Financing the United Kingdom's Welfare States

Howard Glennerster

2020 Public Services Trust
at the RSA

E·S·R·C
ECONOMIC
& SOCIAL
RESEARCH
COUNCIL

Financing the United Kingdom's Welfare States

Howard Glennerster

2020 Public Services Trust
at the RSA

E·S·R·C
ECONOMIC
& SOCIAL
RESEARCH
COUNCIL

About the 2020 Public Services Trust

The 2020 Public Services Trust is a registered charity (no. 1124095), based at the RSA. It is not aligned with any political party and operates with independence and impartiality. The Trust exists to stimulate deeper understanding of the challenges facing public services in the medium term. Through research, inquiry and discourse, it aims to develop rigorous and practical solutions, capable of sustaining support across all political parties.

In December 2008, the Trust launched a major new **Commission on 2020 Public Services**, chaired by Sir Andrew Foster, to recommend the characteristics of a new public services settlement appropriate for the future needs and aspirations of citizens, and the best practical arrangements for its implementation.

For more information on the Trust and its Commission, please visit www.2020pst.org.

The views expressed in this report are those of the authors and do not represent the opinion of the Trust or the Commission.

Published by the 2020 Public Services Trust, March 2010.

2020 Public Services Trust at the RSA
8 John Adam Street
London WC2N 6EZ

ISBN 978-0-9562915-8-5

Author

Professor Glennerster is Emeritus Professor of Social Policy at the LSE where he specialises in the economics and finance of social welfare. He was Co Director of the Centre for Analysis of Social Exclusion there and Chairman of the Suntory and Toyota International Centres for Economics and Related Disciplines. He has been an advisor to H. M. Treasury and a member of the Secretary of State for Health's Advisory Committee on Resource Allocation.

Acknowledgements

The 2020 Public Services Trust and the author would like to thank the sponsor of this report, the Economic and Social Research Council.

Introduction to this series

The Commission on 2020 Public Services is a major inquiry into how public services should respond to the significant societal challenges of the next decade. The Commission is developing a practical but compelling vision of the priorities for public action to address the emergent challenges facing society in 2020. The Commission has three aims:

1 To broaden the terms of the debate about the future of public services in the UK.
2 To articulate a positive and long-term vision for public services.
3 To build a coalition for change.

This series of essays represents a working partnership between the 2020 Commission and the Economic and Social Research Council (ESRC). As part of our commitment to rigorous, evidence-based research, we jointly commissioned a series of experts to examine the key issues in public services. Two broad themes emerged: one considering future relationships between citizens, state and society; the other exploring the future delivery of public services.

Generous support from the ESRC has allowed the Commission to dig deep into a complex set of issues, and ensure its inquiry represents the best contemporary thinking on public services and society, with a strong evidence base.

Each paper can be read separately, and will also be available as a collected volume in the future. We believe that the research and analysis emerging from this partnership is a rich and significant contribution both to the ongoing national debate on public services and to the Commission's vision for the future. We hope that you enjoy the series, and we invite you to share your own reflections and analysis at www.2020publicservicestrust.org.

About this paper

Professor Glennerster's paper is timely and prescient. At a time when public finances are constrained and politicians are arguing about when and what to cut, Professor Glennerster brings a heavy dose of realism to the debate about the future of public services in Britain.

Professor Glennerster begins by setting out the scale of the long term issue, brought to a head by the short term political and fiscal crises. Accusing politicians of having an acute "case of myopia", he asserts that to continue to fund the current range of services, reduce child poverty and help the poorest elderly people pay for the costs of climate change will require an additional 4-6% of our GDP over the next twenty years.

Taking Professor Glennerster's estimates and adding them to HM Treasury forecasts, they increase the share of national income spent by government to over 45% by 2020 and nearer 47-48% by 2030. Yet public tax receipts have never been higher than 45% and rarely above 40%. So, while in the short run we are faced with a £178 billion gap (HMT Pre-Budget Report, 2009) between tax revenues and public spending, in the long run the situation would be still worse.

However, the additional burden of 4-6% outlined by Professor Glennerster refers to costs incurred through changes to the age structures in the population alone. Other known costs (such as transport infrastructure and low carbon technologies, for example) would put *yet more demands* on public spending. The budget deficit problem is one that is likely to continue to haunt us.

To meet some of these additional public spending demands, Professor Glennerster says we must:

- *Think strategically.* We need to think through which demographic, social and income groups are likely to face the greatest needs in the next two decades and which are in a position to make the greatest additional contributions. The younger generations cannot continue to support the increasingly lengthy retirements of older generations. For example, where people can work for longer (perhaps up to age 70), they should be free to do so – and sooner than the Turner pensionable age review is likely to timetable. Nevertheless, if people want to stop work earlier they should have the choice to pay more towards their retirement during their working lives.

- *Think of ways to share the burden with a new partnership approach to funding.* We need to consider what welfare state functions could be done differently. This could be a model of partnership funding in which the cost of services is shared between individuals and the state. This approach would enable citizens to exercise much greater choice about how they paid for, and contributed to, their services. For example, individuals could start to pay a social insurance premium after the age of 45 to help pay towards the cost of long term care potentially needed in later life. Evidence shows that this is the period in life when saving starts in earnest as households' spare capacity begins to mount and they begin to think seriously about the prospect of old age.
- *Think creatively about how services work.* How far can we get services to do more with the same resources? For example, GPs could be given more freedom to develop diverse mixes of private and public provision in consultation with patients. By giving citizens greater information about the costs associated with their public services (such as primary healthcare or higher education), and greater say in how the money is spent, citizens might choose to add to the resources available or opt out entirely.

