SOCIAL INSURANCE IN TRANSITION

An Economic Analysis

Creedy and Richard Disney

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and

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Introduction

It is now widely accepted that the state has a major role to play in ensuring that people have sufficient resources to deal with those contingencies which reduce, either temporarily or permanently, their capacity to obtain income on their own account. These contingencies include unemployment, sickness and invalidity, and old age. The major role of the state in Britain is illustrated by the fact that public expenditure on social security in 1984–5 exceeded £37 billion; over 30 per cent of centrally financed government expenditure.

Nevertheless there is rather less agreement concerning the best form of state intervention to provide social security, and the appropriate extent of state provision. In the present economic and political environment, the latter concern has been given a major emphasis, with state provision increasingly questioned in the light of overall reductions in government spending and a debate concerning the optimal extent of social, relative to private, provision over a wide range of economic activities.

The form of state social security provision which developed in the United Kingdom from the turn of this century, reaching its apotheosis in the Beveridge Report (Beveridge, 1942) and the subsequent post-war legislation, was embodied in the concept of 'social insurance'. In brief, social insurance was based on the idea that the state should operate a quasi-insurance system, exacting compulsory 'contributions' from the working population in order to finance the payment of benefits when certain contingencies occurred: notably unemployment, sickness, and old age. It has been argued, most recently by Dilnot, Kay, and Morris (1984), that this conception of social insurance was fatally flawed from the start. It is easy to see that a scheme of social insurance is not the only form of state social security provision that might be envisaged; for example the state could alternatively finance a range of income transfers entirely out of general taxation. Indeed there developed in the United Kingdom, side by side with the social insurance system, a variety of other income transfers; these include means-tested social security benefits such as Supplementary

Benefit and Family Income Supplement. The complexity of state provision, stemming partly from the operation of several distinct forms of intervention, has served as a focal point for much criticism.

In the past ten years, sweeping changes have occurred in the social security system in the United Kingdom, including the introduction of a new and complex pension scheme, changes in the level of and eligibility for unemployment benefits, the institution of a new scheme of short-term earnings replacement for the sick, and significant administrative changes in the operation of the means-tested sector. The system has in fact been in a state of flux right from the start, but as the title of this book suggests, the extent to which these recent changes have altered the whole character of social insurance provision in the United Kingdom suggests that the system is no nearer to a generally accepted steady state. Indeed the major reforms of the past decade have if anything intensified expressions of dissatisfaction with the social security system, both as a whole and in its constituent parts. For example, the Institute for Fiscal Studies, the National Consumer Council, and many witnesses to the Treasury and Civil Service Committee Sub-Committee (1983a) have all recently been seeking radical reforms of the whole tax and transfer system. Furthermore in May 1984 the government instituted a series of Social Security Reviews in order to examine the operation of various parts of the social security system in the light of overall government budget constraints and it is likely that further changes will occur in the not too distant future.

The present book represents a further contribution to this debate. Unlike some recent contributions, however, its central concern is not simply to propose another 'blueprint' for the reform of the social security system. Rather it seeks to examine in depth the operation of the social security system in the United Kingdom from the point of view of economic theory. It uses as a framework a set of general economic criteria by which to judge the extent and nature of state provision. The book therefore attempts to provide a rational analysis of the issues, rather than proposing a scheme which necessarily embodies a set of value-judgements. Since the concept of social insurance underpins much of the system, it is natural to commence the analysis by starting with a treatment of risk. Chapter 1 therefore posits the existence of risk, reflected in contingencies such as unemployment and sickness, as being a major factor determining the extent and kind of state social insurance provision.

Now the extent to which the state, as opposed to the private sector, should insure these risks, and the nature of this insurance offered by the state, is conventionally conditioned by four motives for state intervention: market failure, paternalism, redistribution, and revenue raising, with the relative administrative efficiency of public and private provision as an additional factor (see, for example, Diamond 1977). These motives are described in more detail in Chapter 1 and then used in ensuing chapters. It will be seen that in considering the motives for state intervention, differences in policy choices can arise both because people take different views about economic behaviour and the effects of policies, and/or because they adopt different basic value-judgements. Since a full rationalization of government policy is seldom, if ever, given at the time, the evaluation of policies is fraught with difficulties. However, the analysis of Chapter 1 is used in an attempt to assess the extent to which actual state intervention in the United Kingdom appears to have been motivated by, or at least is consistent with, one or more of these criteria. This approach underlies Chapter 2, but also underpins much of Part 2, which discusses the provision of pensions, and Part 3, which examines the schemes of unemployment and sickness insurance operating in the United Kingdom.

