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## Funding 21<sup>st</sup> Century Welfare States

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Can European welfare states rise to the challenge of financing the growing demands placed on them by demography, rising consumer expectations, international competition and growing inequality in market incomes? Can they do so without seriously jeopardising the efficiency of their economies?

I think the hard headed answer is: maybe but it will take a lot of adaptation in the institutions that we think of as constituting the welfare state. I shall give some examples. First, I begin with some definitions.

### **Welfare states and efficiency**

By a 'welfare state' I mean those activities of the state which redistribute households' claims over resources. In a pure capitalist economy these claims derive entirely from a household's success in labour and capital markets. The result may be a degree of inequality citizens as a whole find unacceptable – the utility they derive from their individual incomes is reduced by the nature of the resulting societal distribution (Atkinson 1970). The rapid growth in inequality in the UK in the 1980s and 1990s became a major issue of public concern. In 'welfare states' these market derived claims over resources are mitigated to varying degrees by the moral and political claims that derive from individuals' status as human beings and citizens of a particular nation. In Europe these claims are increasingly coming to be framed in terms of European citizenship. (For the origins of the term and societal differences in its form see: Hennessy 1992 and Glennerster 2007; Esping-Andersen 1990).

Many collectively provided services serve another economic purpose, however. They provide alternatives to private market exchanges that exhibit serious market failures and are therefore, in principle, improve economic efficiency. Welfare states can, in short, be efficiency enhancing as well as equity enhancing (Barr 2004). Yet, for all the reasons Okun (1975) classically and Professor Lindbeck (1995) more recently have elaborated, they may also have efficiency damaging results.

- In the long run the way states redistribute claims on resources may change attitudes to work, to marriage and to family caring.
- They may reduce individuals' incentives to save for their retirement and encourage them to spend a larger and larger period of their working lives in retirement without making provision for an adequate income.
- The way services are actually funded and organised may promote inefficient practices in day to day delivery.
- The growing scale of funding through traditional tax measures, at some point, can seriously interfere with work incentives.

The long run evidence does not suggest that the efficiency damaging effects necessarily outweigh the efficiency enhancing ones, even narrowly defined (Atkinson 1995; 1999; Lindert 2004). So, for me, these are not arguments for abandoning states' welfare roles but for re-designing them to minimise their perverse features. The scale of market failures in medical care, long term care of the elderly and pensions are becoming increasingly evident. Moreover, the growing problems that funding state services involve, like demography and cost escalation, face private services on at least the same, if not a greater scale, as I shall illustrate shortly in the case of UK pensions.

The question is whether fundamental reforms are possible in systems that are politically, not market driven, and where provider, user and pensioner interests are so powerful.

I dare to suggest that constructive change is possible though difficult. I am going to take the United Kingdom as my central case with other European comparisons on the way. That is partly because I and other colleagues at the London School of Economics have been rather centrally involved in several of the changes but also because Britain's economic performance twenty years ago had become so bad that decisive changes were required. Now the UK has one of the more successful economies in Europe and I do not think that that fact and the scale of welfare state reform have been unconnected.

### **Enhancing the efficiency effects of welfare states**

To a greater or lesser extent all European governments have endeavoured to mitigate the downside effects of their welfare states in three ways over the past twenty years. They have done so by:

- introducing greater work incentives into benefit systems;
- sharpening the efficiency incentives facing service providers like schools and hospitals;
- encouraging a greater mix of private with public funding but, at least in some cases, in ways that enhance the interests of the poorest.

I shall have most to say about the third of these strategies as the first two have been much discussed in the literature, but it is important to see all three as necessary complements to a single strategy.

### **Work Incentives in benefit systems**

The countries of Europe have differed in the way they have provide some kind of safety net for the poorest who are not in receipt of social insurance benefits. In more recent years there has been some convergence. The UK was unusual, if not unique, until recently in having a single means tested minimum income which is nationally set and regularly revised. It applies everywhere in the country, except in relation to housing costs. The rules that govern requirements to actively seek work as a condition for seeking work are also nationally set, though have been subject to local interpretation in the light of differing employment prospects. It was because these prospects locally became so poor in the 1980s that the test of genuinely seeking work and the handing out benefits with little question, became the norm.

In other parts of Europe public assistance often remained a very local service. The way the long term unemployed and those who do not qualify for unemployment insurance are treated still reflects these very different public assistance traditions (Lodemel and Tricky 2000).

