First steps towards privatising the welfare state

The first step towards the privatisation of the welfare state was announced last week, as the Government announced radical plans to change the state pension system. As pensions are the most costly part of the social-security budget and are a centrepiece of the post-war welfare state, change is long overdue. While the basic principles of a decent education, health system and pensions are still valid, there is a need to bring the whole welfare system up to date. Not only has the nature of the family changed, but so too has the whole working environment. Hence the move towards personalising pensions.

The main pressure for a change to the pension system is the desire of the Government to reduce future costs. But it is also essential any changes provide a safety net and ensure pensions are adequate and will not condemn people to poverty in old age.

All industrialised countries are encountering the same problem, as government debt to GDP ratios rise. The main factors explaining this are rising pension and health-care costs. Alongside the persistent cost of high unemployment this has pushed the UK social-security budget up to £93 billion a year. This is the biggest element of government spending, equivalent to £15 per working person per day. Pensioners account for 45% of social security spending.

The ageing population will place considerable pressure on future public finances. And there will be an increasing burden placed on a smaller band of taxpayers. After World War II there were five workers for each pensioner. Today, the number is 3.3 and by 2020 it will be 2.5 and falling. As the present UK system is based on using current taxation to pay pensioners, this highlights the problem.

As worrying as this is, Britain in a far better shape than other major industrialised countries, as we have the slowest ageing population, our state pension is low and occupational schemes are more prevalent here.

The aim is to privatise the state pension and force people into compulsory saving for their old age. The first group to be affected by this change are just starting work or still in education. They will face the disadvantage of double taxation, whereby they will have to pay not only for existing pensioners but also they would be forced to set money aside for their own pension.

Under the new scheme people will pay their contributions out of taxed income, but receive their pensions tax free. But most pensioners will not pay tax anyway, as their pensions are so low, and it will remove one of the attractions of the current tax system, which allows pension contributions to be tax free.

Nothing is being proposed to address the problem of current workers. These will not be affected by the new plans but already face problems because they are not saving enough and because of previous Government policy. The decision of the Government to break the link between pensions and earnings in 1980 has led to the current state pension being obscenely low, at £3,179.80 per person, and £5,083 for a couple.

This has already put the onus on people to make adequate private provision. But not everyone does, or is able to. People can save through occupational schemes or their own private pension. One of the difficulties is that future pension entitlements are not possible to predict with certainty. Not only do individuals have to try and take account of their own circumstances, such as their future income growth, but Government policy and the economy's performance are also important. Furthermore the performance of funds varies tremendously, particularly as most occupational schemes are money purchase. Although the State Earnings Related Pension is being phased out, it is important to appreciate that this system had many safety nets, which are not always possible in a private scheme. Thus it is important for the Government to provide a safety net, particularly if future returns disappoint.

This is one of the doubts about the new scheme. The mis-selling of personal pensions in the Eighties, and the high costs charged to investors, mean there is a strong need to regulate who people can save with.

Chile's pension system has proved so successful that many leading countries are studying it. Chile has personalised pensions in a way that has been popular and successful. People are forced to save for their old age, and have a choice of tightly regulated funds in which they can invest. Furthermore, each person has his own pension book, which is like a building society account book, and can be continuously updated to allow a person to see how much is in their pension scheme.

A strong economic and stock market performance during the last decade has boosted returns, hence explaining the success of the Chilean system. But there is little talk of how those not covered by this scheme will cope, and whether Chilean public enthusiasm would change if the economy and stock market hit hard times, reducing the value of investments.

The hope must be that personalising UK pensions will prove popular and encourage people to save more voluntarily. If not, there may be a need to force them to save more, and at the same time make sure the funds in which they invest manage the money properly, without excessive charges or risks.

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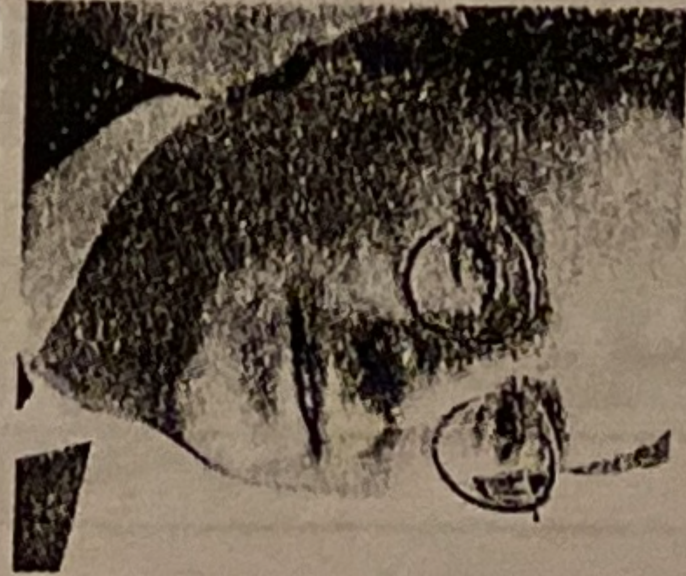

Privatising state pensions has benefits to the nation, but there are costs too, says **Gerard Lyons**