At the same time, Professor Glennerster also warns of rhetoric about 'rolling back the state'. Although attractive to politicians, this solution may not be feasible. In particular:

- Proposals that reduce the state's role in delivery will likely still require state funding;
- Market solutions may not be viable. Often, the state has assumed responsibility for certain public services because of market failures that government remains best placed to resolve;
- The private sector is facing many of the same constraints as the public sector, such as rising labour costs, so there is no reason to think business will be able to fill the government's shoes; and,

- It may be possible to push social welfare costs back onto the family, but this would cost even the most fortunate families over half of their income and would be catastrophic for any family experiencing ill-health.

But the most striking argument Professor Glennerster makes is that *even if* all of his perhaps unpalatable recommendations were implemented, by 2028 the Exchequer would still need to raise a sum of 2-4% of GDP through general taxation. And this is just to meet the additional age-related cost drivers. Rising national debt (and a potential increase in the cost of servicing that debt), a long term need for infrastructural investment (such as transport and renewable energy) and rising citizen expectations of quality of public services are just some of the other elements adding to the overall price tag. The current system – even with tweaks and patches – is financially unsustainable. An informed debate with the public will be necessary to find genuine solutions to this predicament.

Financing the United Kingdom's Welfare States[1]

A long term problem not just a short term crisis.

There can be no doubt that the UK faces an immediate budgetary crisis. In forty years of public expenditure watching I have never seen a long term deficit of this scale. But even when the consequences of the immediate crisis have been dealt with, and that has not yet been done, another larger one looms driven by:

- Demography – a rising percentage of elderly in the population and the consequences of a lower birth rate in past decades. In combination this means fewer workers supporting an older population unless retirement ages rise, as they are beginning to do. The impact on public spending will be sharply felt in the coming decade and continue until mid century.
- The rising expectations of an increasingly well educated and choosy set of public service consumers. They are demanding more and better services available when and how they want them.
- Higher labour costs that high quality social services require. Productivity gains are much more difficult to achieve in human services.

Servicing the debt interest payments on recent borrowing in the medium term will overlap with the growing costs of merely sustaining the welfare state let alone expanding or improving it.

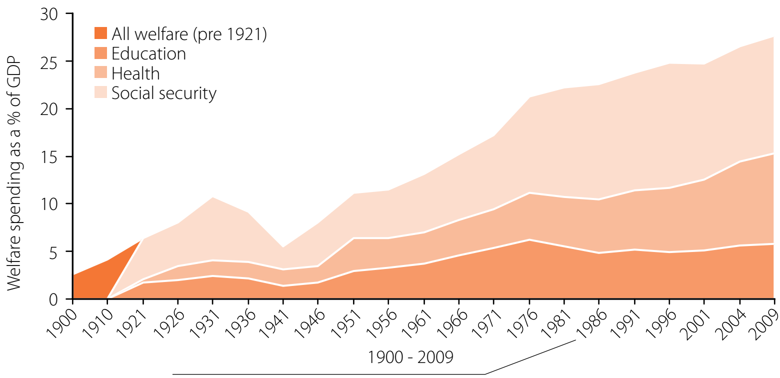
As the *Wall Street Journal*'s London correspondent put it before a recent election, 'the trouble is that the British want to enjoy European standards of social welfare but only to pay American levels of tax'. In the past decade British politicians have tried to give the electorate just that – a move to European standards of health

1 While largely funded by UK sources of revenue much of social policy discussed here is now administered by devolved administrations, excluding social security.

and education spending and higher social benefits without fully paying for them. The additional costs of financing the banking crisis make it impossible to avoid this longer term issue any longer.

In the years between 1986 and 2008/9 social policy spending rose by the equivalent of 5% of the GDP – see Figure 1. During the same period national revenue ("public sector current receipts") fell from 41.6% of GDP to 37.1%. (This excludes the effects of the present crisis according to the Treasury Pre Budget Report (Treasury 2009a). We might take the actual figure of 38.7% for the previous year as a better guide but the story is the same. Social policy spending has risen while tax receipts have fallen.) This trick of spending more on social policy and at the same time lowering taxes has been achieved partly by reducing other spending as a share of GDP – defence, subsidies to what were Nationalised Industries and other items – but part of the explanation is financing through higher debt. None of this can be repeated.

Figure 1: Welfare spending* in the UK 1900 to 2009



	1986	1991	1996	2001	2008/9
Education	4.8	5.2	4.9	5.1	5.8
Health and social care	5.7	6.2	6.8	7.4	9.5
Social Security (incl. housing benefit)	12.1	12.4	13.1	12.2	12.4
All welfare spending	22.6	23.8	24.9	24.7	27.7

Source: Glennerster (2007 updated)

* This includes the old Poor Law, modern social security, housing benefit and its predecessors. From 1987 some small items are included from agencies like the criminal justice system. They formed 0.5% of GDP in 1987. Social care spending has been removed from the official figures on social protection and added to health care for consistency with previous figures. Housing capital is excluded. Sources: Glennerster (2007 updated).

The Treasury (2009b) suggests that the UK is well placed demographically to pay for future social spending as our working population will rise and our state pension promises to the elderly are mean – not their language but the comparative reality. Yet that is not the whole story. Our record of being prepared to pay for such spending is not good.

The IMF (2009) suggests that for the advanced G20 countries as a whole the long term demographic impact on future social spending will be far more important than those produced by the banking crisis and that is especially true for the UK.

Once we have come to terms with the consequences of the banking crisis another much larger one looms.

The Ipsos MORI poll for the 2020 Public Services Trust[2] showed that the public split roughly 50:50 on whether they would be willing to pay more taxes to maintain standards of public services in the present crisis. The long term dilemma is greater still and it is not being discussed realistically.

Private alternatives face the same issues.

Doom mongers have forecast the end of welfare states before. The 'fiscal crisis' literature of the 1970s focused on the state's supposed inability to meet such pressures. In fact, no collapse occurred. Governments, and not just our own, have chosen to tax a little more, to cut back on over generous pension promises and spend more on social policy and less on other things (Castles 2004). Why?

What the previous analysis almost totally failed to see was that each of the factors that made it difficult for governments to fund welfare posed even greater problems for private market alternatives.

