growing *faster* than resources.[15] Add to this the pressures on spending from new technological opportunities, and the move of resources to create greater equity between areas, and some people saw decline in the services available relative to needs. By contrast, in the early 1990s, the volume of resources increased faster than age-related needs, and pressures in the near future will be reduced. Looking ahead, there is further pressure from projected ageing, but over the *twenty-five* years from 1991 it adds up to a smaller increase than over the *ten* years before.[16] Increasing spending on the NHS has emerged as one of the new Government's highest priorities, and spending is planned to increase significantly faster than national income from 1999-2000 onwards.

Personal social services

The key trend in the area of personal care and personal social services in the last twenty years has been the growth of private – as opposed to public – provision. However, much of this remained financed by the public sector in one way or another. During the 1980s the cost to the social security budget of residential care for the elderly escalated rapidly, as elderly people with low incomes and few assets were entitled to have the whole weekly cost of charges by residential homes paid for them. Other forms of support – services to those remaining at home – were less generously funded through local government. In an important set of reforms in the late 1980s, responsibility for both residential and home care was passed to local government. This was intended both to stop the growth of government spending (as the available budgets were now capped, rather than open-ended) and to allow the most efficient choice of services to be made, removing the previous bias towards residential care. Subsequent research has suggested that the first of these aims was dominant, and they succeeded more in capping spending than changing patterns of provision.[17]

These reforms coincided not only with a growing number of elderly people requiring high levels of care, but also with a growth in the proportion of these who owned assets (for instance, a house) and who had significant incomes from private pensions. This group is expected to fund its own care until spending means that savings are exhausted. This has, in fact, been the system for the whole post-War period, but its effects have only really become well-known in the last decade or so as more people have become affected by the means-testing involved. As a result there is a feeling of betrayal amongst many elderly people, who had thought that the post-War welfare state involved the availability of free universal services "from cradle to grave".[18] There is also confusion as to where the boundary line should be drawn between *health* services, which are indeed provided universally, and *care* services, which are not. These two problems – together with that of how to pay for greater costs in the future – were passed to a Royal Commission, whose recommendations are described below.

[15] Hills (1997), Figure 39.

[16] Hills (1997), Figure 40. This assumes that as people live longer they still require as much treatment at a given age as before. It could be that they also stay healthier longer, and increased spending needs are delayed. If so, such indices overstate the effect of ageing.

[17] Lewis and Glennerster (1996).

[18] Parker and Clarke (1998).

3. Financing welfare spending and sources of funds

The flow of funds for welfare spending

At first sight, the way in which the British welfare state is financed is straightforward. There is a limited social insurance system, but the bulk of government welfare spending is financed from general taxation. Although spending on pensions and other social insurance benefits (and a small part of that on the NHS) is paid for through the "National Insurance Fund", there is in fact no real fund, in the sense of assets accumulated against future liabilities. Virtually all spending – including pensions – is financed on a pay-as-you-go (PAYG) basis.

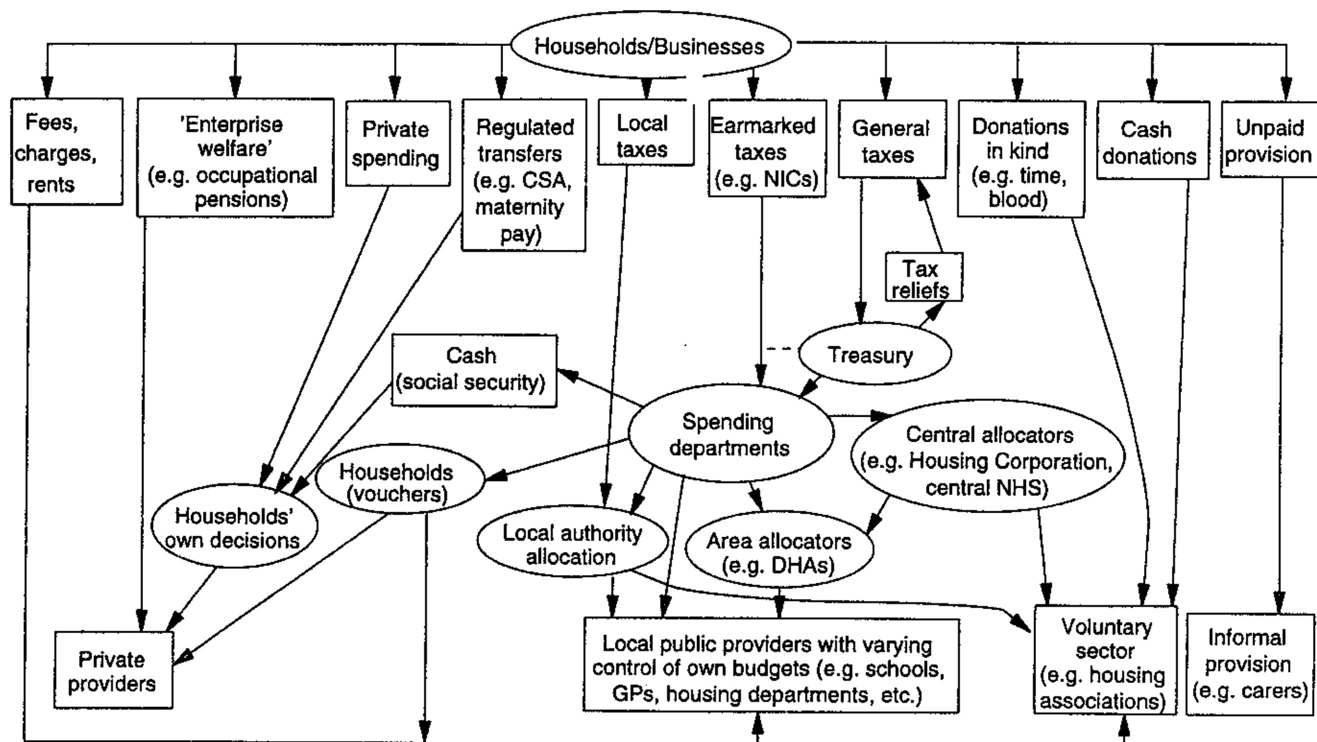
On closer examination, the system is somewhat more complex, as is shown in Figure 1, which traces the flow of funds from households and businesses to welfare providers. Even within the tax-financed part of the system there is a distinction between those raised centrally, like income tax, and property-related taxes raised by local government (which is responsible for education, many personal social services and housing, albeit with substantial central government support). Some taxes are earmarked for particular uses, of which the most important are National Insurance Contributions (NICs). Government services are also financed by direct charges to users. These include prescription charges for the use of drugs within the NHS – although a wide range of exemptions mean that the scale of these in the health sector remains small, financing only 2.2 per cent of NHS spending in 1995-96.[19] More important in scale are the rents charged by local authorities as landlords for the housing they own (although the majority of tenants in fact receive their housing free or at very low cost, paid for by means-tested Housing Benefit, which acts as a form of "voucher").

