Inclusion or Insurance?  
National Insurance and the future of the contributory principle  

John Hills

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  Telephone:       UK+20 7955 6679
  Fax:             UK+20 7955 6951
  Email:           j.dickson@lse.ac.uk
  Web site:        http://sticerd.lse.ac.uk/Case

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Abstract

This paper examines the decline of National Insurance in Britain, as witnessed by its declining share of all social security spending and the steady dilution of the “contributory principle” on which it was originally based. It argues that this decline is not an accident: under governments of the Left, arguments in favour of inclusion have been predominant, non-contributory benefits expanded and contribution conditions softened; under those of the Right, the emphasis has been on focussing limited resources on the poorest through means-testing. Given where we are now, the strong arguments in principle for social insurance look much weaker. However, there are also reasons why the system has not been swept away, notably the way in which the bulk of the system is concerned with state pension rights which have already accrued.

The paper explores current plans for the future development of state pensions, arguing that their combined effect is to restore something like a flat rate state pension, but with significant complexity. This could be developed into a more transparent system guaranteeing a total state pension at a fixed percentage of average earnings for those meeting a participation test, rather than being based on contribution records. This leaves a choice for the remaining sixth of National Insurance benefits: to separate out state pensions and absorb the other insurance benefits within the rest of working age social security, or to maintain the scope of National Insurance, but also based on participation, not past contributions.

Keywords: social insurance, social security, pensions, direct taxation
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I. Introduction

The future of Britain’s National Insurance system may not be hotly debated, but it is none the less a big question. Around £64 billion was collected in 2002-3 through National Insurance Contributions and £74 billion will be collected in 2003-4. More than £6 in every £100 of national income goes through the National Insurance system, making it as important within the public finances as financing the National Health Service.

Large parts of the system still rest – albeit with substantial later modification – on the sixty year-old foundation of William Beveridge’s 1942 report, Social insurance and allied services, written at a time when his concerns might have seemed peripheral, but which turned into a surprise best-seller.

Beveridge’s plan was for a comprehensive scheme of what he firmly saw as insurance to cover the main contingencies which led to “Want” (one of his “five giants on the road to reconstruction”) in the 1930s: unemployment, sickness and old age. It was based on flat-rate contributions – the “stamp” – leading to flat-rate benefits. In that way it was not redistributive, but as it worked through a national pool, those at low risk did subsidise those generally poorer people at high risk, unlike private insurance. As the historian Peter Baldwin put it ten years ago on the fiftieth anniversary of the Beveridge Report, “All for one and one for all: The Three Musketeers meet the Government Actuary” (Baldwin, 1994).

The system was work-based: if in work, you paid the stamp; if you lost work, you got benefit. As Beveridge put it,

“Benefit in return for contributions, rather than free allowances from the State, is what the people of Britain desire… Payment of a substantial part of the cost of benefits as a contribution irrespective of the means of the contributor is the firm basis of a claim to benefit irrespective of means.” (Beveridge, 1942, para.21)

Over the last sixty years many others have argued powerfully for and have eloquently defended the principles of social insurance. Some of their arguments are summarised in section II below, following a recapitulation of the characteristics of National Insurance as it is in Britain today. Section III discusses how the system ended up in this form, and Section IV looks at the implications for its future development. Section V looks in more detail at how state pensions – which account for five-sixths of all national insurance benefits
– have developed and might do so in future. Section VI concludes, discussing how the other parts of National Insurance might fit in with such developments.

The fundamental question posed here is, given the strength of the arguments which have been put for a National Insurance system, why is it in fact in such decline, and given this decline, where should we go from here? Bluntly, sixty years after the Beveridge Report, which established the post-War National Insurance system, should it be heading for retirement?

II. What is National Insurance?

Given the widespread lack of understanding of what National Insurance is and how it operates, it may be helpful to start by summarising its main features:

- Its key characteristic is that it is a contributory system, with special taxes – National Insurance Contributions (NICs) – paying for the benefits paid out. It is the main example of earmarking or “hypothenecation” in the UK public finances.

- Beveridge’s idea of flat rate, Poll Tax-style contributions was abandoned in the early 1960s and contributions are today based on a percentage of earnings above a threshold (of £89/week in 2003-4).¹

- The overwhelming bulk of the spending is on pensions: five-sixths of National Insurance benefits spending in 2003-4 will be on the flat rate state pension or earnings-related additions to it. But contributory benefits also include Widows Pensions, Incapacity Benefit, Jobseeker’s Allowance (for up to six months nowadays) and maternity allowances.² These differ from other benefits in that they are dependent both on a particular contingency and on someone having a satisfactory “contributions record”.