For a long period in the 1960s, 1970s and 1980s the United Kingdom suffered from high levels of unemployment, low growth and high inflation. Instead of having one of the highest per capita incomes in Europe after the war it slipped to having one of the lowest. The UK suffered, in particular, from high levels of long term unemployment. Short term frictional unemployment was not that different from other nations in Europe. Colleagues' research at the LSE (Layard 1997) suggested that the reason for the high levels of long term unemployment lay in the lax administration of the benefits system. The UK set essentially no limit on the length of time individuals could remain unemployed and draw public assistance benefits. The rules had been strict in the 1940s but eroded and became overwhelmed in the periods of high unemployment in the 1970s and 1980s. Once someone had been unemployed longer than six months, and certainly a year, they had little chance of ever re-entering employment. These individuals played no further part in the labour market, in pressing down on wages by offering their services. In this respect countries like Sweden with more active measures to re-enter workers into the labour market were able to sustain higher levels of employment. The UK was prepared to support single parents who were out of work for longer than almost any other European country (until the youngest child left school) and combined this with little in the way of care for children for any working mothers. It was no wonder, then, that the UK had the highest levels of single parenthood in Europe (Lewis 2000; Kiernan, Land and Lewis 1998). The welfare state was, in short, encouraging both long term unemployment and single parenthood, the argument ran.

The UK set about trying to reverse both, beginning in the mid 1990s. This strategy took the form of both sticks and carrots.

### *Sticks*

The Conservative Government replaced the old unemployment benefit by a Jobseekers Allowance which required active job search as a condition of receiving a benefit. The New Labour Government after 1997 developed a whole series of new sticks and carrots applied to different groups of long term unemployed. It copied many aspects of an active labour market policy from its Scandinavian and Dutch neighbours as well as schemes in Australia and New Zealand, less so the United States.

Those aged 18 to 24 without children were the first targeted. If they had been unemployed and receiving the Job Seekers Allowance for six months they were required to attend an interview and be assigned to a personal advisor to assist them in gaining a job. They would receive advice on the particular suitability of different kinds of job, help with job applications, and preparation for interviews. For others it would mean further training, education or work place skills. This phase would last four months. If there was still no job the young person would face four options and had to take one of them:

- A job with a designated employer who would receive a wage subsidy and a training allowance.
- Full time education on full benefit if the individual was deemed to be poorly qualified.
- A job in the voluntary not for profit sector, again subsidised and with a training grant.
- A job with an Environmental Task Force – open air jobs with training included- to prepare young people for work.

If none of these were chosen benefits were reduced.

The approach was gradually extended to other groups:

- Those over 25 out of work for two years and shorter periods.
- Those over 50.
- Disabled persons.
- Those with repeated periods out of work.
- Lone parents.

The government approached the last group particularly gently merely requiring job related interviews for those with older children and those with long periods out of the labour market. No sanctions were introduced of the kind that were a feature of the American welfare reforms.

### *Carrots*

Along side these penalties and enforced advice went financial incentives.

- A minimum wage that grew gradually after a cautious beginning to reach just over over £5 an hour.
- The starting point at which employers and employees had to pay social insurance was raised.

- Tax credits for those working on low pay (Working Tax Credit) and for those with children on low incomes (Child Tax Credit) effectively supplemented low pay for these groups.

### *Outcomes*

The direct impact of the advice/ sanctions package has been cost effective (with a twenty per cent greater chance of young people in the programmes re entering work) but the overall impact was not large in macro economic terms compared to the wider improvements in the economy.

The relative importance of the 'making work pay' component in the strategy has been greater and significant. The same has been found in other countries (Banks, Disney Duncan and Van Reenen 2005).

The big failure has been to reduce the scale of long term sickness absence. This has grown from just over half a million individuals on benefit to two and a half million in 2005. This trend is linked to those thrown out of work in the old industrial areas and the difficulty in gaining access to the labour market for those who have been sick for long periods, often with mental illness. But it is also the result of the fact that long term sickness benefit is more generous and doctors are reluctant to deny their patients access to these benefits if there is any case to be made. New rules will apply to applicants for a new benefit from 2008. This will require careful independent medical and work related assessments to qualify (Cm 6730, 2005).

In short, this has been a long and politically sensitive path but the evidence suggests that those countries in Europe that have adopted measures to reduce the rigidities of their labour markets and to reverse the perverse employment incentives of their benefit regimes have come to enjoy lower levels of unemployment.