At the same time – and as is discussed in detail below – private sector provision is also important, financed either directly by households (such as private schooling), or by enterprises (mainly pensions, but also some private medical insurance). Some of this private activity is in fact publicly financed – for instance, through tax reliefs for mortgage payments, tax concessions for private pensions, or Housing Benefit paid to private landlords. Other parts of "private welfare" may not be financed by money passing through the hands of the public sector, but regulation means that government is in effective control. Such regulated transfers include maintenance payments under the Child Support Act from former partners to lone parents, as well as parts of "enterprise welfare" like maternity pay.

Furthermore, some parts of publicly-financed activity are carried out by private providers on behalf of the public sector. "Contracting out" of services – particularly by local government – made this more important in the 1980s. This included the "voluntary sector" (non-profit organisations like housing associations, which provide an increasing share of social housing) as well as profit-making businesses. Finally, an important part of "welfare" activity does not involve finance at all. In particular, most care for the elderly or disabled is in fact provided informally, largely by relatives.

[19] Le Grand and Vizard (1998), p.95.

Figure 1
Flow of Funds in the British Welfare State in the 1990s



Source: Hills (1995)

Table 1 Public and Private Welfare Activity, 1979-80 and 1995-96 (£billion, 1995-96 prices)

Provision:	Public provision				Private provision				All
Finance:	Public finance		Private finance		Public finance		Private finance		
Decision:	Public	Private	Public	Private	Public	Private	Public	Private	
(a) 1979-80									
Education[1]	15.3	-	-	-	5.5	0.7	-	1.9	23.4
Health[2]	18.0	-	0.2	0.1	4.7	-	0.3	2.2	25.5
Housing[3]	6.6	-	3.3	-	0.3	4.8	0.3	21.5	36.9
Income maintenance[4]	46.8	7.9	-	-	-	11.2	-	15.9	81.9
Personal services[5]	3.4	-	0.5	-	0.5	-	-	0.4	4.8
Total	90.1	7.9	4.0	0.1	11.0	16.7	0.7	41.9	172.5
(b) 1995-96									
Education	18.8	-	-	-	9.0	1.8	-	6.4	36.0
Health	31.3	-	0.2	0.2	9.4	0.3	0.8	7.5	49.8
Housing	7.4	-	2.6	-	1.6	9.5	1.1	48.8	71.1
Income Maintenance	76.0	4.0	-	-	-	16.4	-	18.4	114.9
Personal services	5.6	-	0.5	-	4.7	-	0.7	2.1	13.6
Total	139.2	4.0	3.4	0.2	24.7	28.0	2.6	83.2	285.4

Source: Burchardt (1997)
1. Education: current expenditure only. Does not include student maintenance or pre-school education.
2. Health: some estimates necessary on contacting out, especially for 1979/80.
3. Housing: based on estimates of current rental value of all dwellings. Effects of rent controls on private properties not included.
4. Income maintenance: figures for pensions are contributions, except for basic state pension, which is cost of pensions in payment.
5. Personal services: some expenditure split between 'own provision' and 'contracted out' on basis of volume of service rather than cost. 'Pure private' expenditure estimated for both years.

The changing roles of public and private sectors

Many of the policy changes described in section 2 implied a growing role for the private sector in welfare activity, for instance, pensions or care services. However, the kinds of activity discussed there are very heterogeneous, as are the funding arrangements shown in Figure 1. Private residential care places for the elderly have grown, but much of this is directly publicly financed. Some public services make charges to their users to supplement tax-financing. Housing associations are outside the public sector, but most of the accommodation they provide is both publicly financed through Housing Benefit, and publicly controlled in that allocations are made by local authority nominations. Private pensions are very important in the UK system, but benefit from favourable tax treatment. Payments under the Child Support Act are private transactions, but are publicly controlled. To analyse this systematically, it is helpful to analyse public-private boundaries according to three separate dimensions:

- **Provision**: is the provider a public or private sector body?
- **Finance**: does the public sector pay for the service either directly through subsidy or indirectly through benefits or tax relief?
- **Decision**: can individuals choose for themselves the provider used or the amount of service?

This three-way classification generates eight possible combinations, and total public and private welfare spending is divided between these in the columns of Table 1, showing the positions in both 1979-80 and 1995-96.[20] Looking at each sector in turn:

- In *education*, the striking change is the fall in the "pure public" sector (publicly provided, financed and decided upon) in the left-hand column from nearly two-thirds in 1979-80 to just over half of the total in 1995-96. The opposite "pure private" sector more than doubles from 8 to 18 per cent, driven by growing private spending on items like driving lessons and leisure courses as well as university fees paid privately, and greater spending on private schools. As important is the growth of public finance for privately provided services. This includes grants to independent establishments like universities and further education colleges, as well as contracted-out local authority spending on education (all effectively under public control) as well as for privately controlled activity (such as subsidies to private schools under the – now abolished – "Assisted Places" scheme and, more significantly, government spending on tuition fees in higher and further education).

- Within *health* services, the pure public sector remains dominant, but even in 1979-80 private provision of publicly financed and controlled services represented 18 per cent of the total. The biggest part of this represents general medical services provided by GPs (family doctors who are self-employed contractors, not state employees). The pure private sector almost doubles from 9 to 15 per cent, with rapid growth in both consumers' expenditure on over-the-counter medicines, spectacles, etc., and on private medical insurance. Other sectors also grew, but remain relatively small.

[20] The figures shown are drawn from Burchardt (1997). For further discussion, see Burchardt, Hills and Propper (1999).

- Of all the services, *housing* started in 1979-80 with the largest pure private and smallest pure public sector. With growing owner-occupation and some revival of private renting, the pure private sector provided more than two-thirds of all housing in 1995-96, measured in terms of its annual rental value. In both years, public finance for private housing under private control represented another 13 per cent of the total – with Housing Benefit for private tenants taking over from mortgage tax relief as the largest part of this. Most strikingly, by 1995-96, the pure public sector – local authority-owned housing paid for through Housing Benefit and subsidy – represented only a tenth of all housing provision.

- In contrast to the other sectors, the size of the pure public sector actually grew within *income maintenance and social security* to two-thirds of the total. This reflected a doubling in the real cost of non-pension social security (excluding Housing Benefit and other items included elsewhere) to £46 billion, plus slow growth with ageing of spending on the basic pension and related items to £30 billion. With higher rates of contracting out of SERPS, there was a switch towards increased use of private pension providers, but with public finance from tax reliefs and rebates. The pure private sector – mainly private pension contributions net of tax reliefs – grew in real terms over the period, but fell from 19 to 16 per cent of the total as the public sectors expanded faster.

