Unbundling the welfare state

Changing the boundary between savings, insurance and welfare

By
Professor George Yarrow

ADAM SMITH INSTITUTE
LONDON 2002

Contents

Acknowledgements

The Adam Smith Institute is grateful for the support of Unum Limited in making possible the publication of this report. Unum is working to promote public debate on welfare and employment issues as part of its New Beginnings initiative, a major initiative to improve return-to-work outcomes for disabled adults.

Bibliographical information

Published in the UK in 2002 by ASI (Research) Ltd

ISBN 1-902737-24-5

A dynamic society needs dynamic policy

Social security has always been evolving

Social security, and welfare provision more generally, is ***an evolving system***. Its shape today is quite different from that of fifty years ago, in the immediate post-Beveridge years. To give just two examples:

- as a result of increased life expectancy, not accompanied by an increase in the retirement age, pension provisions are nowadays on a much grander scale than then; and
- the scope of means tested benefits, conceived as a minor supporting feature of the Beveridge reforms, has expanded greatly.

And indeed, Beveridge's principles were completely different to those which prevailed at the opening of the Twentieth Century, when government involvement was much smaller and was focused at the local level.

In other words, the boundaries between state (central or local) and non-state provision (through either individual or collective action[1]) have shifted substantially over time.

Ebb and flow of the state/non-state boundary

Much of this change in the boundaries has been an ***expansion of the state system***, motivated in part by the aim of extending various types of provision to individuals and groups hitherto uncovered, or inadequately covered. This in turn tended to displace, or 'crowd-out' other methods of providing social security. Thus, ***for most of the Twentieth Century, the boundaries of state activities were pushed out, and our reliance on individual action, including voluntary association, declined***.

However, the boundary shift has not been all in one direction. The greatly increased role of the private sector in pension provision over recent decades has been one important development going the other way. Although government expenditures have not shrunk, ***the private sector has absorbed much of the new demand that has come from rising incomes and greater life expectancy***. And following the increasing pressure on the funding capacities of tax and national insurance, there has been great interest in extending the role of non-state providers across welfare as a whole.

---

[1] Throughout this paper, I will refer frequently to non-state provision. By this is meant all activities other than those of central and local government. It is meant, deliberately, to signify a range of activities wider than those generally encompassed by the term 'private'. It includes financial aid and direct support provided in families, in neighbourhoods, though voluntary organisations and charities, through mutual associations and the like, as well as via contractual arrangements with financial institutions and commercial service providers. Beveridge used the term 'voluntary action' for those forms of social action lying between self-interested individual conduct and state activities.

The need to redefine the boundaries for today

Redefining boundaries in a way that most rationally suits the needs of today's society is, unfortunately, far from simple. In principle, the aim should be to select whatever arrangements will best deliver the overall policy objectives, drawing upon the different strengths of different types of provider as most appropriate. In practice, vested interests and limited visions stand in the way.

An advanced society may be judged on how it treats its less fortunate members. In the UK for the last half-century, we have relied heavily and increasingly on the state to fulfil this task. But now we have to ask whether the state is indeed the best-equipped institution to shoulder all of the burdens that we have placed on it.

The development of the welfare state was not intended to crowd out non-state activity on a grand scale —Beveridge expected the basic, state-provided minimum to be supplemented, increasingly, by other forms of provision — but that crowding-out was what happened, nevertheless.

The general problem caused by this expansion of public provision is that ***incentives become distorted***: state action reduces the incentives for people to take action for themselves. This drawback may be inevitable; and to a large extent, we accept the inevitable dulling of incentives as the price we have to pay in return for preserving a decent safety net for the less fortunate.

But the problem can be greatly exacerbated by a number of features that have come to pervade today's state system, such as ***complexity, constant change, and means testing***. While we may all accept the visionary principles of Beveridge, we are right to question how they have in fact been delivered in practice, and to ask whether some parts of the welfare state concept are not, in fact, best left to the state.

A snapshot of social security today

To help us get to grips with the scale and nature of the issues, a snapshot of current social security expenditure may be helpful.

How the state classifies its expenditure

There are a number of ways of classifying the different types of benefits[2] provided, and currently the Department of Work and Pensions (which replaces the Department of Social Security) places emphasis on distinguishing benefits and activities by age groups and associated objectives:

- support for ***people of working age and without disability*** (e.g. jobseekers allowance, family credit/working families tax credit, widows' benefits, income support, housing and council tax benefit, etc.);
- support for ***families and children*** (e.g. child benefit);
- support for ***people with a long-term illness or disability*** (e.g. Disability living allowance, incapacity benefit, attendance allowance, income support, housing and council tax benefits, war pensions); and
- support for ***people over working age*** (e.g. Retirement pensions, income support, housing and council tax benefits, etc.).

On this basis, it is estimated that by 2001/2, of all benefits:

- nearly half will be paid to people over working age,
- a quarter to people with a disability,
- around 17% will go to people with disabilities,
- about 17% to people of working age without disabilities, and
- about 8% will be paid to families through child benefit.

Smaller role for benefits in a strong economy

Total social security expenditure is estimated to have reached around £103 billion in 1999/2000, of which approximately 3.5% is accounted for by administration.