In the 1980s and 1990s the UK ran into inflationary and balance of payments difficulties when its levels of unemployment fell below ten per cent of the work force. Now the figure is nearer five per cent (Nickell and Quintini 2002). The reduction in benefit costs and the extra revenue generated by has meant the UK has been able to expand its health and education system at twice the rate that was possible in the previous decades.

### *Lessons for Latin America*

The lessons for Latin America may not be that direct. They do not have the same extensive unemployment or universal assistance schemes in the first place. But two lessons do, I think, apply.

- More extensive unemployment assistance and safety nets will surely come. Building in positive individual help/advice with some sanctions, so as not to be trapped on benefit, will be important.
- The distinguishing feature of the UK reforms and their success has been positive financial inducements to enter the work force and to do so in ways that improved the incomes of families with children. In the US where the main emphasis has been on getting single mothers to work most of the extra income generated has gone on work related expenses. In the UK most of the extra income families have gained has been spent on child related expenses (Waldfogel 2007). How you go about welfare work related reform matters a lot.

### **Improving the efficiency of state services**

Improving the efficiency of the way in which state services operate is important for several reasons.

- Keeping voters satisfied in ways other than increased spending can mitigate fiscal pressures.
- Using the large human capital and other resources involved in public service provision to greater effect improves overall economic efficiency.
- Keeping consumers satisfied with the quality of collectively funded services is necessary if they are not to exit to private alternatives and hence undermine their capacity to deliver the equity and solidarity goals that they embody.

Over nearly two decades the UK government has sought to introduce a degree of competition and consumer choice into the health, education and care services for the elderly (Le Grand 2003). These moves have parallels in other European countries but they have been greatest in England – not Scotland or Wales whose devolved governments have been much more sensitive to producer interests. In general these changes have popular with users but not with professionals.

Until the 1990s all these services were operated as state monopolies.

- Hospitals received budgets that grew annually with no relation to the number of patients actually treated. Patients had little option but to go to their local provider. The longer a hospital waiting list the greater the opportunity for clinical staff to increase their incomes through private practice.
- Social care services used to be provided by locally elected councils supported by central taxation. There was no choice of provider or individual capacity to vary the mix of services received.
- Schools were similarly provided by local councils with incremental budget allocations and little way for parents to know whether their child was doing well or badly or to do anything about it.

In each case the ways funds reached the institutions provided no incentives to improve efficiency.

Now major changes introduced over a twenty year period have tried to tackle these perverse incentives. Hospital budgets are being determined by the number and nature of the treatments provided. State schools are paid according to the number of children whose parents choose to attend that school. Regular national tests inform parents how well their children are doing compared to nationally set norms. Services for older people and those in need of special care are mainly provided by private and not for profit independent agencies. Individuals and their relatives can increasingly receive a budget with which to purchase their own services.

It would be wrong to suggest that all has gone smoothly. There have been errors in the way rewards and tariffs have prices have been set, unnecessary organisational disruption and much else. The price that it was felt necessary to pay service professionals to accept these changes – notably in big salary hikes for the medical profession- was too high.

Some of the measures do not in my view go far enough. Doctors still do not face enough direct efficiency incentives. But overall standards have risen in all these services and so have their diversity and response to individual needs.

Two decades ago large numbers of people (over 200,000) had to wait over a year for non emergency treatment. Now the maximum wait in England is two months for a non emergency case from diagnosis to treatment. For life threatening cancer the treatment will take days. This has resulted from both more money and central pressure and targets. Similarly a decade ago sixty percent of English children fell below what the state considered to be a minimum level of maths attainment for a modern citizen. Today the figure is down to twenty per cent and falling still.

### *Lessons for Latin America*

Again, the nature of state services differs widely between the UK and Latin America and there may be no direct easy lessons. However, some general points can be made:

- The incentive structures implicit in the ways in which state institutions are funded matter.
- Changing them may be costly and difficult but the efficiency gains can be considerable.
- Often the gainers are the poorest who have had little choice in the past and have suffered most from the monopoly practices of state providers.

Hence, in two important areas, the UK and English governments have moved to tap private funds. But they have done so in ways that do not interfere with the basic goals of the welfare state and again are intended to help the poorest most. I take two examples - pensions and the funding of universities.

### **Mobilising private funds**

#### *Pensions*

The United Kingdom, the Netherlands and Switzerland are unusual in Europe in that they have relied heavily on funded occupational pensions as a major element in their provision for retirement. (For an analysis of how and why this happened see Pemberton, Thane and Whiteside, 2006.) In this sense they are all three nearer to South American pension schemes than anything in Europe.