- Finally, contracting-out has taken the share of *personal services* in the pure public sector down from 70 to 41 per cent of the total.[21] Correspondingly, privately provided, but still publicly financed and controlled, services – containing items like local authority spending on contracted out residential care and Income Support for residents of independent care homes – grew from 11 to 34 per cent. User charges for contracted-out services also become more important, and the size of the pure private sector (private spending on residential and non-residential care) nearly doubled to 16 per cent of the total.

As the table shows, what happened to welfare activity under the Conservatives was far more complicated than might have been expected from a simple model of "privatisation". There was a relative decline in what might be thought of as the pure public sector, and a rise in the pure private sector. But there were important exceptions to this – not least the increasing importance of general social security as the population aged and unemployment grew – and important changes in some of the "mixed" sectors in particular services.

The totals in Table 1 show that overall welfare activity grew by 65 per cent in real terms, but within this total growth rates differed considerably between sectors. In particular, the pure private sector doubled in real terms from £42 to £83 billion, and there was rapid percentage growth in the other three sectors involving private provision. However, when one looks at the shares of welfare activity represented by

[21] Informal care is not included in the table because of the difficulties in putting a meaningful monetary value on the time and energy of informal carers. Putting a value of £7 per hour on informal carers' time yields a value of £41 billion in 1994-95 (Laing and Buisson, 1995), three times that of all the formal services shown in Table 1. Even valuing care at the new minimum wage (£3.60), informal care would be one and a half times larger than formal care.

different combinations of public and private roles, the shifts are perhaps surprisingly gradual. Welfare activity was *already* very mixed in its composition in 1979-80, with the pure public sector only making up 52 per cent of the total. This fell, but only to 49 per cent in 1995-96. Meanwhile the pure private sector did increase significantly from 24 per cent, but still only to 29 per cent. Some of the trends seen within services shown in the earlier figures offset each other, as does the changing relative size of each. The general shift away from the traditional welfare state seen in education, health, housing and personal services is mostly offset by the growing real value of state-provided and financed social security.

Perhaps the clearest message from the figure is that the effect of "privatisation" was more to raise the importance of the four combinations involving private provision, which rose from 41 to 49 per cent, than that of those involving private finance, which rose from 27 to 31 per cent. This is explored further in Table 2, which compares the scale of total public finance and public provision with overall welfare activity, also showing conventional measures of "public spending". As a share of national income, public finance grew from 24.0 to 27.7 per cent. This was a rather larger increase than in "public spending" (from 23.3 to 25.6 per cent of GDP), reflecting the greater use of tax reliefs over the period (as well as some effects of definitional differences).

Meanwhile – despite the trends discussed above – public provision still increased as a share of GDP, although private provision increased faster. As a result, overall welfare activity grew from 33 to over 40 per cent of GDP – more than three times the increase as a share of GDP of conventionally measured public spending on welfare.

In summary, four features stand out from this analysis of the roles of public and private sectors in UK welfare activity:

- One cannot make a simple distinction between "public" and "private" sectors. Their roles vary between services, often reflecting the particular characteristics of the sector concerned rather than ideological preferences.
- Despite eighteen years of Conservative government strongly committed to increasing the role of the private sector and "rolling back the state", the public sector remains dominant except within housing. The welfare mix has changed only slowly.
- The most rapid growth of the private sector has been in terms of private *provision* of services, often financed publicly, either through direct purchase by the state or through tax reliefs. It proved much harder to reduce the role of public *finance* (largely taxation). Both distributional and efficiency problems (such as market failure in insurance markets) limited the Government's scope for shifting the responsibility for paying for welfare to the private sector.[22]
- None the less, there is an important purely private sector in the UK – representing around 10 per cent of GDP including all the services we have covered, and this sector grew rapidly in the 1980s and early 1990s. Some of this spending – for instance on private pensions or private housing – is alongside items which are at least indirectly publicly financed, but its scale is one of the reasons why UK

[22] Burchardt and Hills (1997).

Table 2

Total Welfare Activity, 1979-80 and 1995-96

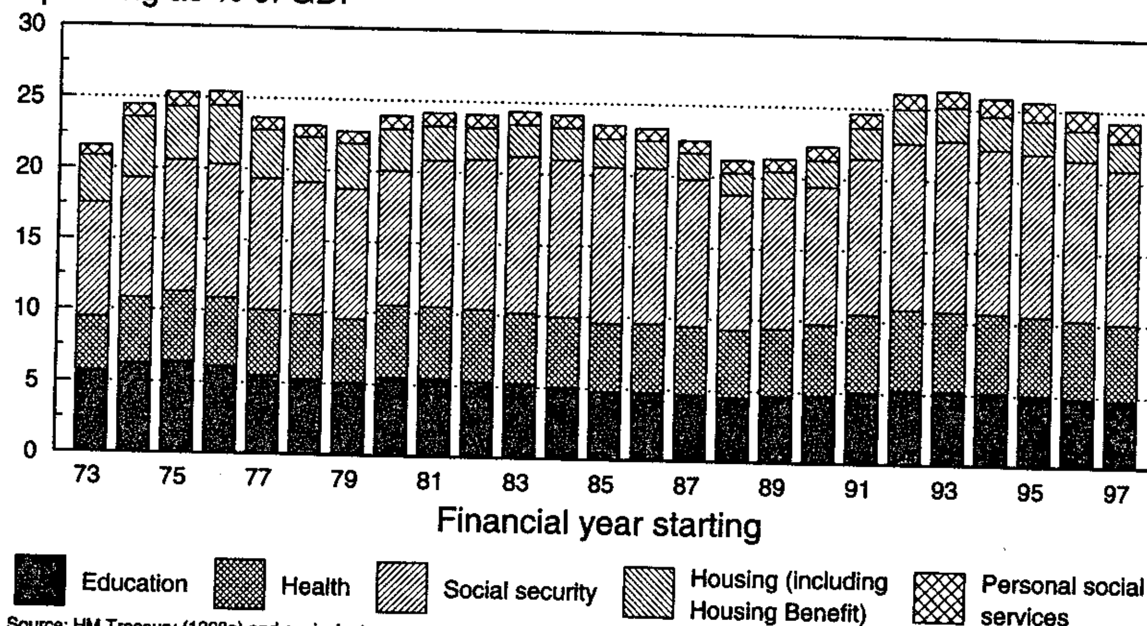
	Public finance	Public provision	All welfare activity	(Public spending)
1979-80 (£billion, 1995/6 prices)				
Education	21.5	15.3	23.4	27.5
Health	22.7	18.3	25.5	23.6
Housing	11.7	9.9	36.9	17.2
Income Maintenance	65.9	54.7	81.9	49.4
Personal Services	3.9	3.9	4.8	4.6
Total	125.7	102.1	172.5	122.1
1995-96 (£billion)				
Education	29.6	18.8	36.0	36.1
Health	41.0	31.7	49.8	40.7
Housing	18.5	10.0	71.1	16.1
Income Maintenance	96.4	80.0	114.9	80.8
Personal services	10.3	6.1	13.6	8.9
Total	195.9	146.6	285.4	182.6
Total as % of GDP				
1979-80	24.0	19.5	32.9	23.3
1995-96	27.7	20.7	40.3	25.6

Sources: Burchardt (1997); Glennerster and Hills (1998), Table 8A. 1.