- When people have been asked what NICs pay for, they suggest “hospitals or the NHS” first, with most mentioning pensions as well (Stafford,

¹ In 2003-4 the contribution rate for employers is 12.8 per cent on all earnings above the primary threshold. For employees, the rate is 11 per cent up to the Upper Earnings Limit of £575/week, beyond which a rate of 1 per cent is now charged on the excess. The self-employed pay a small flat rate amount as well as a low percentage (8 per cent in 2003-4) of profits between the threshold and the upper limit, and 1 per cent of profits on the excess over that.

² Conditions governing Statutory Maternity Pay and Statutory Sick Pay are also closely related to the rules of National Insurance, but these are paid by employers, rather than through the benefit system.
1998), but less than a tenth of NICs have actually gone towards the NHS in recent years (although the increases in contributions in April 2003 are to contribute to rising NHS spending).

- Originally, National Insurance was funded from three sources: employees, employers, and the State. It was this which allowed Lloyd George to promise workers an enticing “ninepence for fourpence” when the original, more limited, version of National Insurance started in 1911. The Treasury Supplement was phased out in the 1980s – one of the ways in which income tax rates could be cut, at the cost of higher NIC rates. It made a brief reappearance in the mid-1990s, but today NI benefits are paid for entirely by contributions – indeed the so-called “National Insurance Fund” runs a surplus and is likely to continue to do so (but the net effect of this is effectively a contribution to general government revenues rather than accumulation of funds genuinely walled off from the rest of the public finances).

The heart of the system as envisaged by Beveridge was straightforward: those who pay in contributions when at work are then entitled to benefits when out of work or retired. This is what the “contributory principle” means. Under the strongest kind of contributory principle, in private insurance, the contributions made are actuarially linked to the potential value – allowing for individual risk and life expectancy – of the benefits. Under social insurance of the Bismarckian kind in countries such as Germany and France, risks are pooled but there is still a strong link between contributions and benefits in that both are earnings-related. Those who pay in more because of higher earnings at work are then entitled to higher pensions and benefits when unemployed.

The UK system as it has evolved has a weaker contributory principle: contributions are mostly earnings-related, but these days benefits are flat rate (apart from the state second pension – what used to be called SERPS – and, as explained below, that is also becoming less earnings-related). But still, the fact of making contributions is what gives an entitlement to benefits:

- except for those who are ruled out for not having paid in for enough years to get the pension (including 4 million paying some contributions in 1995-6, for instance, without it generating a qualifying year); or for not enough weeks in the “last two tax years before the benefit year in which your Jobseeker’s Allowance (JSA) claim begins”; or if entitlement has run out, for instance after six months on JSA; or if claiming Incapacity Benefit while getting other pensions, in which case it will be cut back by half of these.

- On the other hand, you can be “credited in” without making actual contributions for the first two years of education after 16; or if caring
for a child or disabled person; or – recently for maternity allowance –
by earning over £30 per week, well below the contributions threshold;
or, more generally in the last couple of years, if earning above the old
“Lower Earnings Limit”, but below the more generous new “primary
threshold” for contributions.

As Peter Alcock put it in evidence to the House of Commons Select Committee
on Social Security in 1999, “if you teach social security to lawyers and welfare
rights workers, you have to go through it about four times before they
understand it, and then you give them a little example to work out and they all
get it wrong” (HoC Social Security Committee, 2000, para. 14).

What we have is in fact a very weak contributory principle: benefits mainly
depend on the fact of having made contributions, but you can receive
“contributory benefits” without having made contributions, and you can be
ruled out of entitlement despite having made contributions.

Why have we developed such a system? There are very strong arguments for
social insurance, as opposed to other kinds of benefits, and ones which have
proved enduring in Continental systems and for what is in fact that largest part
of the US benefits system.

First, they are a manifestation of social solidarity, through their pooling of risks
– an argument which proved very popular at the height of the Second World
War as the Beveridge Report was published.

Second, and also crucial for Beveridge, benefits come as right, as a result of
paying contributions. As Richard Titmuss put it,

“One fundamental historical reason for the adoption of the
principle was the aim of making services available and accessible
to the whole population in such ways as would not involve users in
any humiliating loss of status, dignity or self-respect.” (Titmuss,
2001, p.117)

As a consequence, this not only improves life for the recipients, but also leads to
higher take-up and hence greater effectiveness in preventing poverty than
stigmatised benefits which people fail to claim.

Third, because they depend on a contingency such as old age or unemployment
rather than a means-test, disincentives to additional self-provision are
minimised. As Beveridge put it, the State “should not stifle incentive, opportunity, responsibility...for voluntary action by each individual to provide more than the minimum for himself and his family” (1942, para.9).