After some sharp increases in the early 1990s, the grand total of benefit expenditure has been broadly stable in real terms since 1994/5, although for 2001/2 a larger increase is projected (2.4% — or more if the new tax credits are treated as benefits). Gross

[2] There are definitional issues concerning new measures such as the Working Families Tax Credit and the Disabled Person's Tax Credit, which may alternatively be classified as benefits, as not being benefits at all for social security purposes, or as being partly a benefit (e.g. to the extent of any net cash transfer to the relevant person as a result of the combined effects of the credit and the normal income tax rates). These complexities will be ignored in this short paper.

Domestic Product has meanwhile continued to rise, so that expenditure has in consequence been tending to fall as a percentage of GDP. In 1991/2, it amounted to nearly 12.5% of GDP, but by 1999/2000 had fallen to a little over 11%.

In relation to the four objectives of the DSS/DW&P, the changes in expenditure in real terms, between 1994/5 and 1999/2000, were as follows:

· Working age	- 23.9%
· Families with children	+ 11.0%
· Disabled and long-term sick	+ 7.8%
· Over working age	+ 10.6%
· Total	+ 1.3%

In part these recent movements reflect ***strong economic growth*** in the UK, and in part they reflect the ***policy measures taken to contain the growth in expenditures***. Clearly, the relative stability of overall spending in real terms has been influenced by the fall in support to people of working age without disabilities due to declining unemployment. But even when these cyclical effects are taken out, it still seems clear that ***social security spending has lagged behind the growth of GDP***.

Another classification: contributory and non-contributory

A second way of breaking down expenditure is according to whether the relevant benefit is ***contributory*** or ***non-contributory*** in nature. Does the level of the benefit received depend on the contributions that the individual has paid in the past — as insurance or savings would do? Or is the benefit paid whether or not the individual has contributed — as charitable giving would do?

The Beveridge approach relied heavily upon the 'contributory principle' and, although the distinction has become less clear since then, it remains useful in thinking about the rationality of the boundaries between state and non-state provision.

Non-state provision necessarily works on contributory principles, with a strong link between what the client puts in and the entitlements received in return. It is natural to ask, therefore: ***Could any of today's contributory benefits be provided other than by the state?***

The main contributory benefits are:

- retirement pensions,
- widows' benefits,
- part of the jobseekers allowance,
- statutory sick pay,
- incapacity benefit,
- maternity allowance, and
- statutory maternity pay.

Much the largest of these is pensions (around £38 billion in 1999/2000, or 38% of total benefit expenditure). The others total to around £9 billion (i.e. around 9% of all expenditure), of which about £6.8 billion is accounted for by incapacity benefits.

The ends and means of social security policy

It is useful to focus on what government departments consider the objectives of a social security system to be, and to focus on what those objectives *ought* to be if we could articulate them rationally and logically.

Vague objectives

The DSS stated its objective as the provision of 'support' to defined groups of people. This might be revised as the new Department for Work and Pensions takes shape; but ***it remains, at best, an extremely vague specification of ends***, since it gives no indication as to the levels and types of support to be provided. Nor do these Departmental objectives make any reference to what might be offered by other types of service providers.

Need to focus on outputs, not inputs

In thinking about aims and objectives, the logical place to start is not with the objectives of a supply-side organisation, such as the Department of Work and Pensions, but rather with the ***requirements of people on the demand side***. What welare and insurance do the lives of the majority of people suggest that they need?

Clearly, most people can expect a life in which they will initially be ***economically dependent*** (as children); then will have a relatively long period of in which they will be able to ***generate earnings***; followed by a period of ***retirement*** or semi-retirement in which their earning capacity falls. The basic social security requirements for such people are, therefore, relatively straightforward:

- Support and care to socially acceptable standards during childhood.
- Protection against temporary disturbances to earnings during working lives, such as might result from unemployment or sickness.
- Provision for income and care requirements in old age.

The first requirement is delivered through an ***inter-generational transfer of economic resources***, chiefly through family units. The processes through which the second and third requirements can be achieved are ***income smoothing*** through ***saving and borrowing***, and ***insurance*** against larger and less predictable risks.

However, some people may be unable to achieve a socially acceptable standard of living over their lifetime as a whole, and/or may be unable to make adequate provision for their children. In such cases, normal saving and insurance will have to be supplemented or replaced by ***redistribution between households***.

Given these different needs, what should be the role of the state? The weight of the existing institutions, and the lack of clear objectives, have squeezed out any strategic thinking on this point. But society moves on, and if we do not reflect on it, our social security system will become ever more out of date.

The unintended effects of state provision

The political marketplace breeds complexity

The jumble of objectives in today's social security system is unsurprising. Social security involves transfers/redistribution of resources; and how that happens is politically determined. There are always competing demands for redistribution from various interest groups, and social security can be viewed partly as the politicians' supply-side response to some of those demands.

As politicians strive to fulfil the demands of different groups, and to do so without making others worse off, piecemeal reforms are added to the system. To meet those competing aims, these reforms themselves are often quite complicated; and as more are added over the years, it produces a highly complex, sometimes perverse, result.

This is plain in the development of social security.