The UK added tax subsidised personal private pensions to the range of occupational and state pensions on offer in the 1980s. Both Switzerland and the Netherlands have required, or all but required, occupational pension scheme membership by law or strong union / employer agreements nationally set. They have built this compulsion on minimum or citizen's pensions which provide a platform of guaranteed state provision at some level of agreed adequacy. Because these basic pensions are not means tested any pension earned in an occupational scheme fully benefits all pensioners.

The UK has been different yet again. It always set its post war flat rate pension below the safety net level provided by its national system of public assistance. In that sense it never implemented the Beveridge Report ( Hills, Ditch and Glennerster 1994) . Then, in the 1980s, the Thatcher Government began to steadily erode the value of the basic state pension relative to average earnings to which the pension had been linked for many years. By raising it only in line with prices, not earnings, the value of the basic pension



for a single person fell from about a quarter of average earnings in 1980 to 15 per cent by the late 1990s and was set to fall to less than ten per cent in the next two decades. It was essentially disappearing. The Conservatives, in their 1997 election manifesto, proposed to abolish the state pension altogether, closely following Chile's original model. Roughly half the population were largely dependent on funded employer pension schemes. The rest have relied on the declining basic state pension, small occupational pension additions and means tested benefits.

As late as late 1990s the government was convinced of the virtues of this pattern (Cm 4179, 1998). Increasingly targeted means tested pensions supported the poor while voluntary membership of occupational and private personal pensions heavily invested in equities were providing varied pensions at a very low cost to the exchequer. At about five per cent of the GDP the UK's state pension cost was containable and would not rise over the succeeding fifty years, indeed it would fall, even though the population would age considerably (H.M. Treasury 2002). Such at least was the Government's hope. Private pensions and private savings would take the strain and they would do so without any state compulsion. This was to prove a completely unrealistic prognosis.

- Major informational problems face individuals wishing to make rational investment decisions about old age. These are not merely concerned with uncertainties about the long term future but about the nature of financial markets. The scale of ignorance here is striking. Even when the information is good people find it difficult to understand and even more to act upon (Barr and Diamond 2006).
- The attempt to draw in individuals with moderate incomes to invest in their own personal pensions with the help of substantial tax relief failed. Many individuals left occupational pensions for immediate tax benefits and found themselves less well covered for retirement. Since companies had not pointed this out to investors they were found by the regulatory agency to have been guilty of miss selling and had to compensate investors. This made companies very wary of selling to people on moderate means. The new cheap private schemes that employers were required to offer completely failed to be taken up by employees.
- Company pension schemes began to fail too. Buoyed up by rising stock markets many companies took 'contribution holidays' only to find that when the stock market fell they were in long term debt. This was compounded by the fact that they systematically underestimated the likely longevity of their members. The rising costs of defined benefit schemes led them to transform their pensions to defined contribution schemes. But not only did they shift the risks in this way to their employees but they took the opportunity to reduce their employer pension contributions despite the growing longevity of their members.
- The large industrial companies that had been the backbone of private occupational schemes largely went out of business in the 1980s. New smaller service industries did not begin this expensive luxury. Final salary defined benefit schemes became largely confined to public sector employees.
- Along side the rapid with drawl of the private sector from pension provision the state continued to run down its own basic pension scheme. But to reduce pensioner poverty it introduced an increasingly complex pattern of pension supplements for the poorest. The combination of these two trends produced the

inevitable outcome – a growing dependency of the elderly population on means tested benefits. The government appointed Pension Commission (2005 p 64) estimated that with no change in policy the UK was heading for a situation in which 80 per cent of elderly households would have been dependent on means tested state pensions. They would therefore have lost much of their incentive to save in any form of private pension scheme.

- Despite the future fragility of pension income the share of individuals' adult lives lived in retirement had steadily grown. It was 17 per cent in the 1960s. By 2005 it was 31 per cent. Working life had not grown in line with the experience of a healthy life.

In short, the UK experiment with voluntary membership of private pension schemes as the prime means of providing retirement income failed.

An independent Pensions Commission was set up to provide an alternative route and, in particular, to consider the case for compulsory membership of private pension schemes. Its two reports in 2004 and 2005 gained unusually wide support. Public concern with a future of uncertain and falling incomes in old age grew to the point that the public was prepared to support painful action so long as it made income in retirement secure. Legislation is going through Parliament at the moment (April 2007) which will implement most of the Pension Commission's recommendations. (Outlined in Cm 6841, 2006 and Cm 6975, 2006) Some important detail remains to be agreed with the private pension industry but the resulting framework will be unique in Europe and provides a contrasting model to the Spanish, Swedish and German models described by other participants at this conference.