The procedure may be illustrated by the example of the radical change in state pension provision in the United Kingdom in the mid-1970s. From public pronouncements, the motive of redistribution *within* age cohorts seems to have underlain the introduction of the new state earnings-related pension scheme in 1978, although previous extensions of state pensions in the United Kingdom have been motivated by each of the suggested criteria at one time or another. Yet, as Part 2 shows, a careful analysis of the post-1978 scheme, using a precise definition of redistribution, shows that the redistributive content of the scheme is very limited. Several possible conclusions follow from this. These include the possibility that the actual motives behind its introduction were somewhat different from public pronouncements on the subject; for example actual motives may have included a desire to extend the tax base in return for promises of better benefits in the future (a revenue-raising motive) or in order to promote a higher savings rate (the paternalist motive). Another possibility is that the originators of the scheme actually had insufficient information and an inadequate conceptual analysis with which to form any judgement as to whether the scheme was redistributive or not.

It is clearly necessary to consider the nature of the policies to be adopted, *given* the nature of certain basic value-judgements. It is important to consider, for example, the extent to which trade-offs among policy objectives must be made. A number of alternatives are therefore examined, although a complete 'optimization model', which may for example specify the optimal policy choice, given a fully specified social welfare function in terms of individual utilities, has not been used. A more basic approach has been used which nevertheless allows a number of simple policies to be compared. Taking the pension scheme as the example again, the question may be posed as: given a desire to secure redistribution within generations, what kind of state pension scheme would be appropriate subject to low administrative costs? It is apparent that the solution would not be the present scheme but one in which, broadly speaking, flat rate benefits were financed by a progressive tax schedule. Even with a desire to limit the degree of redistribution, it is again not apparent that the 1978 scheme would represent the optimal solution. To take another example, this time from Part 3: it is almost impossible for a state unemployment insurance scheme to replicate the working of a private insurance scheme. It is likely that a state unemployment insurance scheme will of necessity contain a high degree of risk-pooling and consequently some degree of systematic redistribution. Measures to limit redistribution will therefore have, and indeed have had, serious repercussions, especially concerning eligibility for benefits and increasing reliance of claimants on the administratively costly means-tested sector. Again rational policy analysis might, depending on the precise trade-offs, suggest acceptance of a greater degree of systematic redistribution in the social insurance scheme, if administrative efficiency is held to be a major aim.

It will be apparent from this brief discussion why this book is not primarily motivated by the desire to promote, or justify, a single overall reform of the social security system, even though in the course of the book it will be argued that there are many aspects of the present scheme which do not consistently meet the criteria of Chapter 1, and that there seems to have been a lack of foresight in the design of several of its parts. The primary motive of the book is analytical rather than polemical. As in other fields, however, general opinion concerning social security follows 'fashions' at any point in time and in recent years the trend, reflected for example in the Treasury and Civil Service Committee Sub-Committee reports and evidence, and described in the recent book by Hemming (1984), has been towards an emphasis on the issues of poverty alleviation, labour supply, incentives, and the operations of the 'unemployment trap' and 'poverty trap'. This fashion has perhaps been underpinned by a shift in the perception of social security, away from the Beveridge conception of social security as a framework of social insurance against specific contingencies and towards social security as part of a system of taxes and transfers, although this view too has its antecedents such as Rhys-Williams (1942, reprinted in 1953) and Friedman (1962). These issues, most notably the operation of the tax and transfer system as a whole, are important and are covered in Part 4 of the present book. As will be apparent from the preceding discussion, however, the same criteria which are used to appraise components of the social insurance system should also be relevant in examining the tax and transfer system as a whole and possible modifications to it. Thus even apparently laudable aims such as, on the one hand, abolishing the 'poverty trap', or on the other hand concentrating resources solely on the poorest, should take account of the trade-off between different criteria which is essential in social security analysis and should be explicit in their rejection, if that is the consequence, of other motives underlying state intervention.

In Part 5, the themes of the book are restated, drawing on the conclusions of Parts 2 to 4. As outlined previously, the use of these motives as evaluative criteria permits a detailed appraisal of the operation of the social security system as a whole and its constituent parts. Their use suggests that there are parts of the social security system which are extremely difficult to justify whatever motive or combination of motives are held by the analyst. As indicated earlier, the social security system is unlikely to be in anything other than a state of transition. There is no simple solution to any of the many perceived problems, but progress can only be made with a more precise awareness of the nature of the issues involved.

PART 1

Social Insurance: Theory and History