The post-war Beveridge proposals were relatively simple. They focused on a small number of major contingencies that threatened income levels; they had (by today's standards) limited ambitions in terms of redistribution of resources; and they afforded only a residual role to means tests. However, ***the distortion of these simple principles started almost as soon as the ink was dry on the Beveridge Report***, and it continued over the subsequent decades.

So we must remember that we have not got to where we are by chance or by mistake, but through the workings of this 'political market'. And ***if we are to reform social security for the future, we must understand how this political marketplace works, and ensure that our proposals are robust enough to survive in it***.

State *provision* is not justified by market inefficiency

Going back to the lifetime needs of individuals, income smoothing through saving, borrowing and insurance is a service that can, in principle, be provided by non-state organisations in financial markets. In practice, however, insurance and capital markets may 'fail' — that is, they may not operate in a fully efficient way. One motivation for public intervention, therefore, is to improve the workings of these markets.

However, a public social security system that focused chiefly on this would probably look very different to current arrangements. The emphasis would be on ***improving market functioning***, and it might be expected that there would be a much greater emphasis on regulatory measures and ***much less emphasis on state provision*** of benefits than is now the case.

Perverse incentives under today's state provision

For lower-income households, probably the chief obstacle to effective market functioning is not so much the 'failures' of insurance and capital markets but rather ***the distorting effects on incentives of today's welfare policies***.

For example, if the public social security system provides means tested income support, this will ***considerably dampen the incentives for individual saving and insurance among lower-income households***. The effect might be mitigated by reducing the withdrawal rates for benefits, but unless those withdrawal rates are very shallow, the general problem will persist.

In particular, ***means tested benefits act like regressive taxes on non-state forms of social security provision***: their impact on incentives is much greater on the poor than on the wealthy.

This point is of fundamental importance. People worry that shifting the balance of social security system away from the state and towards non-state organisations will lead to under-provision. But we should be aware that ***under-provision — among the very groups we are trying to help — also results from the perverse incentive effects of state social security itself***.

The depth of the savings trap

It may at first sight appear odd, in a period when a major concern of public policy is the sheer cost of social security, to suggest that ***shifting the balance toward greater reliance on non-state organisations would actually increase provision***. If, however, means testing could be scaled down too, that would indeed be the expected effect for large numbers of households with modest incomes.

To repeat, ***means tests work like a tax on personal savings and insurance***. They make private insurance and saving a bad bargain for many households who could reasonably provide to keep themselves at or just above the income support level, because that provision leads to their state benefits being withdrawn.

In all honesty, it is hard to measure, or even estimate, the scale of this effect. But intellectually, it seems quite plausible to suggest that a benefit withdrawal rate of only 50% may be more than enough to discourage individual effort. It means that up to twice as much will have to be put to achieve a given incremental income flow than would be needed in the absence of means testing. That in turn may well mean that returns to self-help are actually negative (i.e. the effective tax rate on saving may be above 100%).[3]

---

[3] To illustrate, suppose £1000 now yields £1500 in constant prices (i.e. in real terms) in ten years time. This represents a real income over the period from saving of £500. A 50% withdrawal rate for the equivalent state benefit could, however, mean that the actual value of the funds accumulated at the end of the period was only £750 (50% of £1500), since 50% of the state benefit may be lost. The effect of the means test is then to take £750 away from the saver, which is 150% of the (real) income that would otherwise be derived from saving.

Putting this in its simplest terms, ***means tests may serve to trap a large number of households at the state-defined benefit level, when, at normal tax rates, those households would have made greater provision for themselves***. True, some means testing may be an inevitable, unavoidable part of welfare policy, and if we are to provide a decent standard of living for the less fortunate, we must accept its drawbacks. But we have come a long way from Beveridge, who conceived welfare support as limited and temporary — in which case the damage done by means testing would also be limited. Today, means tests have been insinuated far up the income scale, and the damage they do is proportionately greater as a result.

The welfare reform effort so far

Recent governments have made major efforts to reform social security, motivated among other things by a desire to contain the fiscal burden resulting from this set of public policies. There is now a broad measure of agreement that the boundaries between public and non-state provision should be shifted to give self-provision a larger role, although there are significant differences among political parties as to how this might be best achieved.

Pre-occupation with work incentives

Since the incoming New Labour Government published *A New Contract for Welfare* in March 1998, a number of substantive measures and shifts in approach have been implemented. Some of these measures represent changes that are broadly in line with the aim of placing a greater emphasis on self-provision and that serve to achieve the strengthening of incentives that is necessary to achieve such a shift. Chief amongst these developments is the strengthening of the incentives to work.

However, the reforms have brought mixed results. For example:

- with attention turned to the strengthening of work incentives, there has been ***much less progress, and indeed some regression, in respect of incentives towards saving and insurance***;
- while the attempt has been made to reduce the very high tax rates on non-state provision faced by some families, ***the total number of households subject to the effects of means testing has grown significantly***; and
- some positive incentives have been introduced, but at the cost of ***complexity and confusion***.