In essence it is based on five principles:

- The funding of adequate retirement income will be impossible unless the length of working life increases as fast as the expectation of life. It is only fair in an inter-generational sense that the proportion of life spent in retirement does not continually rise. To the surprise of UK politicians this principle has gained widespread acceptance. The government is legislating for the full state pension age to rise from 65 to 68 by 2050. The pension age for women is already rising from 60 to 65. When that transition is complete the combined full pension age will go on rising to 68. The aim will be to stabilise the share of adult life spent in retirement at 30 per cent. This principle is in line with that adopted in Sweden and Germany though implemented in a different more explicit way.
- Membership of private or occupational pension schemes should not be compulsory. People should be free to choose others forms of saving or not to save at all if they wish (beyond tax enforced funding of a minimum state pension explained below.). The exact pattern of income over a life time is for people to choose. However, this should be a deliberate choice. Given the difficulty individuals have in making long term financial decisions government should arrange for people to be members of such schemes unless they deliberately choose to opt out. Evidence from the US suggests that most will not (Choi et al 2002).
  - Employees over the age of 22 earning above £5,000 and up to an earnings limit will be automatically enrolled into a private funded personal pension account approved by the National Pensions Saving Scheme and chosen by

- the employee or they may opt to enter an approved occupational pension scheme run by their employer. They will have the right to opt out. (The self employed will not be automatically enrolled though they can opt in.)
- Those not opting out will pay at least four per cent of their earnings, up to the upper earnings limit into the nationally organised scheme or into their employer's occupational scheme. Employers will be required to contribute a matching three per cent and government will, through tax relief, add another one per cent. In the case of those opting for a personal account the money will be collected by the tax authorities and transferred to the fund of their choice via the national agency. This will keep the individual's records and give the individual a regular up date. This arrangement will substantially reduce collection and administration costs found in private schemes. People can opt out or change funds at any point.
  - Those who do not opt out but fail to choose a scheme will be automatically assigned to a default scheme. This will be administered by an independent agency which will outsource the management of the fund. Research suggests that this may cover the majority of lower paid employees.
  - For those who do make choices there will be:
    - A restricted number of bulk bought funds with low charges;
    - A wider range of funds to include ethical investments and branded funds with higher charges.
  - This approach gives the private funded sector a much larger role compared to Sweden or Germany. Most of the population will be contributing most of their pension savings through a private funded defined contribution scheme though one that is heavily regulated by the state. The idea of giving individuals choice as to how to invest in funded schemes is common to the Swedish and German schemes. The difference is in the scale of membership. In the UK the funded schemes will form the bulk of pension provision as in the Netherlands and Switzerland. It differs from the Netherlands and Switzerland in continuing with a voluntary principle though heavily weighted in favour of membership. It is closest to the New Zealand pattern.
  - On retirement the accumulated funds will be used to buy annuities.
- The state will play a major role in keeping down the administrative costs of private schemes. This is one of their major defects. The costs of selling and administration can reduce the potential private pension by up to third. The Pension Commission therefore recommended that annual management charges be capped at 0.3 per cent of funds under management. The whole scheme is expected to reduce management costs by between 20 and 25 per cent over the present.
  - It is impossible to expect individuals on low incomes to save for retirement if the benefits are taxed away in the loss of state means tested support. The basic state pension will therefore be raised in line with earnings. In combination with the existing second state pension, and at some point merged, state pension provision should lift most pensioners off means tested income support. It will involve an increase in state pension spending. State pension spending in the UK is currently

running at 5.2 per cent of the GDP. This will rise to 5.9 per cent in 2030 and 6.7 per cent in 2050. This will still be about the lowest in Europe.

- Women will benefit from a general reduction in the qualifying period for the state pension from 40 to 30 years of work. They or any major carer will also have contributions credited to them for periods when they are looking after children or disabled relatives. However, these advantages only apply to the state pension. The same disadvantages as now obtain for women in the private funded sector. Any interruption of earnings or part time work seriously reduces an individual's pension prospects. It is perhaps the scheme's major draw back.