- Rising life expectancy raised the costs of occupational and private pension schemes. These effects were systematically underestimated by the private sector.
  - This has led to the widespread abandonment of defined benefit pension schemes based on end of life incomes. Firms have significantly reduced the size of their pension fund contributions and have shifted the risks onto individuals. But left to themselves individuals save far too little and we now understand better why this is the case from the insights of modern behavioural economics. The UK state has had to come back into this market

2 See www.2020publicservicestrust.org/news/item.asp?n=5531

to underpin it. (The best analysis of the economics and the history of this failure is to be found in the Pensions Commission 2005 and, more popularly in Peston 2008, Chapter 7.)

  - Private insurance to cover long term care has largely collapsed. The uncertainties that surround predicting the costs of long term care far into the future are just too great. On the demand side most people are even more reluctant to contemplate life in an old people's home and to insure to pay for it than they are to pay into pension schemes. (For the economics of this see Kings Fund 2006.)
- Rising relative labour costs apply as much to the private as to state services, indeed more so. What private schools sell are better staffing ratios. It is not surprising that private school fees have been rising at 6% per annum, faster than the incomes of those who usually buy their services.
- If these private service sectors were to become affordable to poorer families it could only be done by reducing their standards and their comparative appeal.
- If we provided vouchers to all families funded by the state for families to buy private education that would, at a stroke, increase the education budget. Extra money would go to the 7% or more of the population who now pay for their own children's education. There may be a case for doing so, if you come from the Conservative side of politics, but it would cost a lot of money.

In short, all the cost pressures governments will have to face in the next twenty years apply to private providers, insurers and the voluntary sector, only more so. There is no easy way out there.

Political heads in the sand

Nowhere in current political debate are these dilemmas openly recognised by politicians. None of the 'crisis' cuts envisaged for public spending by any party come anywhere near meeting the long term fiscal shortfall. No long term increases in tax are suggested by any party. Yet it is plain from many public opinion surveys, including that done for the RSA, that the public do not want reduced standards of welfare provision. When politicians attempt to talk 'tough' this usually takes the form of making individually eye catching proposals to save public money but none seem to be driven by any coherent set of priorities. Since two thirds of public spending goes on the welfare state this lack of any coherent fiscal strategy for its future means that politicians are giving us no realistic view of what our welfare futures might be. It means there is no attempt to create a constituency for the kinds of tax changes over the long term that will be required to sustain a decent welfare state.

'Rolling back the state?'

Clearly one route forward would be to withdraw the state from many of its current welfare activities. In his Hugo Young Memorial speech in November 2009 David Cameron used the phrase 'rolling back the state', but only to immediately qualify it, arguing for a 're-imagination of the state's role' not its retrenchment. A careful reading of the speech suggests few areas of long term retreat in state spending as opposed to state intrusiveness. He advocated:

- Better early years provision for young children;
- Sure Start to stay but be run by voluntary organisations;
- Better education;
- Increasing the working family tax credit for couples;
- Safeguarding the NHS budget; and
- "Recognise marriage and civil partnership in the tax system in the next Parliament." – quote from the Conservative Party Draft Manifesto. This must mean reintroducing the married persons' tax allowance in some form – a potentially hugely expensive promise.

Relying on voluntary organisations to deliver more services does not in itself reduce the cost. Demands on the NHS will continue to grow. Proposals to tighten the rules about claiming benefits are already in train and will be difficult to implement in a recession whose consequences may last a long time. Reductions for better off families on Child Tax Credit are tiny in overall spending terms.

The one clue we find in other Cameron speeches is that the definition of poverty should be more tightly drawn – concentrating on the really seriously poor. It may mean defining poverty nearer to 40% of median income than the present 60%. That would go a long way to abolish poverty at a stroke giving the opportunity to hold down all benefits perhaps in line with prices for a period. But no one is actually saying that.

There is a good deal to be said for reducing the scale and complexity of means testing that has grown under this government. The IFS and others have made suggestions to simplify out of work benefits. But even the IFS suggest this would cost money (Brewer et al 2008; Sainsbury and Stanley 2007).

In the end reducing the spread of means testing involves either increasing the speed at which benefits are withdrawn or giving benefits more universally. One increases those in poverty and the other increases spending.

The Liberals are no better. While asking for a less intrusive state and a more locally administered one their plans also include more pre school provision, lower primary class sizes and the gradual elimination of deferred university fees. While they propose to abolish the Child Trust Fund, which is more generous to the poor, their university funding proposals will largely benefit the above average earner and will be costly. They also propose to raise the limit at which individuals begin to pay tax. All this must imply significant increases in tax higher up the income distribution even before the demographic problem hits us.

In short, no party is currently addressing the fiscal problem with which we began.

The implications for family budgets of rolling back the welfare state

To severely reduce or role back state provision requires private households to spend a great deal more of their incomes paying for their children's education or taking out private health and long term care insurance.

I recently calculated what 'replacing the state' would cost a family with two children aged 14 and 18 (Glennerster 2009). I assumed they would pay into their own private pension scheme, educate their children privately, would be paying for them to go through university, would cover the family's health care through private insurance, take out long term care insurance and own their own house. Getting a range of quotes from insurance companies, schools and mortgage companies it was clear that these costs came to well over half of the income of an average family, depending on how much they could spread the costs of schooling and university over time. This was a conservative estimate. It assumed that the family was in good health and not faced with supporting a disabled child or a long term sick parent. In the absence of a way to pool social risks over a whole population the private insurance costs to the individual family will be much higher than the taxes it pays at present.

There is a perfectly respectable political case for making individuals more responsible for their own family's well being. But that policy entails a very large increase in the share of the family budget that would have to go to schooling or health insurance even for an average healthy working family. The consequences for anyone with long term sickness would be catastrophic and would require state help. Those who advocate the virtues of this approach have to have the honesty to spell out its implications for family budgets.

Devolving fiscal responsibility

Local government.