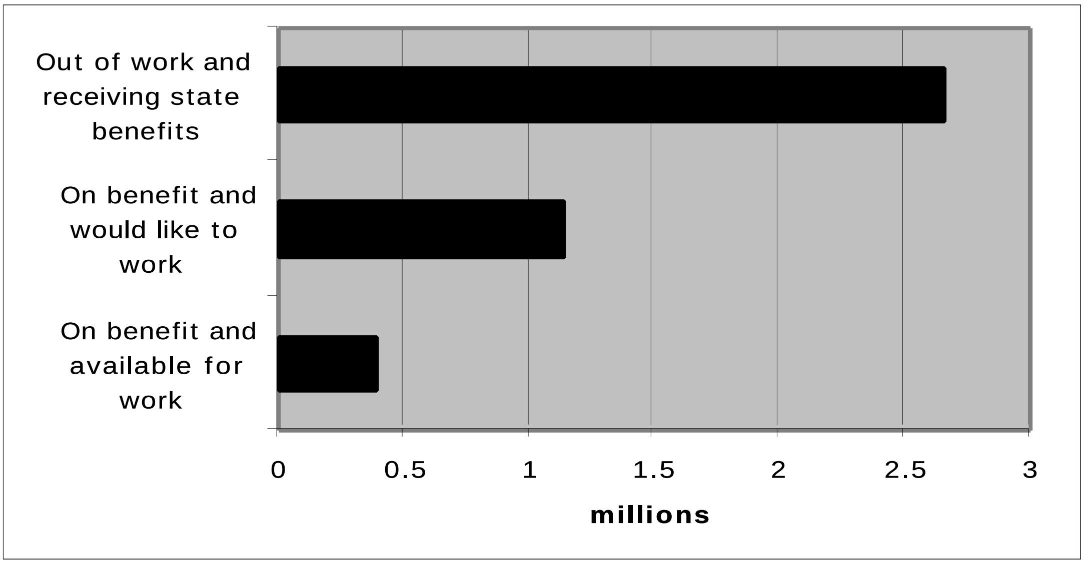
Three typical examples

It is instructive to look at three particular directions of current policy: work incentives, tax credits, and the focus on children. Each is positive in terms of the general direction of movement, but problems remain in all. While they are indeed significant, they still do not amount to a systematic reconsideration of the structure of the welfare system.

Incentives to work. In the DSS *Departmental Report 1999*, the first of eight principles of welfare reform was stated as: ***The new welfare state should help and encourage people of working age to work where they are capable of doing so***. A variety of policy measures, not confined to changes in social security benefits, have indeed had the effect of increasing incentives to enter into paid work.

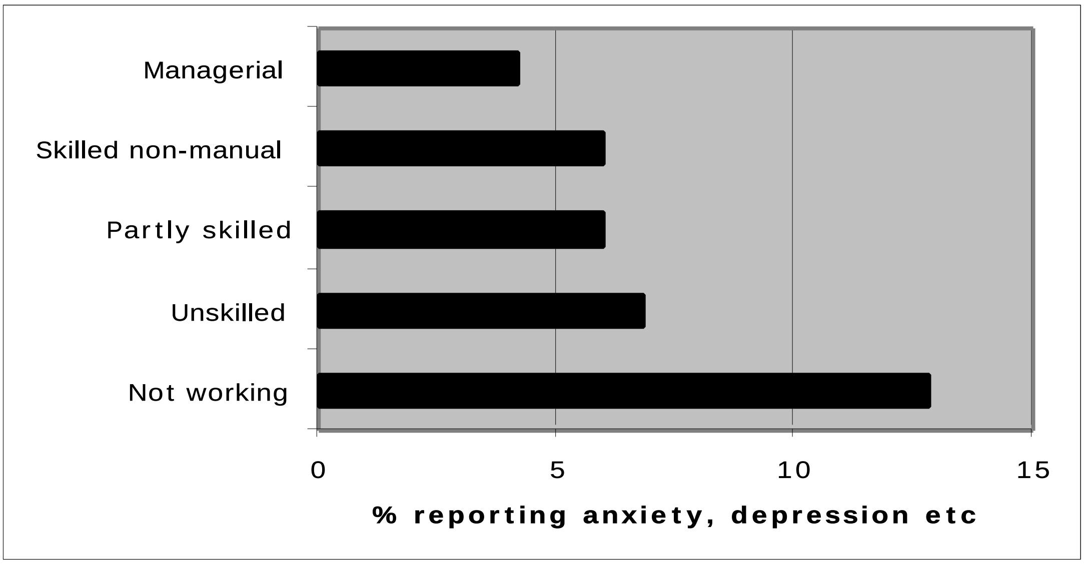
There is, of course, no question about the economic, social, and psychological value of getting people off benefits and into work where this is possible. The ***economic*** case is straightforward. If we discovered, for example, some way to help just one-third of those on incapacity benefit to find work at just 80% of national average wages, the total boost to the economy would be in the region of £5 billion per year — about £2.2 billion saved in benefits, and £2.8 billion in terms of the extra contribution to income tax, national insurance, and VAT receipts.

The ***social*** case is just as strong. Although many people on disability benefit (to follow through with that example) cannot work because of their disability, the Summer 2000 Labour Force Survey showed that over a million, out of the 2.6 million out of work and disabled, would like to work (see chart).



Source: Labour Force Survey Summer 2000

In terms of ***psychology and mental health***, the case for finding people a route into employment is strong too. As following shows, the highest incidence of self-reported anxiety and depression — by far — arises in those who are not in work.