The UK is thus set upon a significantly different path from most other European countries. The low state spending on pensions may give room for other state spending to rise. The higher private savings rate that could result may raise investment and productivity but none of this is guaranteed. The government is trying to give the private funded model a boost and make it the dominant provider without making membership compulsory. How far it will succeed is another matter. It will surely be watched closely. Its major weakness has to do with the treatment of women. The gender sensitive model introduced into the basic state scheme does not carry over to private schemes.

#### *Lessons for Latin America*

The UK has moved nearer to many Latin American schemes than most other European countries. But it is different and there are some aspects that are relevant to those thinking of reform in Latin America.

- The foundation for private saving is to be a universal above poverty line state scheme. Though not a full citizen's pension the state builds in equal state pension right accruals for those while not working because they are caring for children or other family members. Latin American schemes have not been good at poverty relief or meeting women's needs.
- Membership of private schemes is not compulsory but heavily encouraged by assuming membership, requiring a person to contract out and giving matched employer and state funding.
- The restricted range of schemes available to members of the state savings scheme, resulting from wide competition and government rules, will reduce the costs of administration and selling by a large margin.

#### **University finance**

The vitality of the university sector contributes critically to the efficiency of advanced economies and hence their capacity to support a growing elderly population and welfare states more generally. It does so both in terms of the supply of highly educated people and in the spin off from advanced research. However, all European nations are finding it difficult to sustain the quality of their universities especially in competition with the US and, increasingly, Asian institutions.

- In most countries tuition has been provided free or at very low cost.
- In only a few countries is there extensive finance of student living costs.

- In some all young people gaining a given entry qualification can enter university.
- In all countries there has been a drive to expand entry from a narrow base to mass provision.

The results are inefficient and inequitable.

- Universities are struggling to sustain quality with rising intakes.
- There is no incentive for students to make economically efficient choices:
  - as to whether to stay on at all;
  - in the courses they choose, high and low cost courses appear equivalent;
  - in the type of institution to attend. At the moment those who follow vocational courses have to pay, those who follow academic courses in universities do not.
- The opportunity costs of staying on after school are high for poor families even when tuition is free.
- State funding is thus strongly pro rich. In the UK expenditure on post school education has been five times as great for the richest fifth compared to the lowest fifth of the income distribution (Glennerster, Falkingham and Barr 1995).

In 1997 universities in the UK were in serious financial trouble. The Labour Government in the following year put some extra taxpayers' money into the system but more significantly permitted universities to begin charging for tuition in England. (This was not the case in Scotland which gained power to make its own policy in this period.) A required fee was set at £1,000 a year, increased by inflation thereafter. The fee was related to the income of parents so that students from families in the lowest third of the income distribution paid nothing, the second third paid half the fee.

This gave universities some respite but not much. The scheme was unpopular and steps to limit the costs to poorer families meant that it ended up not producing a great deal of revenue. By 2003/4 these fees only produced £400 million a year out of a total budget of £8 billion for higher education. Nor could institutions vary their fees to reflect the cost of their courses so there were no efficiency signals. The scheme relied on parents' willingness to pay the fees. However, there was one advance. The loans available to cover living expenses were to be repaid through the income tax system as a percentage of future income paid until the loan was paid off. The whole satisfied neither the universities nor students.

The Labour Government tried again and the new financial settlement was introduced in 2006. It involves higher fees repaid after graduation through a form of graduate tax. As someone who advocated such a solution long ago (Glennerster et al, 1968) and was involved in the design of the current scheme, I am clearly prejudiced. (For an account of the evolution of the intellectual case see Barr and Crawford, 2005). But I would like to think that the OECD was right to suggest that it could become the role model for other European universities. The OECD 2004 Report on the UK Economy concluded:

'Given the growing constraints on public finances, it would be difficult to raise large amounts of extra funding for British universities via general taxation, nor would it be fair when considering that the individuals endowed with education enjoy large gains from it. In particular for higher education, the private returns are large, and in the UK those with a university degree earn, on average, about twice as much as those without post-

compulsory education. Because of this large wage differential and because, as in other European countries, most of the spending on higher education is paid out of the public purse, the average economic return to individuals taking higher education is probably the highest in the OECD ... The whole package of changes [described below] will generate an amount equivalent to about 0.2% of GDP'.

So, how does the scheme work and what are its long term advantages and limits? What still needs to be done?

