed, one way of dealing with these two issues is to make everyone over retirement age entitled to a Citizen's Pension at the same rate for men and women irrespective of their work and contribution record.[18] Abolishing present contribution conditions would solve the problem of carers and parents staying at home to look after their children – but at the expense of weakening people's feeling that they had explicitly contributed to their state pension. This might be alleviated if the concept of *crediting* people with contributions were extended to cover all forms of 'caring' i.e. looking after children, the disabled or older people; but there would be a large grey area of people tempted to say that they were 'caring' for an elderly relative, although in practice they did not do much about it. Again, it is arguable whether couples sharing a house need as high a pension as two individuals living on their own, but as increasing numbers of retired couples will not in future be officially married, treating people purely as individuals irrespective of whether they are living together may be a practical necessity. The proposed simple Citizen's Pension may therefore be the most practical solution in the end.

Introducing the proposed Citizen's Pension at the same level as the state pension for single people (£64.70 a week) would have cost an estimated £2.2 billion per annum in 1998 – less than 3 per cent of the total benefit bill. A more generous scheme with a Citizen's Pension of £90 a week would cost around £10 billion or 1.3 per cent of gdp and reduce the number of pensioners on Income Support by 80 per cent.[19] This could be financed in a number of ways. If it were done solely by raising national insurance contributions, this would require an increase of 4.6 per cent. This would, however, be reduced if the opportunity were taken to abolish altogether the anomalous upper earnings limit above which income increases incur no additional contributions. If the cost were financed solely by increasing Income Tax it would require an increase of 4.6 percentage points if the rates for all bands were raised by the same amount; but an increase of less than 1 per cent in the standard and lower rates, if the top rate were increased to 50 per cent.

These figures suggest that the short-term cost of a shift away from means-tested benefits for pensioners should be within the limits of political acceptability, once we can get away from the present Dutch auction to reduce tax rates. Since revenue from contributions and taxation can also be expected to increase broadly in line with earnings or national income, such a shift would not present a longer term financial problem, were it not for the concern about the forecast increase in the ratio of pensioners to workers – the so-called 'Ageing Time Bomb'. Although these demographic projections are concerned with the situation 10, 20 or 30 years ahead, they have affected the treatment of pensioners today and have been a largely unstated rationale of the Government's failure to relate state pensions to earning and to rely increasingly on means-tested benefits. It is time they were considered more critically. As health improves and people live longer they will also be capable of, and wish to, work longer.

4. The Demographic Time Bomb

Official comparisons of the long-term costs of indexing pensions to prices or earnings are based on population projections (which are notoriously subject to error) by the Government Actuary's Department. These projections suggest that the number of people over the state pension age in Great Britain[20] will rise from 10.5 million in 1999 to 13.8 million in 2030, despite the increase in the pension age for women from 60 to 65. Although, there is expected to be an increase in the population of working age from 35.5 million to 36.7 million over the same 30 year period this is relatively small proportionately, so that the ratio of the number of people of working age to those of pension age is expected to fall from 3.4 to 2.7.

The forecast rise in the number of pensioners by 2030 (including those living overseas) is somewhat greater, from 10.9 million to 15.2 million, reflecting the number of women who qualified for pension before the pension age reached 65. (It is due to be phased up from 60 to 65 between 2010 and 2020.) In parallel, the Government Actuary's Department estimates that the ratio of the number of people contributing to the National Insurance Fund to the number of pensioners would fall from 1.8 to 1.4.

Despite the growing number of pensioners, the Government Actuary has estimated that the cost of indexing the basic state pension to earnings from 2003 (and taking into account the increases proposed in the Pre-Budget Report for the next two years) could be met by running down the accumulated surplus in the National Insurance Fund up to 2006-7 without increasing the rate of NI contributions required.[21] In the longer run, however, the joint NI contribution rate (employers and employees) would have to rise to 27 per cent in 2030, from today's level of 20 per cent; whereas if pensions were only linked to prices the contribution rate could come down to 19 per cent.

The cost of the basic state pension in 2030-1 (in 2000 prices) would be £49 billion if the pension were linked to prices and £77 billion if linked to earnings – as compared with £34 billion in 2000-1. By 2030-1 the additional cost of indexing pensions to earnings would thus be £28 billion. This comparison, however, does not take into account the corresponding *saving* in spending on means-tested benefits if benefits were indexed to earnings rather than prices. No official estimates of this saving are available – a striking omission if there is to be any reasonable discussion of the alternatives.

It is projections on these lines that have stimulated discussion (both in the UK and elsewhere) of the 'demographic time-bomb' and growing burden of meeting the costs of pensions. But even the most superficial examination of the problem suggests that the vast edifice of calculations based on the projections by the Government's Actuary's Department (and others) of the proportion of the population over 65 does not tell the real story. This depends on the number of people at work relative to those who are in some sense 'dependent' – this would include pensioners, children and people of working age who are not working. Not sufficient attention has been paid to the fact that the rise in the number of older people over the next 30 years will be partly offset by the decline in the number of children, which is expected to go down by 1 million. In *real terms* the key point is that the consumption of those not at work has to be met from the production of those who are. The crucial assumption in the Government Actuary's Department's estimates is that the numbers at work in 2030 would be 27.2 million or 45.3 per cent of the total population as compared with 27.6 million or 47.8 per cent in 1999. It would therefore need another 1.5 million people at work to maintain the same ratio of workers to dependents.