Source: British Household Panel Study, ISER, Essex University, Future Foundation

The emphasis on paid work, however, appears to go some way beyond these objective economic and human benefits. It has become part of the political agenda, being seen as a vehicle to promote 'social inclusion', and to demonstrate the ability of politicians and officials to design and run a 'joined up' government service. And so, through mechanisms such as the single work-focused gateway (SWFG), the welfare system is being developed in ways that are bundling advice with benefit assessments.

However, it is not clear that these strategies are appropriate and robust. There are, of course, obvious questions about the conflicts of interest that must arise when advice and benefit assessment are bundled, and what incentive structures are in place for officials, and how these affect the outcome.

But there is also the issue of sensitivity. Everyone is different, and employment patterns in a modern economy are highly complex. Can state agencies really have the flexibility and sensitivity to address the diverse needs of disabled people and other vulnerable groups? For those groups it may be particularly hard to find the right balance between paid work and family responsibilities for which we all strive. And people with different kinds and degrees of disability differ very widely in terms of the kind of work they can and wish to do. They are not well served by the tick-boxes of officialdom. ***So it seems very doubtful that the state will prove an efficient supplier of what is, in effect, a bespoke service (individual advice).***

Pre-occupation with a single choice (labour force participation) also risks the neglect of other, highly important social security issues. ***The distortions in income smoothing and insurance incentives for people of working of age are not being tackled with anything like the same vigour*** as distortions in incentives to work.

Tax credits. The development of tax credit arrangements is potentially of very great significance since, in principle, it can facilitate the unbundling of the state's redistribution role from its provision of saving and insurance products.

Although for many state benefits there is a nominal link between contributions and benefits, ***the reality is that the national insurance system has come to be based on quite massive cross-subsidisation of certain groups***, which in turn distorts decisions in relation to similar, non-state products and services. Cross subsidy is, of course, an inevitable part of the genuinely welfare elements of the welfare state, in that we rely on wealthier families to subsidise those who are less fortunate. It is, however, at odds with the principles of private saving and insurance, which can only work when the final benefits received are linked to the sacrifice that has been made in terms of past contributions. ***Any attempt to redefine the boundaries of provision so as to achieve more effective complementarity between state and non-state activities will need to address this cross-subsidisation***, and tax credits offer one means of doing just that.

However, the limitations of such developments to date include:

- ***The complexity of the emerging arrangements.*** Tax credits are a form of negative income tax, which could be implemented in much more systematic and simple ways.
- ***Bundling with other work-related issues.*** Redistributional issues are much more general than the question of work incentives, and tying credits too closely to the

labour force decision risks either limiting their scope, or, in effect, turning businesses into welfare organisations (which may be bad for business).
- ***Means testing of credits through specified withdrawal rates.*** The effect is to increase marginal tax rates, and hence to discourage self-help.

The focus on children. The Government has committed itself to the principle that the system should support families with children, as well as tackling the scourge of child poverty.

As we have seen, children are necessarily dependent upon inter-generational transfers of resources — they cannot opt themselves to make provision for their period of dependency. Although the principal means of achieving such transfers is the family, public policy clearly has a major interest in this area, both to protect children against parents who fail to provide an acceptable level of care despite being able to do so, and to supplement family resources where they are inadequate to provide such care.

However, it is in the details that this strategy again falls short. Specifically, ***there seems no reason why the policy measures should turn out to be so complicated, or why child credits should be subject to withdrawal rates***.

To illustrate the latter point, consider a family of modest means who, as well as seeking to make ends meet on a day-by-day basis, would like to make provision for the future by way of insurance and saving. If the parents work for longer hours in order to be able to do this they will, as a result of the means testing of child credits, face a loss of the state benefit. That is, ***parents' incentives to save and insure are dampened relative to people without children***. This seems perverse.

Lack of overall design

A common element of all these threads is ***a lack of attention to the overall design of the welfare system*** when introducing new measures, even when the general features of those measures are broadly desirable.

This in turn makes it much harder to achieve the second of the DSS's stated principles for welfare reform, namely that ***The public and private sectors should work in partnership to ensure that, wherever possible, people are insured against foreseeable risks and make provision for their retirement.*** For all too frequently welfare reform measures are being introduced in ways that conflict with, rather than satisfy, this principle. ***Policy measures are still distorting markets in which non-state providers might realistically operate***, leading to inappropriately defined boundaries and crowding out of individual effort and initiative.

In sum, ***reform is not yet a joined-up process***.

The need for systematic reform

Need for strategic thinking

While there is some progress on a number of fronts, ***there has been little strategic thinking about how to make state and non-state provision work effectively together***. Perhaps the political desire to contemplate a fundamental re-design of the system is still lacking. But that strategic vision is what is needed. Resolving the issues will require considerable investment — of time, effort and resources — and, if the prospect of progress is low, neither side is likely to commit to that investment.

The current shape of self-provision is a function of the historical development of the welfare state. The supply-side structure was not always as it is now — individual and voluntary action (self-help and mutuality) was crowded out during the Twentieth Century — and it will be different again if the state social security system is redesigned. Whether looking backwards or looking forwards, ***relatively long time horizons are required to understand the potentialities that exist***.