*The 2006 reforms : Improved access and a 'Graduate Contribution'*

The key elements to encourage access were:

- 'Up front' tuition fees paid by home and European undergraduate students on entering university were abolished. (Universities have always been able to charge for postgraduates and overseas non European students.)
- Maintenance grants covering living expenses for students from poor homes were reintroduced.
- Loans to cover maintenance costs for the non poor were made more generous and repaid through the tax system. These carry no interest but the debt increases in line with inflation. A ceiling to the availability of these loans prevents the rich benefiting.
- In giving permission charge fees recoverable after graduation universities have to agree to take steps to ensure they take special measures to attract poorer students and those from state schools in poorer areas.

The increase in tuition income from home students was achieved by:

- Charging students a fee of up to £3,000 a year depending on the course they take. This limit is set for the coming Parliament but will surely rise further.
- The university gets the fee income when the student attends. But the money to fund this action is borrowed on the open market by a not for profit Student Loans Company. This Company then repays those loans from the revenue collected by the Inland Revenue from graduates.
- Government pays the company to undertake this task and under-writes any shortfall that occurs because a graduate does not pay the full sum through earning too little, for example. Only this sum appears under the government's public spending totals.
- Students will repay only when their income rises above £15,000 a year - a figure that will probably rise to keep pace with earnings. Ex students pay 9 per cent of any income received above that sum until their debt is wiped out. After 25 years the debt is wiped out in any case. If a graduate's income remains low or non-existent because of poor health, bad luck or caring responsibilities she will never have to repay the full sum. This applies particularly to women who, it has been calculated, will repay only 60 per cent of their fee 'debt' on average.
- The student loan carries no interest but the debt rises in line with inflation.

The advantages of this set of arrangements are that:

- Universities gain an income free of government restrictions and begin to compete on price and quality.

- It opens the way to increasing income from students while preventing an up front price barrier.
- There are incentives for universities to attract children from poorer homes or disadvantaged schools. They lose their fee freedom to raise fees unless they do.
- The whole is much less favourable to higher income groups. It frees part of the potential education budget to be used on needy groups such as for pre school provision.
- The fear was that the whole idea of a 'fee', even paid in the future, would deter students. This has not happened. Applications to universities in England have risen by seven per cent in the past year - a much faster rate than in the other parts of the UK where there are no fees and this scheme does not apply – Scotland, for example.

•  
*Some improvements still to make.*

- The fee ceiling is still low. It will surely gradually rise as the scheme becomes accepted.
- Some of the potential advantages are minimised because of the subsidised interest rate on borrowing. In the New Zealand a moderate interest rate was charged (1% above government borrowing rates) but this has been much reduced. An Advisory Committee pointed out that this had led to richer students making money by borrowing at the subsidised rate and lending at market rates. (New Zealand Tertiary Education Advisory Commission 2001). In Hungary the government sets an interest rate at the level the government can borrow plus a risk premium and administrative costs. There is no subsidy. Public spending could be used more effectively and in a more redistributive way if this policy were adopted in England. If the loans were given at a near market rate, there would be no reason to limit such loans on a means test basis. That would reduce the complexity of the scheme. It would also reduce the scale of what is counted as public borrowing in the National Accounts.
- The logic of the scheme is so strong that it could be expanded both upwards and downwards in the education system. If there were no interest rate subsidy those wishing to take post graduate courses could be included. So could those wishing to take vocational or other courses. They are often credit constrained at the moment. .

*Why not a pure graduate tax?*

The original proposal I made forty years ago was for a graduate tax. Those who graduated would pay back the cost of an average degree, or the average for their subject, by an addition to their income tax for life or until a given age when on average the costs would have been covered. The rationale was mainly one of equity and the taxing of private gains made from public investments. It had several disadvantages.

- The costs of expanded free education came immediately while the revenue gains would be reaped by the next government.
- There was no gain in university freedom. The central government would still control the universities' incomes while the Treasury gained the tax revenue.

- There was no gain in allocative efficiency – there were no competitive institutional price signals or competition.

It was for these reasons that I came to advocate a more subtle form of graduate contribution that improved efficiency incentives for universities and reduced the scope for government control.

*A model for other countries including Latin America?*

The basic financial problems faced by the English universities are not that different from those in Europe or Latin America. The necessary ‘three legs of reform’ (Barr and Crawford 2005) are:

- Variable fees to improve institutional efficiency.
- An income contingent loans scheme large enough to cover both maintenance costs and fees which are not full cost but reflect the fact that higher education has some public as well as private benefit. It should not be interest free since blanket subsidies of this kind cost a lot and result in complexity if limited to certain income groups. An established income tax system is a very efficient collection mechanism. Default and avoidance is very low – currently only 1 per cent of receipts for the maintenance loans given so far.
- Active measure to promote access.