The Conservative Party has also made much of devolving power from the centre and reversing decades of central accretion of power. Again there is a powerful case here. Yet behind that centralising trend lies the steady erosion of local taxing powers. The UK has one of the very lowest levels of revenue raised locally of any advanced economy. Only 5% of tax revenue is raised locally. So, of course, central government dominates every service.

Yet, after a lengthy review of local government finance, the present government chickened out of doing anything (Lyons Inquiry 2007). That Inquiry showed that a local income tax was feasible in the medium term as were other local sources of revenue like a local business property tax or localising the revenue from vehicle licenses. A tax on car travel is now feasible, varied by miles travelled at more and less congested times and places. The Netherlands is about to embark on such a course. The Conservatives seem to have no plans to increase local taxing powers and indeed favour capping the council tax thus defeating their own major, admirable, policy goal.

To restrict or abandon the only property tax we have would further distort the tax system by leaving property under taxed. To really revive local government there is a case for retaining both the council tax and giving local government powers to tax income with central government helping councils with a very poor tax base.

Scotland, Wales and Northern Ireland.

Beyond social security there really is no longer a UK welfare state. Each of the devolved administrations administers their own health, welfare and education systems. Yet the overall scale of spending is determined at Westminster to a large degree. There seems to be a powerful case for devolving more taxing powers to these Assemblies so that they can make their own trade off between taxing and service quality. The Calman Commission (2008) made this case.

Local government finance and the proper funding of devolved powers are central to the basic argument I am making. If we wish to present real choices to the electorate we have to tie together more closely people's local knowledge of service standards with their capacity to do something about them - voting more, or less, money or forcing better administration of services.

A case of Myopia

Part of the democratic deficit on this issue has been central government's refusal to be open about the future costs of social policy. Until recently the Treasury's long term projections for social spending have systematically underestimated the impact of demographic change. The 2008 projections (HM Treasury 2008) did foresee age related spending, on pensions, health, long term care and education, rising from 20 per cent of GDP in 2007/8 to 25 per cent by 2037/8. But they assumed that two per cent of this additional GDP cost would be off set by reductions in the relative costs of other benefit spending. The Treasury maintained that there were no current policy commitments to raise other benefits in line with earnings, or indeed any other rule. Hence benefits were assumed to fall steadily relative to earnings. This generated significant 'savings'. As many people complained, that was unrealistic (Glennerster 2009; Hills 2009).

The latest Treasury (2009b) projections of long term spending have given up any attempt to include an overall future total though do include a range of estimates for health, long term care, education and pension spending. They have abandoned putting a figure to the offsetting 'reductions'. We believe that in the real world sustained reductions in the relative generosity of non pension benefits will not occur. The age related spending increases below must therefore be funded in full.

The new Treasury estimates for service spending are thus more varied and useful but may be still on the low side.

- Life expectancy has been consistently rising faster than projected in the past. The longer life expectancy variant in these figures thus looks more likely.
- The Treasury has assumed in the past that the length of healthy life would go on rising and that the proportion of life spent needing long term care would remain constant. This has been questioned. Some work suggests that the proportion of men and women over 65 suffering from poor or very poor health may have been increasing significantly since 2000 (Khoman, Mitchell and Weale 2008).
- Pressure to do something about the means and asset tested nature of long term care is growing. The present government policy is to move towards free personal care

for the most needy first. The Kings Fund (2006 table 57) estimated that completely free personal care would roughly double the costs of state funded long term care.

- There are strong trends all over Europe for more extensive and cheaper child care not least to support the fertility rate and encourage more women into the labour market (Lewis 2009). We can see the impact this is having on discussion in this country. Any moves to extend more help to young families would raise public spending even if it had positive longer run consequences.
- If non pension benefits were to be up rated in line with average earnings over the next twenty years this would require the 'non age related' spending to rise nearly in line with the GDP though this will depend on the share of the population able to work. It looks unlikely that we shall be able to rely on major 'savings' here.
- The IFS estimated the costs of taking nearly all children out of poverty as currently defined (living in a household receiving below 60% of median income adjusted for the size of the family in question). They concluded it would cost £37 billion in current prices (Brewer et al 2009). We are already assuming that benefits should rise in line with earnings or GDP per capita (see above). The cost of 'over indexation' to reduce child poverty would have to be added. Thus if we conclude that if future governments are pressed to retain the promise to reduce child poverty to Scandinavian levels it would cost 1.4% of the GDP by 2020 and more by 2030 if the child population rises somewhat on higher fertility assumptions.
- That policy would still leave working families with no children living on incomes well below the standard needed to live a healthy life (Glennerster et al 2009; Marmot 2010). Pressure to implement the Marmot recommendations would cost even more. I do not include any estimates below.
- I do add something for social welfare related costs of climate change - improving housing insulation and paying the higher costs of fuel and travel that would fall on poor families.
- We could also add some cost of improvement in the standards of services such as old people's homes. Surely no family in 2030 will accept current standards for their relatives' care. I shall assume that these pressures for improved standards will absorb any savings that might arise from increased 'productivity'.
- It is possible that, for example, drug prices might fall and the relative costs of health equipment might fall and that we all become healthier as the Treasury's lowest health projections suggest. On past experience this looks unlikely.

In short, the estimates of future rises in costs I set out below are extremely conservative; there are more 'upside' than 'downside risks'. Note that these estimates refer only to the effects of a changing age structure of the population. There will be additional cost pressures (such as need for transport infrastructure, affordable housing or renewable energy technologies) on public spending not captured in Table 1 below.