Fourth, they are in origin a work-based system. This has two sides to it. The entitlements boost the return to formal, declared work (or at least, offset the resultant taxes and contributions). Also, as Tony Atkinson (1995) has argued, the existence of unemployment insurance can be seen historically as a form of subsidy to employment in the industrial sector, and as improving the working of the industrial labour market. Given the importance of reinforcing the importance of work to New Labour, one might have expected this aspect of National Insurance to have been strongly emphasised in recent years, but it has not been.

Finally, there may be greater willingness – or at least less reluctance – to pay contributions for a clear purpose like this than taxes into a general pool. However, the word “may” is important here: what evidence there is of public attitudes suggests that people do not make a very big distinction between contributions and other taxes (Stafford, 1998; Hedges and Bromley, 2001). As I will come back to, the word “clear” may also be important: as Hedges and Bromley put it, “it may be that the less [National Insurance] is thought to be dedicated to Health and Social Security, the more it is seen as just another tax.”

III. What has happened to National Insurance?

So what has happened to the scope of National Insurance since the post-Beveridge system was brought in by the Attlee government in 1948? Contributions in 2003-4 represent about 6.5% of national income. Contributory benefits in 2003-4 are forecast to be just over 5% of national income. As Figure 1 shows, this is down from their peak of 6.5% of national income 20 years ago. But more strikingly, contributory benefits and pensions are a much smaller share of the total than they used to be. The growth in social security as a share of GDP in the last 20 years has come from a combination of non-contributory contingency-based benefits (such as extra costs benefits for disabled people) and means-tested benefits. As Figure 2 shows, at their peak in the 1960s and

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3 That is, people gain from any additional insurance or pension coverage which they organise for themselves, in contrast to the position with means-tested benefits, where part or all of the benefit may be lost. Under any kind of social security cover, the fact of that coverage may mean, of course, that people decide that they do not need any more, whereas in the absence of state protection, they might have organised some for themselves.
1970s contributory benefits accounted for 70 per cent of all social security spending. By 2003-4, they will be less than 45 per cent of the total.

Why has this happened? In a talk he gave at the York Conference marking the 50th anniversary of the Beveridge Report, Steven Webb (now Liberal Democrat social security spokesman) invented the country of “Bevland” – a mythical
country where the conditions favourable to social insurance applied (as opposed to the UK in the 1990s, where he argued they did not) (Webb, 1992).

Figure 3(a) shows what Bevland looked like in 1973. The lightly shaded central area represents the proportion of the country – or at least of its social security system – ruled by National Insurance in 1973-4. Its territory ran from Kintyre in the West to Northampton in the East. To the left, non-contributory non-means-tested benefits ruled the equivalent only of Northern Ireland and the Western Isles. To the right, means-tested benefits controlled only the more darkly shaded strip north and south of London.

Figure 3: The shrinking domain of National Insurance

But since then Bevland has been squeezed from both sides. To the left, the proportion covered by non-contributory benefits has extended up the Clyde towards Glasgow and to Anglesey, while to the right the zone of means-tested benefits (including tax credits) has widened to cover most of England and to Aberdeen. What remains may be the heartland of the country, but there is a lot less of it. And, as we have seen, what is left is ruled by a much less pure version of the Beveridge principles than before. Furthermore, many recipients of contributory benefits also receive a top-up from means-tested benefits such as Income Support. For them, the contributory benefits make no difference to their incomes – for instance, one in seven of those getting the basic pension had it topped up by Income Support in 2001. You could argue that around a tenth of the central area is in fact controlled by the forces to the right.

Asked why Denmark was so much smaller than it used to be historically, a Danish friend replied that, “you have to understand – we lost fifteen battles in a
row”. The story is the same for British National Insurance – except that it has lost a lot more than fifteen battles since 1948.

The most obvious change is in the relative value of contributory benefits. Figure 4 shows that, compared to average earnings, the basic state pension has been falling pretty well continuously since its peak in 1979, and what used to be Unemployment Benefit since its link to the pension ended in 1973. But the thresholds for means-tested benefits have not fallen as fast in relative terms. In 1978, the basic pension was 24.7% of average full-time earnings, and the Income Support (then called Supplementary Benefit) level for most pensioners was 25.2% of average earnings. Apart from the important complications of Housing Benefit, only a small amount of other income could carry someone clear of the worst of means-testing.

![Figure 4: Basic Pension and Unemployment Benefit (as % of full-time adult earnings)](image)

By 2002 the basic pension had fallen to 16.2% of average earnings (which were £465 per week in April 2002 for full-time adult workers), but what is now the “Minimum Income Guarantee” had only fallen to 21.1% of average earnings – a much larger gap to get over.