Getting more people into work

Examination of the Government Actuary's assumptions about 'activity rates' (i.e. proportion of people in the labour market) at different ages suggests that such an increase is well within the bounds of possibility. The Appendix shows the Government Actuary's Department's estimates of activity rates in 1999 and 2030 and an alternative estimate for 2030 assuming that by then men and women are working longer. On these alternative assumptions there would be over 1.7 million more people over the age of 55 at work, one million of whom would be women.

Health apart, activity rates for older women seem likely to increase appreciably as the higher proportion of younger women now working grow older.

The slackening of demand for labour in the 1980s has left a legacy of low levels of employment among men over 50, particularly in some Northern areas dependent on manufacturing industry. More effective policies to get more jobs into the Northern areas of the country with heavy unemployment could significantly reduce the cost of uprating benefits and increase the revenue to meet them. The scope for increasing activity rates among older people is illustrated by the fact that in the period March-May 2000 the activity rate for men from 50 to 64 and women from 50 to 59 was only 61.3 per cent in Wales, as against 76.8 per cent in the South East. These figures suggest that any effects of greater prosperity in leading to voluntary early retirement are more than outweighed by the effects of stronger demand in keeping people in jobs. Given a strong demand for labour and a greater willingness to employ older people, it is not difficult to envisage sufficient increase in activity rates to maintain the current ratio of workers to non-workers across the population as a whole, allowing for the expected decrease in the number of children.

Such an increase in activity rates would go a long way to offsetting the cost of the growing number of pensioners. It has been estimated that getting another 1 million people into work would save about £3 billion a year in expenditure on unemployment, sickness and disability benefits etc and raise about £7 billion extra in taxes and insurance contributions.[22] The resulting £10 billion a year would meet the cost of benefits for over 3 million pensioners. Thus getting another 1.5 million older people into work would broadly pay for the additional cost of benefits for the additional 4.3 million pensioners expected in 2030 (as compared with 1999) at today's level of pensions in relation to earnings.

Such estimates suggest that the economic 'burden' of the changing age structure, and hence the need to keep down pensions, is in danger of being considerably over-rated. The key to the 'ageing problem', such as it is, is not to pare down pension support for the retired, but to establish the conditions for greater participation in the labour market by the over 55s. To make this possible, it will be necessary to maintain a high demand for labour, so that as older people come onto the labour market they are additional to, not replacements for, younger people. It will also need a change in attitude by employers and others, including the abolition of compulsory retiring ages and, more controversially, gradual increases in the standard ages of retirement in state and occupational pension schemes, combined with flexible pensions for early and late retirement. If the standard retirement age for calculating pensions is 65 today, it would be reasonable to expect it to be somewhat higher in 20 or 30 years time.

Second pensions

The most confusing part of the pension system is the area of state and private 'second' pensions i.e. pensions additional to the basic state pension. Occupational schemes have generally been the best in this field because they have stable rules linking pensions to earnings, and employers both make a significant contribution to the cost and take the risk of additional contributions being needed because of vagaries in stock market prices or interest rates or the age and pay structure of their employees. 'Stake-holding' and other personal private pensions are subject to considerable uncertainty over the eventual value. The main drawback to occupational schemes, however, is the difficulty of transferring from one scheme to another – the principal exception being certain parts of the public sector. For salary earners expecting to move up the salary grades during the course of their career, merely being credited with the value of the accrued money contributions when they move is much less valuable than being credited with their number of years' service. It is important therefore to keep such transfer provisions under public review.

The Government's own contribution in this field is to replace SERPS with the curiously conceived Second State Pension. Initially it will be a more generous substitute for the emaciated version of SERPS left after successive Tory cuts. But eventually it will merely be a second flat rate pension also indexed to prices, and hence getting progressively less significant in replacing the loss of earnings on retirement. By 2050, the flat rate second pension will be rather higher than the flat rate basic pension: £35 per week in terms of today's earnings against £30 per week for the basic pension.[23] This gives a total pension equivalent in present day terms to £65 per week. So the Government's long term concept is an increasingly meagre state pension of which people may contract out of over half i.e. the Second State Pension portion. If they can contract out of part of the flat rate pension, then the next step will be to permit contracting out of the whole thing.

In an age of growing labour mobility, a straightforward state earnings related scheme, with its relatively low administrative costs, would seem a valuable alternative to private schemes, such as personal or stakeholding pensions, with the uncertainties inherent in money purchase schemes about future share prices and interest rates. Again ill-judged panic about future costs seem to be behind the decision to abolish rather than reform SERPS. It seems difficult to believe that the proposed Second State Pension will survive for long in its present form, but it has created yet another source of uncertainty about future benefits.