Table 1 Age related social policy spending as a percentage of GDP

	2009/10	2029/30	2059/60
NHS	8.0	9.3	10.7 (8.0-11.2)
Long term care			
As now	1.2	1.7	2.2 (1.9-2.7)
Free	-	(3.4)	(4.4)
Education	6.5	6.5	6.3
Public sector pensions	1.8	1.9	1.8
State pensions	5.5	6.0	8.0
Reduced child poverty	-	1.5	1.5
Climate change impact[3]	-	0.5	0.5
Total	**23**	**27.4**	**31.0**
Additional to 2009/10	-	4.4	8.0
With free personal care	**-**	**29.1**	**33.2**
Additional to 2009/10	-	6.1	10.2

Source: Treasury 2009b - mostly mid points of the range or ONS principle projection. Also see text. Bracketed range reflects the Treasury projections.

Summing up we reach the conclusion that it will take more than an additional *four per cent* of our GDP over the next twenty or so years merely to deliver what we now do, significantly reduce child poverty and help the poor pay for climate change. If free personal care were included that figure rises to *six per cent*. If we look further ahead to 2060 the figures would be much larger still.

Others come to the same kind of conclusion. Hills (2009) concluded that demography alone would add 6% to the share of public spending in the GDP by

3 A certain part of the impact of climate change, it could be argued, will be felt disproportionately by the elderly in terms of heating costs. This estimate seeks to capture the age-related social cost of climate change.

2046 assuming that all benefits in cash and kind were allowed to rise in line with GDP per capita growth.

So different methods and assumptions produce slightly different results but they all suggest significantly higher taxation will be needed merely to do what we are doing now let alone what politicians say they want to do in addition.

This future is incompatible with the limits electorates have implicitly set to taxation, and hence public spending, since the crisis of 1976, namely 40% of GDP. Total public sector current receipts have varied between 37 and 45% of GDP over the past nearly forty years. Only 17 times has a government increased the share of income taken by the tax man to over 40 % and then only by an average of less than 2.5%.

It is clearly possible to tax at higher levels than that and not face the country with economic disaster, as the Continental and Scandinavian countries show, but electorates have to be prepared to acquiesce. If they do not we end up with unsustainable levels of borrowing that derive from political cowardice.

So what should do we do?

- *Think strategically.* We need to think through which demographic, social and income groups are likely to face the greatest needs in the next two decades and which are in a position to make the greatest additional contributions.
- *Think of ways to share the burden.* We need to consider what welfare state functions could be done differently, repatriated to the family or local communities or where costs could be shared between taxpayer and user to a larger extent.
- *Think creatively about how services work.* How far can we get services to do more with the same resources?

Should we shift the fiscal and work balance from the young to the old?

In the next thirty years the share of the population over 65 will rise from 16% in 2008 to 23% in 2033. Within that the share of the population over 85 will double to 5%. Should we ask the younger generations to shoulder more of these costs? My answer is no.

The hard truth is that the older age group in the past twenty to thirty years has enjoyed an extraordinary bonus of healthy leisure and higher pension incomes compared to their forebears. This has been enjoyed, in large part, as a result of raising the tax burdens on families where both husband and wife are now working.

Retirement age

One of the most important reasons for rising social expenditure has been the fact that life expectancy has grown sharply and faster than expected since the Second World War. The length of working life has not risen in line. Indeed, for many years it fell as pensions enabled people to retire earlier. (My father entered paid work at age 14 and retired 51 years later. There are very few who could boast that today. A similar length of post education work would take most people up to retirement at 73!) In 1950 males spent 18% of their adult life in retirement. By 2004 this percentage had risen to 30.5%. If we keep spending a longer and longer part of our lives not working the cost of pensions will rise.

The Turner Pensions Commission (2005) suggested that this share (30%) should not rise further. Thus, as the expectation of lifespan rises, so, too, should the age at which a full pension can be drawn. Though applying only to state pensions this sends a strong signal to those in work that they should set their sights on retiring later and planning their own pension to do so. Remarkably, to many politicians' surprise, the public accepted the logic of later retirement. The proportion of people working up to the state retirement age has already been rising (Treasury 2009b). This public acceptance was helped by the fact that the proposal to raise the full pension age was pushed into the future- until 2026 after the date at which women's pension age, after rising from 60, reached 65 (2020). The Conservative Party propose to do this for men in 2016 and for women later.

At present the government plans to raise the full pension age in stages to 68 by 2046. The expectation of lifespan at 65 has risen nearly a year for men and women since the Turner figures were estimated for 2003-5. Healthy life expectancy of those aged 65 rose by about 2.5 years in the twenty years from 1981 and is now over 14 years for women and over 12 years for men. Over the past thirty years expectation of lifespan at birth rose steadily- for men by six years and for women by five. It looks like continuing to do so. The Turner Commission suggested regular reviews of the full pension age. Such a review would now probably recommend that full pension age should rise to 69 or 70 by 2050 and the process should start earlier than is now legislated.

The objection to this line of argument is that many people, and mostly those who have done manual jobs, pass the capacity for sustained work much earlier than others. It is all very well for academics to suggest retiring at age 70 but not for building labourers, or ex miners or steel workers. Indeed, three quarters of the population at birth do not have a healthy life expectancy of 68. That was even more so when the retirement age was set at 65, of course. Many working men never have reached retirement age.

The answer has to be that there will be medical tests that determine capacity for work and those who cannot work on will be able to draw a pension or some other kind of state benefit. They already do. These numbers may be quite high. But most people, in fairness to their hard pressed children and grandchildren, should work longer both reducing the need for pension spending, public and private, and increasing tax revenue. Yet people should have a choice. If they wish to retire at 65 and pay more during their working lives they should have the opportunity to do so. Pension schemes, including the state scheme, should make this an easy option to take rather than the rigid rules that apply today.

How can the state and the individual share responsibility for a decent old age?
Individuals do not take adequate steps to save for their own retirement without help. Modern behavioural economics shows us why. Not only is the financial market too complex but even if people understand the decisions they need to take it always seems rational to put them off until tomorrow. Yet people can be helped to make such decisions. That is the basis for the new national scheme of approved individual pension accounts into which people are to be encouraged to save for retirement. If employees are not members of an approved occupational or other scheme four per cent of their earnings will be taxed away and put in a state approved pension pot unless they object. Employers and the state must match that contribution with the state helping through tax relief.