Norway, Sweden and the Netherlands all have loans systems of some kind to cover student living expenses. Hungary, Australia and New Zealand have systems that recover tuition fees through their tax systems. These countries also have some of the highest rates of entry to tertiary education (OECD 2006). As in so many other ways the non Scandinavian, non Anglo Saxon European countries differ significantly, though even there tentative steps are being made to raise tuition fees.

The in principle case advanced here applies as strongly to Latin America as it does in England I would argue. Indeed, in countries with very high levels of inequality and poor state universities it applies even more strongly. The major constraint is with the effective revenue raising capacity of the income tax system. Latin American countries have difficulties here. However, failure to repay through that mechanism does not eliminate the debt to government in legal terms. There a lot to be said in the long run for an international scheme – perhaps a Latin American one.

*Some objections met*

Discussions with colleagues in Europe suggest a number of objections to the spread of this idea.

- Governments will, they suggest, merely reduce their support for universities by the same sum as any increase in fees from students and nothing will change financially. This is what happened in Australia in the long term. However, the Australian case is different in a number of respects. All universities had to charge a flat fee that differed by subject. In England growing freedom to charge will be less easy to merely offset with across the board real cuts. Even if that were the case the big gain would be that universities gradually freed themselves from government controls. However, I find the argument not supported by English



- experience so far. The political constituency for increased university funding did not go away when fees were introduced. Indeed the whole debate about fees raised the political profile of university funding. Funding from the tax payer has grown faster after fees were introduced, perhaps as a result of that higher profile. Even if it did turn out that the Treasury ‘saved’ on the change it would still be a more equitable way to fund education and release funds to be spent on the education of young or pre school children.
- Graduates already pay for their higher education as they earn more and hence pay higher taxes. This is a false argument.
    - Its appeal partly rests on the assumption that those with higher incomes already pay a higher proportion of their incomes in tax. However, only one fifth of tax revenue in the UK comes from direct taxes where this is true. The poor actually pay a higher proportion of their income in taxes overall than the rich. This means the poor contribute proportionately more of their incomes towards the costs of higher education than do the rich. The changes in university funding in the UK will make the tax system more redistributive (Dearden, Fitzsimons, Goodman and Kaplan 2007).
    - Under a system of free higher education those earning higher incomes who did not benefit from any state investment in them are required to pay just as much as those who have not so benefited. This is unfair.
    - Those who have benefited and are deemed, on this argument, to be using their taxes to ‘pay back’ the costs of their higher education are not contributing as much of their tax revenue to other purposes. They are not paying their fair share to the cost of the National Health Service or to schooling.
  
  - Some people have more spent on them by the NHS than others. Does this mean they should pay more? No. So why should university students? Answer, the case is quite different. We pay into the welfare state as an insurance against bad things happening. We spread these risks as we do in any insurance scheme. Higher education is not a risk in the same way. It is a benefit. I am not better off by virtue of being sick or unemployed. There I am merely compensated for being worse off. In so far as an individual invests in higher education and then fails to get a good job or decides to bring up children or looks after an aged mother then the state will pay his or her university fees under this scheme. She has suffered so the state compensates her. Here the state is acting in exactly the way it does in the rest of social policy. It is insuring against such risks. However, in so far as a graduate raises her income and benefits by virtue of the state’s investment in her, she pays more. It is exactly the same principle as applies, or should apply, to differential gains in property prices that arise because of the state’s activity in granting planning permission for development, putting in sewers and roads on one person’s land and not another. Such a private gain we call ‘betterment value’ and it is, or should be, taxed.

### **An emerging strategy?**

I have suggested that slowly and in a piecemeal fashion European welfare states have begun to respond to the fiscal pressures they are under. They have taken three routes:

- Improving the efficiency of the services themselves to make more use of the scarce tax funds that are available. This has, in the UK, taken the form of introducing more diversity into the range of service providers and competition between them.
- All countries have sought to reduce the perverse incentive effects benefits that have sustained long term unemployment. It was particularly true of the UK which has steadily tried to adapt the benefit system to re-engage those at risk of long term unemployment.
- All European countries are developing a mix of private and public funding for some key services. The notion that social policy has to be funded by taxation is giving way to the notion that it can be funded in some cases by shared public and private funding while the nature of the funding and its purposes are subject to collective regulation and can be engineered to help the poorest most. Both the UK experiments in university funding and private pensions are in their early stages of development. But they do suggest a new and promising path if only for some services.

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