The real potential of a new partnership

There is a considerable inertia in current arrangements. But ***piecemeal changes in the existing state/non-state balance in provision will not stimulate the radical supply-side developments that are needed*** for non-state provision to play a larger and more effective role. In the absence of these developments, it is then all too easily to argue that non-state providers are unable to take on a greatly enhanced role (e.g. 'the available products/services are not suitable', 'costs are too high', etc.).

It is, of course, even possible to take the view that no major reforms are needed. The social security budget, which was growing rapidly, has recently been declining as a fraction of GDP; private provision has increased, most notably in the field of pensions; and new challenges might be met by the continuous adjustments in state benefits that we have seen over past decades.

But this view is mistaken. As with a number of other products/services supplied by the state (e.g. health, education, and transport infrastructure), the basic problem in social security is not one of cost but of ***under-provision***, resulting from the limitations of tax-funding and the political determination of provision levels.

Thus, ***millions of households with modest incomes enjoy less in the way of insurance and income smoothing than they would choose for themselves if they faced a less-distorted set of incentives***. Given this, neither the containment of social security spending, nor the increased targeting of benefits (which generally means higher tax rates, at lower income levels, on self-provision) can be regarded as indicators of success.

Clearing the ground for reform

If the second principle of welfare reform — that the public and private sectors should work in partnership — is to be taken seriously, a number of issues need to be tackled, by both Government and non-state providers alike.

Contractual clarity for state and non-state providers alike

Of necessity, non-state providers need to operate in a ***clear contractual environment***, with a reasonably close link between contributions and benefits.

In developing its own welfare reform proposals, the Government has used the language of 'contracts', most notably in *A New Contract for Welfare*. In return for entitlement to state benefits, something is expected *from* the recipient (e.g. to seek training or work, to provide support to other family members, etc.).

However, these obligations are defined only in the very broadest of terms. ***More clarity in the contractual approach to state provision is needed if the public and private sectors are to work in complementary ways.*** Any extension of non-state provision will require considerable investment in new products, services and systems, and that will only occur if there is a clear understanding of what the state system will and will not be likely to offer over a relatively long time horizon.

In general it is desirable that public policy should:

- be ***clear about its aims*** and the means by which it seeks to achieve those aims;
- seek to ***unbundle*** measures that are specifically directed at ***income redistribution*** (e.g. through development of tax credits) from arrangements that contain ***income smoothing and insurance*** elements (e.g. contributory benefits). This will help limit distortions at the boundary between public and private provision;
- ***avoid heavy means testing*** of benefits that is liable to distort incentives for saving and insurance; and
- be ***stable and credible over time***.

In general, complexity and bespoke service provision are better dealt with through decentralised market mechanisms that by centralised, bureaucratic structures, and this suggests that ***state activity would be better focused on broad income distribution measures rather than the supply of support and assistance that is tailored to fit individual circumstances***.

Responsibilities of the different partners

This refocusing of the activities and responsibilities of the state implies that the activities and responsibilities of individuals, employers, and private-sector financial and service providers will need to change too. The following chart summarises these different roles.

Role of the state. The state clearly retains its fundamental role in supporting those who are unable to achieve a socially acceptable standard of living, or make adequate provision for their children, through measures to redistribute income between households. It must also protect those who face unavoidable risks that are impossible to insure or to save for adequately. It must set the agenda in terms of the rights which people have (in terms of equal treatment of the sexes, for example), and the requirements falling on individuals and employers to save, insure, and pay their taxes.

State	**Employers**
· Redistribution between households · Uninsurable risk protection · Rights (eg equal access) · Rules (eg contributions, taxes)	· Retirement and sickness benefits · Health, long-term disability · Severence, early retirement · Payments and administration
Providers	**Individuals**
· Standardised, simple offerings · Complementary products/services · In-kind help (eg job search) · Lower-cost distribution methods	· Save for contingencies · Add-on insurance provision · Bear costs of personal risk-taking · Focus on family health and welfare

Enhanced role for employers. Employers could play a major role in this new division of responsibilities in several ways. There are several potential gains from this, for example:

- provided that they meet certain minimum requirements, ***employers have much more discretion than state agencies*** over the package of benefits that they provide, and they can tailor benefits far more closely to their employees' specific needs.;
- ***employers have the ability to assemble large groups of potential members*** for such benefit schemes, and to handle much of the administration within their payroll systems, which makes them much cheaper than benefits which are marketed, sold, and administered individually.;
- the payroll-deduction system means that ***employees can contribute regularly and easily*** to such schemes without facing the weekly or monthly temptation to spend the money on more immediate but less important things.

At present, ***retirement pensions and sick pay*** are the principal benefits which employers are required to provide or give employees access to, and there have been clear economic and social gains on each of these fronts. Pension savings in the UK are among the world's highest as a result of our long attachment to employer-led schemes. Workplace absence is much better managed than used to be the case, with employers making greater efforts to ensure that their employees stay fit or are helped to recover and return more quickly. The same effects has been seen in the Netherlands and other countries which have implemented analogous reforms.

Expanding the basic employer benefits package into other insurable areas, such as long-term sickness or disability, might well make administrative sense and provide a more responsive, more joined-up service than the present division of responsibilities between the state and employers. Healthcare, early retirement, and other family benefits are all candidates that could be included in such a package.