The state must play an additional crucial role. Private savings have to be built on a secure and adequate state pension platform. That is something we do not have. Hence the state needs to increase the basic pension in line with average earnings otherwise the scale of means testing will continue to rise and the incentive to save decline.

Hence the new pension arrangements that are to come into force in 2012 provide a good example of the ‘partnership principle’ I am advocating. But it has to be said neither the long term commitment to raise the basic pension or the scheme itself is yet in place. This will be a crucial test. Without that basic state pension floor many people will feel their savings are not worth undertaking. Any new government will have to decide when it will raise the basic pension in line with earnings. If it decided to put off that move, or abandon it altogether, the long term partnership model would be put at risk.

Are there unfair gainers in the collective contribution to some older people?

Tax treatment of private pension contributions

The total of tax relief paid to those with private pensions amounted to £20 billion in 2008/9. Most of this huge sum went to those on above average earnings – the higher the income the more the subsidy. For those on lower incomes this encouragement to enter some pension arrangement is worth while. For those on higher incomes the impact is doubtful. Much of the effect is merely to shift the form in which individuals save rather than the total.

The present government has begun to limit such tax benefits at the top of the income range and took this further in the Pre Budget Report in December 2009 but it could go further still by putting a lower tax credit limit on the sums that can be derived in this way. This cap could be imposed in cash terms and gradually tightened.

Public sector pensions

At the moment a large slice of public expenditure will go to subsidise public sector workers' pensions. In ten years time they will be costing the exchequer nearly 2% of the GDP. Current workers' retirement ages are not to rise in line with the above targets. The finance of these schemes requires large tax payer support. Private sector workers have had to suffer serious down grading in their pension schemes but this has not happened in the public sector. It is argued that these workers have had a long term bargain where they agreed to be paid less in return for security and a better pension. But public sector wages are not below those of most private sector workers now and their pension agreements are much more generous. The rules which govern these schemes have been tightened and limits put on the Exchequer's obligations but there is further to go.

How can we share the preparation for long term care?

This is another classic case where the state cannot simply walk away and hope people will provide for their own long term care. Nor can it afford to do all the work from general taxation. A partnership is needed.

There are well known problems with the market for long term care insurance. For insurers there are grave difficulties in estimating the future costs of long term care they will have to meet for anyone taking out a policy. Life expectancy and the scale and intensity of care are difficult to estimate a long way ahead. The estimates keep changing and there are ‘moral hazard’ problems that arise. Families now do the bulk of care. A small shift in that preparedness to care by families would cause havoc to the estimates of likely cost. The better the care the more the incentive for a family to use a private long term care home.

Then there are problems for the person who might want to take out insurance. Doing so a long time in advance might be quite cheap but few young people think seriously about their chances of ending up needing intensive care late in life. Once old and with problems emerging the costs are very high.

The recent government Green Paper, ‘Sharing the Future of Care Together’ (Cm 7673), put forward some reasonable options and importantly suggested that people might be given some choices in the path they took. Less encouraging was the lack of detail on how the options might work or what they might cost.

One route is social insurance. For all the reasons listed above social insurance is the most efficient solution. It can accommodate the uncertainties involved and it pool risks over the whole population. In Germany both workers and pensioners pay 2% of their income in a dedicated contribution to long term care costs. When they need it the severity of their need is assessed and they can receive either care or cash to allow the person and the family to buy care themselves. Since people only begin to appreciate the problem of old age in later life there is a case for applying the tax later – say from 45 on. An age identifier could be built into individuals’ National Insurance numbers to trigger a required additional contribution. That would entitle people to benefit rights as in Germany. We know that after 45 is the period in households’ life courses when saving starts in earnest. This suggests that households’ spare capacity begins to mount then and that people begin to take seriously the prospect of old age.

There is a case for giving people the opportunity to add to the basic care package the state might provide or to opt out of this route altogether into their own private insurance scheme. The scale and quality of the scheme would have to be approved by government. It would have to be good enough for the individual not to fall back on the state. Such a choice could lead to those with family histories of good health (absence of a history of Alzheimer’s, for example) getting a better deal (cream skimming). This danger would require a statutory minimum contribution rate but does not eliminate the case for such a choice.

Another option is for people to choose to pay an upfront capital sum that would give them the right to care later. Although the amount would have to be large enough – and the sum is difficult to calculate given the uncertainties I discussed earlier – this option should not be ruled out.

Yet another option is that people could agree to pay the costs of any state care they received when they died plus interest. This charge would be assigned to the deeds of their house or estate. A sum would be taken off by the state when they died or when a house was sold. If not paid off the debt would pass to the family.

None of these ideas are politically easy or technically simple but options for people to *choose* how to pay for their long term care would alert them to the issue and link payment to benefit. Choice would require time and thought and a default option – pay a 2% tax. But at least options would be on offer.

Options for health funding?

If these arguments apply to long term care why not health?

One answer is that the diversity and scale of financial risk is so much greater. A lifetime of serious disease or disability, mental health, care in old age or very serious illness are so expensive that no private insurer will take on such risks, at least without very high premiums. These conditions take much of the NHS budget. That is why private insurance is largely confined to the healthier, better off working population!

Other countries do things differently certainly. Social health insurance makes it clearer to people what their health insurance costs are. But in practice it usually puts the burden on employers of the working population even though most of the costs of health care arise in the non working population. Employers are not likely to welcome any such move here.

The Dutch have a specific health tax. The Swedes have a local health tax. Both bring home to people the costs of rising health care.

However, overall the arguments for big upheavals in the way we fund health care seem weak. There is a case for devolving continuing care health budgets to individuals in a way that would give them more freedom to determine how to spend state funded resources and add to them. GPs could be given more freedom to develop diverse mixes of provision in consultation with patients.

Distributional equity. Should we apply the benefit principle more widely?