Note: Public spending figures exclude tax reliefs, include capital spending and in education, student maintenance grants, and use cash-flow definitions of housing subsidies.

Figure 2

UK GOVERNMENT WELFARE SPENDING 1973/4 TO 1997/8



Source: HM Treasury (1998a) and equivalents.

government welfare spending is smaller than that in many comparable European countries.

4. Current issues in welfare reform

The cost of government spending

A crucial – and largely successful – part of the rhetoric and policy stance of the new Government has been to try to break the "tax and spend" image of the old Labour Party. As in many other countries, the British welfare debate has been dominated by concerns about the rising cost of social spending. However, the result of many of the developments described above has been that for the last twenty years welfare spending has *not* been absorbing a steadily rising share of national income. The end of twenty-five years of growth after the War in the relative scale of the welfare state came not in 1979 (when the Conservative Government under Mrs Thatcher came to power), but in the mid-1970s in the fiscal crisis in the aftermath of the first oil shock.

This can be seen in Figure 2, which shows government welfare spending as a share of GDP since 1973-74. In contrast to the rhetoric of both Right and Left, there has neither been inexorable growth nor decline in the scale of the welfare state relative to the economy in recent years. By and large, the total has fluctuated with the economic cycle. The share of national income represented by welfare spending in 1996-97 was exactly the same as it had been twenty years before (albeit at what was then a less favourable stage in the economic cycle). The tightness of the constraints which the new Labour government imposed on itself can be seen from the way in which welfare spending fell by nearly one per cent of GDP between 1996-97 and its first year in office, 1997-98. What has changed in the medium-term has been the *composition* of welfare spending - away from housing and education, towards social security and the NHS. The new Government now aims to shift it away from social security, towards education and the NHS.

The effects of ageing

Looking ahead, there remain concerns about the effects of the ageing population. Official forecasts suggest that between 1994 and 2041 the proportion of the population aged over 64 will rise from 16 to 25 per cent, with the proportion in their nineties trebling.[23] This is a more favourable position than most industrialised countries both in that the UK has already absorbed a sizeable growth in the elderly population and in that future ageing is relatively slow. However, it will put pressure on pensions, health care, and the need for care for the elderly.

At first sight, however, current forecasts for the future costs of pensions are not very alarming – indeed they show a *fall* in the future cost of the system. Official projections made for the independent Pensions Provision Group set up to review the current pensions system as an input into the Government's Pensions Review suggest that *on current policies* National Insurance Contribution rates could fall from 18.2 per cent of chargeable earnings (employee and employer contributions combined) in 2000 to 14.0

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[23] ONS (1996).

per cent in 2050.[24] The share of total earnings taken by NICs would fall from 11.7 to 8.9 per cent. Earlier OECD projections showed the cost of public pensions in the UK rising only from just below to just above 5 per cent of GDP between 1995 and 2035, much less than in other countries (for instance, a rise from 6 to 16 per cent of GDP by 2050 for Japan).[25]

However, as the Pensions Provision Group suggests, the issue facing British pensions policy is not one of its affordability to the state. Rather, it is one of adequacy of the pensions which will be received by a significant proportion of the pensioner population. The "current policies" assumed in the projections are that pensions (and other cash benefits) continue to be uprated in line with prices, rather than with economic growth or earnings. This implies, for instance, that if real earnings growth is 1.5 per cent, by 2050 the basic pension would be only 7.5 per cent of gross average earnings;[26] if earnings grow by 2 per cent, the ratio would be this low by 2035. Already one of the major factors in the increased inequality of incomes in Britain is the growing gap between the incomes of those with and those without work. With price-uprating, the gap grows whenever the economy does.

The most straightforward solution to this kind of problem would be to return to increasing pension and benefit levels in line with earnings rather than prices. However, this would mean rising costs. For instance, the same official projections suggest that the combined NIC rate would have to rise to 24.3 per cent, taking 17.3 per cent of average earnings by 2050, if earnings-linking for social insurance benefits was restored. This kind of increase is hardly beyond the bounds of possibility, but health care and other social costs are expected to rise at the same time, and current government policy is to increase the share of national income going to education to meet global economic competition. At the same time, the present Government is keen to avoid accusations that it is planning higher taxes in future. The background to the current debate on pensions reform is therefore the difficult task of keeping future public pensions costs down, while delivering a better floor to pensioner living standards in retirement.

Means-testing and targeting

One way of achieving this kind of aim would be to continue the trend of policy under the Conservatives towards greater "targeting" of social benefits on the poor, particularly through extending the use of means-testing. Indeed, in the summer of 1998 the Government announced an increase in pensioner Income Support rates (renamed a 'Minimum Income Guarantee' for pensioners) over and above inflation. It has now said that its objective is to raise the value of the MIG in future in line with earnings, not prices.

However, this kind of policy has its own undesirable side-effects. For instance, an effect of the growing reliance on means-testing has been to extend the "poverty trap", where those with low incomes in work face very high effective marginal tax rates from both direct taxation and benefit withdrawal as earnings rise. By 1995-96, nearly 1.5 million workers faced combined effective marginal tax rates of over 70 per

[24] Pensions Provision Group (1998), Figure 5.15.
[25] OECD (1995).
[26] Pensions Provision Group (1998), Figure 5.7.

cent, up from 1.0 million in 1985.[27] Such work disincentives have loomed large in the new Labour Government's reform agenda, as have concerns about the vulnerability of means-tested systems to fraud.

Related problems affect pensioners. For those with a small amount of private savings or a small private pension, the effect of the means-testing already in place is that the additional gross income is worth very little to the recipient: means-tested benefits are cut back sharply, so that net income is little higher than it would have been without any savings or private pension at all. This causes both feelings of injustice and potential disincentives to save for retirement: the exact reverse of what is needed overall in the light of the ageing population.