Individuals and families. The refocusing of the state's responsibility may place new responsibilities on individuals and families. They may well decide to take out additional insurance against events such as ill health or disability if they feel inadequately protected by the state or the employer. And it will be much easier for them if they merely have to top up an employer's package within a thriving private market, than if, as today, they have to seek completely new insurances within a market that is marginalized by the state.

At a more basic level, though, greater personal responsibility is generally reckoned today to be no bad thing. Our universal welfare-state services give people very little incentive to save or insure for future needs (such as unemployment), or to avoid risks (such as smoking and other health hazards), because they know that state benefits and services will be there for them whatever happens. If we could somehow unite individuals with the cost of their behaviour, we should expect a more rational approach to risk from them, and therefore a reduction in the 'free rider' costs they impose on the whole community.

Non-state providers. Among non-state providers, there have been significant recent developments in risk assessment and risk management techniques, in financial product variety, in the depth of capital markets, and in information technology systems. Together, these increase the potential for the sector to supply insurance and income-smoothing products.

The major limiting factor remains cost, and even more substantial reductions in cost-to-service ratios are necessary if non-state organisations are to play a much greater role in social security provision, particularly for households with modest incomes.

Factors that might facilitate cost reduction include:

- an ***increased scale*** of activity,
- a focus on ***standardised and simple products*** (particularly for lower-income groups),
- ***more efficient packaging*** of products and services, and
- ***lower marketing costs***.

There is much for the non-state sector to do. ***Substantial structural change on the supply side is needed*** in order to achieve a lower cost base, since existing structures have not been developed with the provision of mass-market social security products and services in mind.

Building the foundations of reform

Identify and unbundle cross-subsidies

As noted earlier, a considerable fraction of social security benefits are classified as 'contributory'. Although the links between individual contributions and entitlements have been eroded over time, the nature of these benefits suggests that there is scope for re-strengthening of those links.

The key here is explicitly to 'unbundle' income redistribution (other than that which is inherent in any insurance arrangement, associated with risk pooling) ***from the relevant insurance or saving functions.*** State-provided products and services would then no longer incorporate cross-subsidies, and undistorted boundaries between public and private provision could be drawn.

Identify risk barriers to non-state provision

Even with cross-subsidisation reduced or eliminated, there are still large barriers against the expansion of non-state provision. These include how to deal with:

- ***unquantifiable or correlated risks***; and
- ***adverse selection*** and ***moral hazard***.

The difficulties vary in scope depending upon the particular type of product or service. Thus, ***unemployment benefit*** and ***long-term care*** are often cited as examples where the problems are so great that market solutions can, at best, play a highly limited role. On the other hand, the problems appear to be of much less significance for a benefit such as ***statutory sick pay***.

In considering the future evolution of social security, however, ***we must challenge some of the existing presumptions concerning the effectiveness of non-state provision***. Notwithstanding efforts over the past decade to slow the growth of public expenditure on social security, relatively little systematic thought has been given to the question of how the boundaries between public, private and voluntary action might most effectively defined on an enduring, longer-term basis.

The unemployment benefit example. In relation to unemployment benefit, for example, it is certainly the case that there are correlated risks, since the incidence of unemployment will be heavily affected by macro-economic policy. Correlated risks may complicate contractual insurance arrangements, but are not fatal to their further development. Lending to small businesses is subject to similar risks, but few would suggest that it should be nationalised. ***Risk can be spread to capital markets***, and the burden of carrying systematic risk is therefore not necessarily confined to the pool of those covered by the insurance.

Further, because *some* risk is systematic/correlated does not mean that *all* risk has this characteristic. ***More accurate risk assessment and measurement*** opens up the possibility that, if risk pooling and risk spreading via capital markets are inadequate, the state might continue to provide supplementary insurance in contractually defined contingencies (spreading part of the total risk beyond risk pools and capital markets). The practical issues here concern the precise form that such risk-bearing arrangements might take (i.e. exactly what risks should be borne the different parties).

The long-term care example. Similar points apply in relation to long-term care. There exist unquantifiable risks (e.g. in relation to mortality, morbidity, medical developments, etc.), which are also correlated amongst individuals. Whatever arrangements are in place, however, those risks have to be borne somewhere, sometime, by somebody: ***the risks do not disappear if provision is on a public basis***. Their existence does not in itself imply that *all* insurance is best supplied on a non-contractual basis. Contractual provisions can potentially be devised such that at least a part, and possibly a large part, of the burden can be dealt with through contributory arrangements.

Moral hazard and public policy

Insurance against unemployment and long-term care needs are also subject to the more general problems of ***adverse selection*** and ***moral hazard***. However, a variety of existing and potential mechanisms are available to address these issues.

Policies to deal with adverse selection. In relation to adverse selection, for example, one obvious possibility is a ***mandatory requirement for self-provision*** of a basic social security package (which could also extend to pensions and other benefits currently provided through the state system), coupled with restrictions on the ability of providers to refuse cover.

Another would be to ***make tax credits***, varying with defined assessments of needs, ***contingent upon some degree of self-provision***.

Policies to deal with moral hazard. Moral hazard and related problems (e.g. fraud) are not avoided by public provision, and tackling them has been a major focus of recent developments in public policy; but again, market-based providers have their own means of addressing the issues.