5. Conclusions

The current policy debate on social security policy has been almost entirely focused on the question of indexing pensions to earnings rather than prices. This is only one, albeit the most important, example of the Government's implicit strategy of abandoning the post-war social security system and moving over to a system of means-tested benefits. Although the Government are reluctant to acknowledge that this is the case, there can be little doubt that it is the inevitable end-result of the measures they are adopting. It is time that this strategic issue was brought out into the open, and the expenditure and taxation implications of re-establishing a new social security system properly assessed.

Future policy should be based on the principle of social insurance – that is adequate benefits received as of right, financed by a combination of social security contributions and taxation, with means-testing reduced to a minimum. The system should be made more inclusive by reviewing contribution conditions, including the lower earnings limit which creates particular difficulties for part-time women workers. The main benefits, and in particular the basic state pension, should be set at a fixed proportion of average earnings and uprated automatically with increases in earnings. This would require a transition period during which current levels of benefits were phased up to a higher proportion of earnings.

The cost of benefits is highly sensitive to the proportion of the population in work. Neo-liberal economic policies, based on a low level of demand for labour and a pool of unemployment in order to avoid inflation, raise the social security bill, as we saw in the 1980s. The Government should maintain a high demand for labour to facilitate higher employment rates in depressed regions and among older people. Full employment is much the best weapon for making a decent social security system affordable. The answer to the so-called 'ageing time-bomb' is not to whittle away pension provision, but to increase the number of older people, and others, at work. This requires a change in attitude among employers, and more flexible pension provision allowing people to draw their pensions over a wider age-range and acquire additional pension by retiring later. Compulsory retirement ages in both the public and private sectors should be abolished. The standard retirement age for state pensions should gradually be increased over future decades as people remain healthier and live longer.

Such an approach would involve a radical change in the Government's implicit strategy, and in particular the restoration of the earnings-link. This would not in itself solve the problem of creating political stability in the pensions field and hence greater security as to the benefits people could look forward to when they retire. But it seems unlikely that the Conservative Party would rush into a commitment to abolish such a link.

The fact remains, however, that an adequate system of universal benefits will require higher contributions or taxes than an increasingly means-tested one. This is a choice that the public should have the right to discuss and the electorate to decide. The system now being created for future generations should not be predetermined (as it has so far in the life of this Government) by a short-sighted election pledge not to raise Income Tax. The Labour Party should be offering the public a better social security system, albeit at a higher cost, and at the same time a more vigorous programme of measures to bring more people into employment who are at present excluded because of their age or where they live.

Notes

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20 *Quinquennial Review of National Insurance Fund* by the Government Actuary's Department, Cm 4406
21 *Report by the Government Actuary On the Cost of Uprating The Basic Retirement Pension In Line With The General Level of Earnings*, Cm 4920
22 These estimates (at 1996/7 price and income levels) are from Kitson, M., Michie, J. and Sutherland, H., *The Fiscal and Distributional Implications of Job Generation* (Cambridge Journal of Economics, January 1997). The cost of state pensions per head in 1996/7 was £3,220 (Cm 4614)
23 DSS, *A Partnership in Pensions*, Cm 4179 (Chart 5) 1998

APPENDIX
EFFECTS OF CHANGES IN ACTIVITY RATES

1 Activity Rates (per cent)[1]

Age	Men 1999 Actual	Men 2030 GAD forecast	Men 2030 Alternative forecast	Women 1999 Actual	Women 2030 GAD forecast	Women 2030 Alternative forecast
16-19	66.9	67.9		63.1	61.4	
20-24	83.7	85.7		70.5	74.1	
25-34	93.3	91.0		75.2	79.9	
35-44	92.0	89.4		77.0	78.6	
45-54	88.5	87.3		76.8	82.7	
55-59	74.6	71.1	80	53.1	54.5	75
60-64	53.8	49.2	65	30.3	36.0	60
65-69	15.0	13.0	20	3.5	3.8	10
70+	4.6	4.4	7	3.5	3.8	5

2 Extra numbers in labour force in 2030 on alternative assumption (thousands)[2]

	Men	Women
55-59	172	383
60-64	337	504
65-69	144	129
70+	109	65
	762	1081

Total additional active	1843
less 4.7% unemployed (GAD estimate)	87
Total additional employed	1756

Notes

1 The first column (for both men and women) shows activity rates (percentage of people of working age seeking or at work) for 1999, and the second the estimate used by the Government Actuary for 2030 in Table 14.1 in his Quinquennial Review of the National Insurance Fund (Cm 4406, July 1999). The alternative estimate in the third column gives greater weight to the desire of older people to carry on working and to the effects of raising the state pension age for women from 60 to 65 by the year 2020.

2 The difference between the two activity rates for 2030 has been multiplied by the Government Actuary's population forecasts by age group for 2030 in Table 13.1 of the Quinquennial Report.

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phone 0115 970 8318 fax 0115 942 0433
e-mail elfeuro@compuserve.com www.spokesmanbooks.com

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