Inequality and relative poverty

The final issue looming large in the current welfare debate is the way in which income inequality and relative poverty have increased sharply since the late 1970s. Figure 3 shows the proportion of the population with incomes below half the average (before housing costs) from 1960 until just before Labour came into office. This reached a maximum of over 20 per cent in the early 1990s, more than double the rate in 1979, although it should be noted that the growth in inequality and relative poverty began after 1977, before Mrs Thatcher came into office. The figure shows that the very rapid growth in relative poverty halted after the early 1990s, with a fall in relative poverty under the Major Government in the period between 1993 and 1995 as the economy initially came out of recession, but followed by a rise again in the later stages of economic recovery. The growth of relative poverty and inequality may have halted in the 1990s, but Britain remains a much more unequal society than it was in the 1960s and 1970s.

This growth in income inequality – which was not confined to the UK, but was particularly rapid here – had a variety of causes, rather than being the simple results of government policies.[28] The most important of these can be summarised as:

- Growing earnings inequality, in part linked to increasing premiums for skills and qualifications, in turn related in part to technological change. While such pressures hit many countries, the results were most dramatic in the UK and USA. In the UK case this is partly related to long-term factors like the high proportion of the workforce with low qualifications. It also reflected shorter-term policy influences, like the declining importance of trade unions and of what minimum wage protection there had been (through the "Wages Councils").
- Rising unemployment and larger numbers receiving benefits, with a particularly rapid growth in the proportion of working age families without any family member in work.
- The change in policy towards price-linking benefit levels, rather than maintaining relativities with incomes.
- At first sight more surprisingly, the overall effect of taxation was neutral, with inequality in post-tax incomes growing as fast as that in pre-tax incomes. This

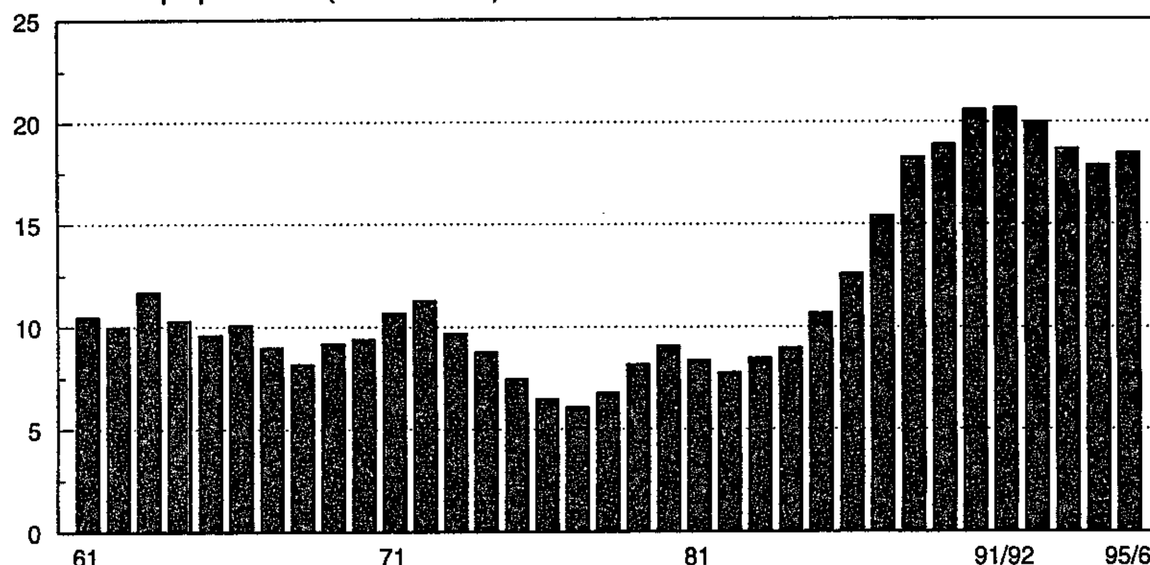
[27] Evans (1998), Table 7.18.

[28] Hills (1996, 1998b). While income inequality grew rapidly between the late 1970s and early 1990s, the inequality of wealth has remained remarkably constant since the mid-1970s. This, however, marks a break from earlier periods when wealth inequality declined rapidly.

Figure 3

POPULATION BELOW HALF AVERAGE INCOME

% of total population (individuals)



Source: Goodman and Webb (1994); DSS (1998).
Incomes are before deducting housing costs.

Table 3: Growth in public spending and spending plans, 1993-94 to 2001-02

	Real annual growth rates			
	93-94 to 96-97	96-97 to 98-99	98-99-01-02 (planned)	96-97 to 01-02 (planned)
NHS (England)	2.1	2.3	4.7	3.7
Education (GB)	0.7	-0.3	5.1	2.9
General Government Expenditure	1.4	0.9	2.8	2.0
Social Security (including Welfare to work)	1.6	0.5	2.0	1.4
Defence	-4.3	-0.9	-1.4	-1.2
GDP	3.1	2.4	2.2	2.3

Source: HM Treasury (1998), Tables A1, A2, A3 and A6

was the result of two conflicting factors: as market incomes became more unequal the tax system tended to have an "automatic" effect slowing inequality growth, but this was entirely offset by "discretionary" changes to tax policy which shifted the tax burden from those with high to those with low incomes.

Examining why the trend changed over the 1993 to 1995 period, the reason lies in very *slow* income growth for most of the population (with little growth in real earnings but rising taxes), but income gains at the bottom (reflecting factors like abolition of the Poll Tax system of financing local government and falling unemployment). Between 1995 and 1997 tax changes and earnings growth favoured those with higher incomes.

Summary

The key issues in the background to Labour's plans for welfare reform are to some extent in conflict. First, the new Government is very concerned to continue to restrain welfare spending, and hence demands on taxation. However, it does face rising pressures on that spending, notably from the ageing population, but also for other programmes such as education. The obvious ways to continue to keep spending under control are further reliance on means-testing and to continue to allow the value of pensions and social security benefits to fall relative to other incomes. However, the UK system already embodies a heavy degree of reliance on means-testing, with potentially damaging effects on incentives to work and save, and on incentives to make greater private sector provision through various forms of insurance. Inequality and relative poverty are much higher than in the 1960s and 1970s; continued falls in the adequacy of social security benefits would further worsen this.

5. The current direction of welfare reform

New Labour's first two years

Writing nearly two years after the Blair Government's election, a number of events stand out as beginning to define its approach to the welfare state:

- The contents of the Manifesto on which it fought the 1997 election. Notably this pledged not to increase rates of income tax, and to hold public spending totals for the first two years in office to those planned by its predecessor. The exception to this was to be spending on "the New Deal" programme to reduce unemployment, financed by a £5.2 billion "windfall tax" on some of the public utilities privatised under favourable terms by the Conservatives.