Co-insurance, whereby a fraction of the risk is left with the claimant, is perhaps the most important of these, and it can be achieved in a variety of ways. One example is bundling of insurance with savings, such that claims are met partly from pooled funds and partly from a designated, individual savings fund (at least until any such fund is exhausted), an arrangement that was used by some of the early friendly societies.

Again, there needs to be a ***dialogue between state and non-state providers***, leading to a ***concordat*** which specifies how such strategies can work to the satisfaction of both the commercial and the public policy objectives.

The research agenda

Where we are, and where we should be

The first step must be to ***clarify the proper objectives of social security policy***, insofar as general agreement on this can be achieved. Those objectives should attend to the outcomes that we wish to achieve, not on the current capabilities and objectives of state and non-state provider organisations.

We must then ***identify how far social security policy has become detached from these objectives***: how far social change has made benefit programmes work perversely, how far the political marketplace has created under-provision and complexity, and where there are gaps in provision that should rationally be filled.

It is necessary to ***explore the role of tax (including national insurance) and benefit structures (including means testing) on the incentives that face households***, especially for lower-income households. As well as looking at the incentives in respect of labour force participation, this analysis will attempt to measure the disincentives against self-provision (crowding out) that stem from means testing and the tax/benefit traps.

Identifying the potential for change

This in turn will allow us to measure the scale of the under-provision today, and to ***estimate the potential scope for increasing non-state provision*** if it were possible to scale back some aspects of state provision and reduce the role of means testing in the state system.

To see where the state could practically and rationally transfer current functions to non-state providers, we must attempt to ***identify which of today's benefits are truly contributory*** (on the model of savings and insurance) ***and which are genuinely non-contributory*** (welfare transfers between households). Since most benefits have evolved as a mixture of both features, we will need to measure how far each principle extends in each benefit, and to identify if and how they could be unbundled.

The next step must be to ***demonstrate the different strengths of state and non-state providers***, so that those strengths can be matched to the relevant array of human needs in order that our overall policy objectives can be met.

Creating the contractual framework

It will be necessary to ***create contractual clarity for both state and non-state providers*** alike. If the non-state sector is to make long-term investment with confidence, and the state sector is to reshape itself without leaving gaps, each must be clear about the overall aims that they seek to achieve. Disparate functions must be unbundled and assigned to the most appropriate provider. Means testing and other disincentives that could destabilise the new partnership must be avoided. And everyone must be confident that the new concordat will stand the test of time.

The non-state sector will have a number of issues to resolve. How can it reduce costs by extending its scale, packaging products more rationally, reducing complexity, and cutting its marketing costs? And some of this will ***necessarily involve public policy decisions***. For example, employer-based schemes might be a good way of generating volume and reducing marketing costs; tax incentives focused on employers may promote this; but might such a regime leave people unprotected when they are between jobs (as the US health insurance regime does), and is this not unacceptable?

The new partnership will throw up other issues that require policy analysis too. For example, ***non-state providers will want to limit their exposure to unquantifiable or correlated risks, to adverse selection or moral hazard, and to fraud***. Non-state providers already have mechanisms to deal with these, such as co-payments, caps on benefits payable, waiting periods and deductibles. We need to ***explore how far such mechanisms would be consonant with public policy***, such as where the state might need to step in to support anyone caught in these risk-avoidance gaps, or to encourage savings plans that would reduce the need for such welfare support.

Robustness in the political marketplace

The new partnership envisages not just a new division of responsibilities for state and non-state providers, but a more rational division of effort between the roles of saving, insurance, and welfare. Redefining these boundaries will not be easy. In particular, we will need to ***pick our way through the political debate*** and ensure that whatever new policies we devise are ***robust enough to survive in the political marketplace*** of the future.

Vision and programme

As we have already observed, an advanced society may be judged on how it treats its less fortunate members. In the UK for the last half-century, we have relied heavily and increasingly on the state to fulfil this task. But the boundaries between state and non-state provision have never been set in stone, and today, after half a century of growth, we have to ask whether the state is indeed well-equipped to shoulder all of the burdens that we have placed on it.

Yet redefining the boundaries between saving, insurance, and welfare — and in a way that most rationally suits the needs of today's society — by no means simple. How do we play to the strengths of each sort of provider, in ways that will best deliver the overall policy objectives?

To solve these problems, the Adam Smith Institute believes we need a three-point programme, and we are currently engaged on exactly this. Through research, interviews, events and reports, we will define and outline:

- ***the reasons for change:***
    - how large are the economic and human losses from today's confused system and perverse incentives
    - the case for focusing the state on broad distribution issues and harnessing the power of choice, competition and provision in insurance/saving provision
    - the gains in terms of greater responsiveness, more positive incentives, and increasing demand for saving/insurance services
- ***what can be done:***
    - practicalities of extending personal and employer action into specific benefit areas such as health, incapacity, long-term care
    - the commercial appetite of providers and employers to share the burden
    - overcoming practical barriers such as risk management, taxation, incentives
- ***the political route***
    - feasibility and politics of unbundling welfare-state services
    - public acceptability of a new state/employer/individual partnership
    - designing the tax and incentive structures needed to create change.