Since Adam Smith's days there have been two principles for a fair tax. One is that it be set to take account of people's capacity to pay. The other, rather neglected, is that it should reflect the benefit they derive. If the benefit is largely confined to them

– such as a local road – the cost should be shared by the users. There is a case, in equity, for taking the benefit rule more seriously. Two examples illustrate this.

Site values

When a local authority improves a local park or raises the standards of policing in a 'rough' area or the local school SATs results improve, those living in the area reap a windfall gain – their property values rise. When a major new development takes place, like a new shopping area or underground or tram facility, local property prices rise sharply. 'Planning gain' arrangements try to recover some of these last private benefits from public activity but only to a limited extent. A tax on rising site values, a betterment tax or some equivalent, is again a perfectly feasible technical option. Property owners have been remarkably effective in blocking previous attempts to tax their unearned gains.

Higher education

To some extent we all benefit from living in a more highly educated society. But a large part of the gain derived from a graduate's education is reaped by the graduate. What is more graduates come from relatively better off families as well as going on to earn significantly more than non graduates with similar school level qualifications. It is probably true that their jobs are more satisfying too.

For the last few years ex students have been repaying some of the costs of their higher education through the income tax system. The maximum sum they repay was designed to be no more than about a quarter of their costs for those who repaid in full. Those with lower earnings and interrupted work patterns, notably women, will pay much less than this - roughly half in fact. There is a cut off for repayment after 25 years and many women have not repaid in full at this point.

The sums repaid per month are quite small compared to other forms of tax. Someone with annual earnings of £25,000 this tax year will be paying £485 in tax and NI per month. Her student loan repayments will be £67.50. For someone on £50,000 the sums will be £1,182 and £262.5 (Barr 2010).

Such an ex student will still be contributing considerably less than the full cost of her education partly because the fee is only a quarter of the average cost (less now in fact) but partly because of the delay in payment, effectively a kind of loan from the state. This carries no interest. This implicit subsidy counts as public expenditure in the national accounts. It is also wasteful because it encourages families who could afford to pay for their children's education to use the delayed payment as a subsidised form of borrowing.

The sums involved are large. The cost of the zero real rate of interest and the 25 year write off in 2007/8 was about £1 billion or almost a tenth of all public spending on English higher education. On average 29 pence out of every pound of maintenance loan is not repaid because of the interest subsidy. The comparable figure for the fees loan is 42 pence. The subsidy to the average graduate in the middle quintile of life time earnings for graduates is £6,195 or about a third of the value of the average loan. Overall about half of the true value of the debt graduates owe government is not repaid. Of this, 15% is because their life time incomes will be too low. This element is entirely legitimate and the point of an income contingent loan repayment scheme. The case for the rest of the public expenditure cost is hard to make. (These figures derive from Barr and Johnson 2009.)

There is therefore a case for both charging interest on the loan and a higher share of the tuition cost. There is also a case for extending the period over which the loan is repayable but it is less strong.

- Interest on the maintenance loan and the fee element should be charged at the rate at which governments have to borrow over the long run, say 3%.
- Fees should be permitted to rise to reach 50% of the tuition cost or indeed even higher in the long term.
- The maximum repayment period could be extended, though this would fall most heavily on the lower end of the graduate earnings distribution.
- The cost of paying for those students who cannot repay in full could be made to fall on other graduates not the taxpayer. This could be done by charging above the government borrowing rate. This is to go too far in our view. Such a subsidy to low life time earning graduates is arguably best done by the general taxpayer.
- It might be possible to sweeten the pill of charging interest on the state's loans by reducing the 'graduate tax' rate.

If some students felt that paying half the cost of their university education was too much and did not stay on that could be seen as an efficient outcome. If it really is the case that university education is only worth half its cost to a potentially well off and informed individual it is probably better for everyone that he or she does not undertake it. At present 80% of children from the professional and managerial classes go to university. This may well be more than optimal – the result of inertia rather than a choice with a realistic price tag attached.

Experience since 2004 in the different parts of the UK suggests that access to university in England has not been reduced by the new 'graduate tax' nor has access by children from poorer homes. Demand for places and entrance to university has grown faster in England than in Scotland or Wales where no such changes in fees policy took place. Access in class terms narrowed slightly in England but not in Scotland and Wales. (Evidence is again contained in Barr's evidence to the Review.) Clearly moves to raise fees and remove interest subsidies would have to be closely monitored to watch for unwanted side effects of the pace of change. The direction of policy should also be clear.

Charging fees for other services

This has been a favourite device in the past both in the UK and abroad. We charge for dental and optical care. The French health care system makes people pay 20% of their doctors' fees, partly recoverable through additional insurance, and charges for hospital accommodation. The Swedes pay a charge when they go to their GP. We charge older people for care in England. However, there are strict limits to the political viability of this approach in services other than higher education which confers future income benefits directly on its recipients.

- An appealing political case can usually be made for exceptions – the old, the long term sick, nursing mothers, children, those on income support. As a result 85% of all NHS prescriptions are free.
- We know from work done in the US many years ago in the Puget Sound HMO (Health Maintenance Organisation) that charging to attend a primary care physician can delay approaching the doctor. This results in later diagnosis and more costly treatment.
- If the fee is kept very low to avoid deterring people from seeking care this still requires a charging structure in each GP surgery and the administrative costs could outweigh much of the revenue. Much the same is true of charges for hospital accommodation as we move to day cases and those who stay are often the elderly, the long term sick and poor.

Some rough estimates of the scale of taxes or mixed funding required

None of the suggestions in this paper will prove popular. How much would they save the Exchequer or raise in 'quasi' taxes?