- The July 1997 Budget, which brought in the New Deal, concentrating in particular on the young unemployed, offering four options for training, subsidised private sector work, voluntary sector work, or work with an Environmental Taskforce, but no "fifth option" of benefit receipt for the unemployed young people (under 25) beyond six months.

- Reforms to the funding of higher education, including the introduction from October 1998 of a standard annual fee for (previously free) university education

(although this is waived on a means-tested basis for students from poor families), and replacement of the previous mixture of loans and a means-tested grant for living costs with a loan system repaid as a percentage of future income.

- Establishment of a large number of review groups and committees covering most aspects of the welfare state, including: a Minimum Wage Commission to recommend the level of minimum wage, the principle of which was in the election manifesto; a series of Comprehensive Spending Reviews looking across the whole of public spending; the appointment of the independently-minded Frank Field MP as a special Minister for Welfare Reform; an internal review of the pensions system; appointment of an (independent) Royal Commission on Long Term Care (see below); establishment of a small Social Exclusion Unit within the Cabinet Office, initially concentrating on school exclusions and truancy, street homelessness, and the most difficult social housing estates; and a review of interactions between the tax and benefit systems.

- Implementation of a cut built into the Conservative's spending plans (to which Labour had committed itself) to remove special additional social security benefits to lone parents. This led to the most serious internal row within the Labour Party since the election, with a substantial back-bench revolt in Parliament.

- A new series of area-based policies such as Health Action Zones, Education Action Zones, and Employment Zones, where innovative policies can be tried out (with limited additional resources) in low income neighbourhoods and areas, together with significant new resources for an integrated "New Deal for Communities" covering a number of the country's poorest areas.

- The March 1998 Budget, which announced the implementation of recommendations from the review into tax-benefit interactions. These include transformation from October 1999 of the existing cash benefit for low paid workers with children, Family Credit, into a "Working Families Tax Credit" (WFTC) to be paid (usually) via the wage packet, combined with increases in its generosity (including very favourable treatment of childcare costs) and a reduced withdrawal rate as income rises. It also included reforms to the National Insurance Contribution system to align it more closely with income tax, to reduce the cost to employers of lower paid workers (increasing the cost of higher paid ones), and a promise of reduced contributions for lower paid employees. It included the announcement of an increase in the universal Child Benefit going to all parents from 1999, and in the rates of Income Support for the poorest families with children aged under 11. The amounts involved meant that, combined with the new WFTC, virtually all lone parents with younger children would be no worse off than they had been before the withdrawal of special lone parent benefits, despite the equalisation in support across family types.

- Publication a week later of the welfare reform Green Paper, *New ambitions for our country: A new contract for welfare*, setting out the Government's broad principles in approaching welfare reform, but containing little or nothing by way of specific proposals which had not already been announced. At the end of July 1998 the Minister originally responsible for this paper, Frank Field, resigned rather than accept a move to an alternative post still outside the Cabinet. In

acrimonious exchanges Field said that his plans for radical reform to reduce the role of means-testing had been blocked, particularly by his boss, Harriet Harman (who also lost her job as Social Security Secretary in the reshuffle) and the Chancellor Gordon Brown. The core of the tensions within government appear to have reflected Mr Field's aim to establish a revitalised form of social insurance, including more generous pensions, but at what for other parts of government was an unacceptable cost in terms of higher earnings-related contributions.

- Spending plans for the three years 1999-00 to 2001-02 were announced in the Comprehensive Spending Review, published in July 1998.[29] These involved health, education and capital spending rising faster than GDP, some increased benefits for the poorest pensioners, but overall current government spending growing no faster than national income (see below).

- A further set of reforms to the social security system are included in the "Welfare Reform Bill" in the legislative programme for 1999. These involve changes to benefits for the disabled – most importantly reducing entitlement to certain social insurance based benefits (but preserving the rights of existing recipients), and increasing the role of means-testing. Changes were also announced to the system of benefits to widows. In order to comply with European Union rules on "equal treatment" of men and women, these benefits were extended to widowers. However, benefits will be made less generous in cases where there are no dependent children.

- Legislation has also been announced which will abolish the "internal market" within the National Health Service, including the system of GP fund-holding. However, under the proposed reforms, all family doctors will become members of "commissioning groups", which will have much of the budgetary control previously devolved to fund-holders. In effect, some features of the previous system have been retained, but made universal.

- Publication of the Government's proposed pensions reforms (see below) in December 1998[30], with consultation on them until the end of March 1999. The final shape of the reforms will be decided later in 1999.

- The March 1999 Budget, which included further reforms to the personal tax system. These included abolition of the tax relief for mortgage interest payments and the special tax allowance for married couples. Instead of the latter, an additional tax credit for families with children will be introduced. This will be paid as well as the universal Child Benefit, but the tax credit will not benefit high income families. The combination of these measures with changes to the structures of income tax rates and National Insurance Contributions redistribute income towards the bottom part of the income distribution. An important part of this is a significant increase in the ceiling up to which National Insurance Contributions are payable.

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[29] HM Treasury (1998).
[30] DSS (1998c)

The Green Paper on Welfare Reform and the future of social insurance

"Work", and its promotion, lies at the centre of most of the new Government's initiatives. In the most comprehensive statement of its views on welfare reform published so far, the March 1998 Green Paper, the first of the eight principles which it sets out as underlying reform is that, "The new welfare state should help and encourage people of working age to work where they are capable of doing so", and the relevant chapter entitled "The importance of work" starts with the statement that, "The Government's aim is to rebuild the welfare state around work".[31] Indeed the central slogan of the Green Paper in Tony Blair's introduction is that,

> "We want to rebuild the system around work and security. Work for those who can; security for those who cannot."[32]

Not, it should be noted, "security for all", which might have been the slogan for the post war system established by Beveridge (and it is hard to imagine that this is an accidental slip given how high a profile this statement has). Here one can begin to see a tension within the emerging policies of the Government. On the one hand, it would like to re-inforce the connection between work and welfare. On the other, it does not want to offer too easy a safety net even for those who are currently working, for instance through general increases in social security benefits. Instead, most of its efforts have been put into "welfare to work" initiatives like the New Deal.

Similarly, it shows little sign of strengthening the national insurance system which embodies one form of such a connection. Indeed, several recent moves – for instance the reforms of disability benefits – imply a weakening of social insurance in the UK. This was despite the fact that the Minister for Welfare Reform in whose name the Green Paper was issued had argued before appointment in favour of social insurance-based systems, albeit run by an arms-length National Insurance Corporation or in some cases by mutual organisations rather than the state.[33] One of the reported disputes which led to his resignation was opposition from the Treasury on cost grounds to his ideas for strengthened social insurance in order to reduce reliance on means-testing.