- Raising the full pension age to 68 for men and women by 2030 would hold the cost of pensions constant as a percentage of the GDP (Turner 2005; Figure 1.46) a saving of 0.6% of GDP. To try to do so up to 2050 would require a pension age of nearly 73! Recent work by the National Institute gives a higher figure taking account of the larger GDP that would be earned by the new workers and other effects (Barrell et al 2010). But it is rather optimistic about the extent to which raising the full pension age would result in a longer working life.
- Reducing the cost of public sector pensions by a quarter though later retirement and higher employee contributions could save 0.5% of GDP.
- Putting a tax credit cap on tax reliefs for private and occupational pension schemes might reduce tax expenditure by half or 0.7%.
- Making the present private contribution to long term care more acceptable would not actually save money compared to now but it might avoid additions to public spending. Because many people will not contribute to a long term care social security tax or have the assets to repay afterwards it is unrealistic to assume that our various suggestions would remove the whole cost from the general exchequer. Reducing the cost to its present level despite longer life and a move to more free personal care would require new forms of funding equivalent to about 2% of GDP.
- Ending the interest rate subsidy on student loans, applying a 3% interest rate and raising the maximum fee to roughly half the tuition cost could save the Exchequer a possible 0.4% of GDP in the long term. Actual savings would depend on the future pattern of graduate employment and places funded and the speed with which fees were raised. It would also depend on how much the government wanted to use the extra revenue not to save money but to increase universities' resources which would otherwise not be possible.

Table 2 Savings/ alternative sources of revenue as a percentage of GDP 2030

Extra costs from Table 1	**4.4**
Savings	
State pensions – raising the full pension age to 68 by 2030	0.6
Public sector pension changes	0.5
Reduced tax relief on private pensions	0.7
Higher university fees and an end to loans subsidy	0.4
Total excluding long term care	**2.2**
Including costs of free personal care and new funding arrangements	4.1

In short, if all these less than popular measures were taken together it might reduce the welfare state's claim on general taxation that otherwise would otherwise arise by 2030. It would not eliminate them.

Summary

- I have argued that politicians have not been straight with people about the tax implications of sustaining a viable welfare state.
- Part of the extra costs need to be shared with the state not exclusively shouldered by taxpayers, especially not younger taxpayers.
- Even when we assume the government will take measures to share the future costs with service users in longer working lives, private pensions, or 'quasi' taxes like student repayments or long term care contributions, significant extra traditional taxes will be needed.
- People need to have more choice in the financing methods they face.
- These implications are economically sustainable over the next twenty years but they need to be argued and people's support won.
- The alternative of families paying for their own children's schooling, university tuition and their own health care would be even more costly for family budgets, especially the uncertainty involved if their health or earnings were to falter.

References

Barr, N and Johnson A. (2009) 'Interest subsidies on student loans: a better class of drain' Available from n.barr@lse.ac.uk

Barr, N. (2010) *Paying for higher education: What policies in what order?* Submission to the Independent Review of Higher Education Funding and Student Finance n.barr@lse.ac.uk

Barrell, R., Hurst, I. and Kirby, S. (2010) *How to Pay for the Crisis or Macro economic implications of pension reform* London: NIESR

Brewer, M., Saez, M. and Shepherd, A. (2008) *Means testing and tax rates on earnings: Evidence to the Mirrlees Commission* London: Institute for Fiscal Studies

Brewer M., Browne, J. Joyce, R. and Sutherland, H. (2009) *Micro-simulating child poverty in 2010 and 2020* London: Institute of fiscal studies

Castles, F.G. (2004) *The Future of the Welfare State: Crisis Myths and Crisis Realities* Oxford: Oxford University Press

Calman Commission (2008) *The Future of Scottish Devolution within the Union* (www.commissionscottishdevolution.or.uk)

Cm 7673 (2009) *Shaping the Future of Care Together* London: The Stationery Office

Glennerster, H. (2007) *British Social Policy 1945 to the Present* Oxford: Blackwell

Glennerster, H. (2009) *Understanding the Finance of Welfare: What it costs and how to pay for it* Bristol: Policy Press

Glennerster, H., Bradshaw, J., Lister, R. and Lundberg, O. (2009) *Reducing the Risks to Health* CASEpaper 139 London: LSE/CASE

Falkingham, J. and Hills, J. (1995) *The dynamic of welfare: The welfare state and the life cycle* Hemel Hempstead: Harvester

Hills, J. (2009) 'Future pressures: intergenerational links, wealth, demography and sustainability' in J. Hills, T.Sefton and K.Stewart *Towards a more equal society? Poverty, inequality and policy since 1997* Bristol: Policy Press

International Monetary Fund (2009) *Fiscal Implications of the Global Economic and Financial Crisis* IMF Staff Position Note SPN/09/13 Washington DC: IMF

Khoman, E., Mitchell, J. and Weale, M. (2008) 'Incidence-based estimates of life expectancy of the healthy for the UK: coherence between transition probabilities and aggregate life tables' *Journal of the Royal Statistical Society Series A* Vol 171 (1) pp 203-22

Kings Fund (2006) *Securing Good Care for Older People: Taking a long term view* London: Kings Fund

Lewis, J. (2009) *Work-family Balance, Gender and Policy* Cheltenham: Edward Elgar

Lyons Inquiry (2007) *Place shaping: A shared ambition for the future of local government* London: The Stationery Office

Marmot Report (2010) *Fair Society, Healthy Lives, Strategic Review of Health Inequalities in England* London: UCL

Pensions Commission (2005) *A new pension settlement for the twenty first century; Second report of the Pensions Commission* London: The Stationery Office

Peston, R. (2008) *Who Runs Britain? And who is to blame for the economic mess we are in* London: Hodder and Stoughton

Sainsbury, R. and Stanley, K. (2007) *One for all: active welfare and the single working-age benefit* London: IPPR

Treasury, HM (2008) *Long-term public finance report: an analysis of fiscal sustainability* (www.hm-treasury.gov.uk)

Treasury, HM (2009a) *Pre- Budget Report 2009* London: The Stationery Office

Treasury, HM (2009b) *Long-term public finance report: an analysis of fiscal sustainability* London: HM Treasury (www.hm-treasury.gov.uk)