Again, some relative priorities can be deduced from the reforms being made to National Insurance Contributions. The threshold for contributions is being raised, benefiting low paid workers, but those who earn between what is now the threshold for contributions and the new one will still be "credited in" to entitlements for national insurance benefits like the state pension. This will have positive distributional effects, but will further weaken the already tenuous links between the work-based contributions people pay and their benefit entitlements. The judgement is clearly that such links are so obscure that social insurance has little positive role to play within the agenda for promoting work. Rather it is to be reformed to remove disincentives caused by the structure of contributions, and the administration of contributions is to be moved from the Department of Social Security to the Inland Revenue (which runs income tax); it may only be a matter of time before contributions and income tax are merged.

[31] DSS (1998a), p.23.
[32] DSS (1998a), p.iii.
[33] Field (1995).

A further tension within the Government's policies can be seen in its attitude towards the private sector. The Green Paper sets out as one of its principles that policy reforms will follow a "third way":

> "The welfare state now faces a choice of futures. A privatised future, with the welfare state becoming a residual safety net for the poorest and most marginalised; the *status quo*, but with more generous benefits; or the Government's third way – promoting opportunity instead of dependence, with a welfare state providing for the mass of people, but in new ways to fit the modern world."[34]

Statements like this rule out the most radical forms of privatisation or the simple change of more public spending without welfare reform, but they do not do much to narrow down the numerous policy options between those two poles. The Government does say that it is explicitly looking for "new partnerships" between sectors to meet some welfare needs, and believes that, "The public and private sectors should work in partnership to ensure that, wherever possible, people are insured against foreseeable risks",[35] including, for instance, wider take-up of private Mortgage Payment Protection insurance. However, its moves in some areas towards greater means-testing – for instance through the increases in Income Support for pensioners, or the proposed reduction of Incapacity Benefit for those receiving private insurance payments – create disincentives to make greater use of private provision.

The Comprehensive Spending Review

It is in terms of public spending that "New Labour" can most clearly be seen as different from Old Labour – and where it is most clearly open to the accusation from the Left of being no different from the Conservatives. Such a conclusion does, however, have to be qualified. First, the biggest early initiative of the new Government, the "New Deal" for the unemployed, involves additional spending equivalent to 0.65 per cent of annual national income spread over five years from 1997-98, financed by new taxation, albeit collected from an unpopular group of businesses rather than from individuals. Second, the 1997 and 1998 Labour Budgets *increased* spending above previous plans for both health and education, using corners of the overall budget like unallocated reserves, or under-spending elsewhere.

More generally, the Government would argue that the effects of changing priorities within its total spending of over £330 billion will be far greater than those of adding a billion or two pounds to the total from higher taxation. Its mechanism for this was the "Comprehensive Spending Review", the results of which were published in July 1998. Some of its key effects are shown in Table 3. In its presentation of this review the Government gave two messages, aimed at different audiences. The first, for financial markets, was that its plans for *overall* spending were very responsible. General government spending is planned to rise by 2.8 per cent a year in real terms in the three years for which new plans have been made (1998-99 to 2001-02), giving an annual average of 2.0 per cent over the period between 1997 and the likely date of the

[34] DSS (1998a), p.19.

[35] DSS (1998a), pp.33 and 40.

next election. This would leave total government spending at 40.6 per cent of GDP in 2001-02, up from 39.6 per cent in 1997-98 (but below the 41.1 per cent in the Conservative's last year, 1996-97).[36] Within this total, net capital spending is planned to rise significantly as a share of GDP, but current spending to remain fixed.

The second message – for the public at large – was that its plans represented a huge increase in spending on the popular areas of the NHS and education. By comparing spending plans for future years in cash with those of the base year, and then adding the increases for three years together, the Government managed to generate newspaper headlines which talked about increases of more than £19 billion for education, and £20 billion for the NHS. The figures in Table 3 give a more realistic view of the reallocation of resources which has been achieved. Over the three year period, health spending (shown for England, but the rest of the UK moves in proportion) is planned to grow by 4.7 per cent per year in real terms, education spending by 5.1 per cent. Allowing for the austerity of the first two years, the average growth rate for the Parliament as a whole falls to 3.7 per cent for health and 2.9 per cent for education. In both cases these are faster than expected national income growth and than government spending as a whole. The overall effect – if things turn out as planned, which is often not the case – is that these two items grow from 22.4 per cent of government spending in 1996-97 to 23.9 per cent in 2001-02.

Put like this, the main achievement of the review sounds less than dramatic. However, the reallocation of resources involved implies spending on health and education running at a level more than £5 billion a year higher by the end of the period than they would have done if the distribution of government spending had remained unchanged. This is roughly equivalent to what would have been raised by putting up income tax rates by 2p in the pound. The Government can therefore claim that it has produced significant extra spending in popular areas without the kind of politically damaging tax increases which might have been expected as the way of paying for them under "Old Labour".

Surveys consistently show that a sizeable majority would rather have higher public spending, even if it means higher taxes.[37] However, majority support for higher spending in specific areas is mainly focused on health and education, not other parts of public spending. In addition, until the two or three years before the 1997 election, a majority saw Labour as potentially increasing taxes and spending *too much*. Since Tony Blair became leader and the emphasis of policy was put firmly on restraining spending, the perceived position of Labour moved towards one where much more balanced numbers saw it as increasing spending by too much or too little.[38] In other words, people wanted increases in spending, but not by too much, and focussed on health and education. Overall, therefore, what the government has done seems closely tuned to evidence of what the public wants.

[36] HM Treasury (1998b), Table A6.
[37] Lipsey (1994); Brook *et al.* (1996).
[38] Heath and Curtice (1998).

The Pensions Review

The Government's Green Paper proposals for pension reform[39] have five main elements:

- The means-tested minimum income for pensioners – now called the Minimum Income Guarantee –is being made more generous, and "over the longer term our aim is that it should rise in line with earnings". The level set for a single pensioner is now equivalent to 17.5 per cent of male average earnings.

- The social insurance-based Basic Pension, paid at a flat rate to all qualifying pensioners, will continue but the plans assume that it will remain price-linked. Government's projections imply that it will fall from over 15 per cent of male average earnings to around 7.5 per cent by 2050.

- The additional pension paid through the State Earnings Related Pension Scheme will be renamed as the State Second Pension (SSP). After an intermediate stage, it will become flat rate, not earnings related, with a value on retirement for those with a full working life equivalent to 10 per cent of male average earnings. After retirement the SSP will be price-linked.

- Those earning over the equivalent of £9000 per year (40 per cent of male average earnings) will, however, be encouraged by National Insurance Contribution rebates to "contract out" of the State Second Pension into a private or employer-provided pension. The government will encourage pension providers to set up a new kind of private pension, a "Stakeholder Pension". This will be tightly regulated to keep down costs and give guarantees on benefits. Through this route, and contribution reliefs, the Government hopes there will greater private pension provision amongst those earning between 40-80 per cent of male average earnings (above which level most earners have private pensions already).

- Pension providers – including the State – will be required to give contributors an annual statement of the rights they have accrued and a forecast of their likely pension on retirement.

The Green Paper says that public spending on pensions totalled 5.4 per cent of GDP in 1997/98. By 2050, if the Basic Pension remained price-linked, SERPS continued as now, but with the means-tested Minimum Income Guarantee linked to earnings, this would fall to about 4.2 per cent of GDP. Under its proposals including the transformation of SERPS into the SSP it forecasts that spending would fall slightly less, to 4.5 per cent of GDP.[40]

In essence what the proposals do is to return the UK state pension system to a flat rate structure, winding up the current part which is related to previous earnings.

[39] DSS (1998c).
[40] DSS (1998c), pp. 8 and 44.

However, unlike Beveridge's original scheme, this flat rate pension will have two parts: the Basic Pension, which will decline in importance; and the State Second Pension, which middle and higher earners will be encouraged to "contract out" of, using private pensions to substitute for it. The role of contributory state pensions will become one of providing a floor to income in retirement, while the private sector will provide extra pensions related to previous contributions or earnings.

One of the main aims stated for the reforms is to reduce future reliance on means-tested benefits and hence maximise incentives to save. However, the proposals as currently specified will not be entirely successful in achieving this, essentially because the State Second Pension will not be generous enough by itself to carry people beyond the means-tested Minimum Income Guarantee.[41] Given that public spending on pensions is forecast to fall as a share of national income on these proposals, the Government does have some "headroom" to make the contributory part of the system more generous, which would increase its effectiveness in this respect as well as its generosity. Whether it will modify its final proposals will not be known until later in 1999.

Long-term care

The independent Royal Commission on Long Term Care published its report in March 1999.[42] Its key proposal was that the State should pay, from general taxation without a means-test, for *all* nursing and personal care costs (but not housing or "board and lodging" costs). At present the financing of these costs depends on where people are living: in hospitals they are already all paid for through taxation; in residential care homes, the State pays the costs only for those with low incomes and after they have sold off most of their assets; and for people still living in their own homes, limited domiciliary care may be available from local authorities, but subject to charges, sometimes on a means-tested basis. The Royal Commission's proposals are aimed to equalise treatment between these cases, and to reduce the extent to which people need to spend down their capital in order to qualify for help in residential care homes, a very unpopular feature of current arrangements. It rejects both private insurance and a new social insurance system in favour of funding from general taxation.

The Royal Commission calculates that the total cost of long-term care borne both publicly and privately is currently £11 billion, or 1.6 per cent of GDP. Public spending represents £7 billion, or 1.0 per cent of GDP. It suggests that its proposals would cost £1 billion at today's prices. By 2031 its central estimate of total costs rises from 1.6 to 1.8 per cent of GDP. Public spending on its proposals rises to 1.3 per cent of GDP, compared to 1.1 per cent under current arrangements (all these estimates for the future are subject to very wide margins of uncertainty).

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[41] The problems include: periods of unemployment do no count towards SSP rights, so incomplete working lives reduce its value below the target; after retirement the SSP is price-linked, but the MIG is earnings linked, so people may fall into means-testing in retirement; the falling relative value of the Basic Pension means that eventually (after 2050 in the Government's projections) the total of the maximum SSP and Basic Pension falls below the MIG, even on retirement; and the way in which means-tested assistance with rents for tenants means that they will still be caught by means-testing even if income is above the MIG.

[42] Royal Commission on Long Term Care (1999).

There is no guarantee that these recommendations will be accepted by government. The Commission itself was not unanimous and two members produced a minority report, criticising the main proposals for giving too much help to those with assets (who would benefit from the reduction in means-testing) and for being over-optimistic on the cost of extending state support. The Government has simply said that it will study the proposals, with no commitment to implement them.

5. Conclusions and implications for the debate in Japan

It is, of course, very difficult to draw direct lessons from the experiences of one country for another which has very different social and economic systems. However, an understanding of the ways in which the UK has met some of the pressures which also face Japan – and the trade-offs which it has faced in doing so – may be helpful.

From a static point of view, the pension sectors of Japan and the UK are currently in a very similar situation. Both countries have a pay-as-you-go, two-tier pensions system, composed of a flat-rate and universal basic pension and an earnings-related pension, which is mandatory only for part of the working population. Table 4 summarises some of the information given above, and compares it with some related statistics for Japan. For those retiring today (1999) on average earnings, the UK State system is at its most generous, in some respects exceeding relative payments in Japan. The share of elderly people in the population is slightly higher. Overall, contribution rates and spending on pensions as a share of GDP are fairly similar. The main difference is the importance of means-tested benefits in the British system. One effect of the differences in roles of the states in contributing to the incomes of different kinds of elderly households can be seen from the fact that in the UK the proportion of gross income coming from state benefits falls from around 80 per cent for the poorest two-fifths of retired households to below 70 per cent for the middle fifth, just over 50 per cent for the next fifth, and only 22 per cent for the top fifth.[43] By contrast, in Japan state retirement benefits make up 60-70 per cent of income for all of the bottom four-fifths of the elderly population, falling to 40 per cent for the top fifth.[44]

In dynamic terms, however, the situations of Japan and the UK differ markedly. The present cost of the UK system reflects the workings of a fairly mature set of arrangements (although the SERPS system is only now becoming mature), and one which is planned to fall in generosity relative to earnings. The Japanese system is not yet mature, but is planned to be more generous than that in the UK. The UK does not face the kind of crisis of government social spending rising rapidly in relation to GDP which faces Japan. To start with, its demographic problem of ageing is far less acute than in Japan. In addition, the private sector plays an important and increasing role in welfare provision, particularly within the pension sector. The objective of the current pension reform proposals is that the private sector should be providing 60 per cent of pensioner incomes by 2050, and the State 40 per cent – the reverse of the position now[45]. With the eventual abolition of the earnings-related part of the UK State pensions, the State is redefining its role as that of providing a floor to incomes in retirement, not one of income replacement. Current policies towards pensions, even

[43] 1997-98 figures from ONS (1999), Table 4A, Appendix 1.
[44] Fukawa (1999).
[45] DSS (1998c), p.8.