But, as Table 1 lists, this has not been the only issue. The story of the last 55 years has been one of only a few battles won for the contributory principle supposedly at the heart of National Insurance – albeit some quite big ones – but many lost. Right from the start, although many of Beveridge’s key recommendations were implemented by the Attlee government, many were not. On the one hand, the idea of entitlement to the full basic pension building up
only after 20 years of contributions to the new scheme was rejected to give immediate gains to existing pensioners. On the other, the rates set for National Insurance benefits were both lower than those which would have been implied by proper indexation for war-time inflation of those on which Beveridge based his recommendations, and failed to get people clear of the means-tested safety net, which was then known as National Assistance. It was this last feature in particular which undermined the idea of national insurance as being a way of abolishing “Want” without a means-test.4

But, as the (by no means exhaustive) list of developments in social security since then given in the table shows, when decisions have been made about the future development of its structure, few have reinforced the idea of a system based around National Insurance benefits linked in any strong way to past contributions. The introduction of SERPS from 1978 did try to re-establish a strong link between what were by then earnings-related contributions and subsequent benefits. However, it came twenty years too late to create an embedded system seen as the main source of income replacement for middle and higher income groups, of a kind which has resulted in the strong political defence of continental social insurance schemes. By the late 1950s, one third of those at work were already covered by occupational pension schemes. When mildly earnings-related (“graduated”) state pensions were introduced in 1961, members of such schemes were allowed to “contract out” in return for lower contributions, as had also been possible under pre-War legislation (Ward, 2002). This principle was carried over into SERPS, arguably the key factor in the system’s later lack of resilience when its generosity was cut back in the 1980s, and its structure altered in the late 1990s. As Jochen Clasen argues, contrasting the British case with other European social insurance systems:

“... the decline of the contributory principle in Britain would be difficult to comprehend without recourse to the role of earnings-related transfers. Essentially, because of the poverty rather than wage-replacement orientation, there is a much weaker incentive structure for contributors (employees and employers) to be involved in matters of social insurance (2001, p. 651).

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4 See the contributions to Hills, Ditch and Glennerster (1994), particularly those by Glennerster and Evans and by Veit-Wilson.
Table 1: Battles lost (and some won) by the contributory principle

(a) Gains for the contributory principle

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1948</td>
<td>Many of Beveridge’s recommendations implemented</td>
</tr>
<tr>
<td>1966</td>
<td>Earnings-related additions to unemployment, sickness and widows benefits</td>
</tr>
<tr>
<td>1974-9</td>
<td>Pensions and other ‘long term’ benefits linked to higher of earnings and price increases</td>
</tr>
<tr>
<td>1978</td>
<td>State Earnings Related Pension Scheme (SERPS) implemented</td>
</tr>
</tbody>
</table>

(b) Gains for contingent benefits/crediting in/less link to contributions

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1948</td>
<td>Immediate introduction of full pensions, not built up over 20 years</td>
</tr>
<tr>
<td>1961</td>
<td>Contributions become earnings-related without much earnings- relation in benefits</td>
</tr>
<tr>
<td>1985</td>
<td>Upper Earnings Limit for employer contributions abolished</td>
</tr>
<tr>
<td>1997-2001</td>
<td>Contributions Agency goes to Inland Revenue</td>
</tr>
<tr>
<td></td>
<td>‘Shadow Lower Earnings Limit’ – low earners exempted but still credited in Maternity Allowance given if earnings above £30 / week</td>
</tr>
<tr>
<td></td>
<td>SERPS reformed to become more flat rate for low earners, with ‘crediting in’ of some non-earners to ‘State Second Pension’</td>
</tr>
<tr>
<td></td>
<td>Employer contributions used as part of Climate Change incentives</td>
</tr>
<tr>
<td>2003</td>
<td>National Insurance Contributions rise to pay for higher health spending</td>
</tr>
</tbody>
</table>

(c) Gains for means-testing/restrictions in contributory benefits

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1948</td>
<td>Unemployment Benefit restricted to one year</td>
</tr>
<tr>
<td></td>
<td>Levels set for contributory benefits not fully adjusted for inflation since 1930s; no clearance above social assistance</td>
</tr>
<tr>
<td>1950s and 1960s</td>
<td>Failure to establish earnings-related pensions</td>
</tr>
<tr>
<td>1961</td>
<td>‘Contracting out’ allowed from ‘graduated’ pensions</td>
</tr>
<tr>
<td>1972</td>
<td>Resources channelled into means-tested Family Income Supplement and housing benefits</td>
</tr>
<tr>
<td>1973</td>
<td>Link between Unemployment Benefit and basic pension ended</td>
</tr>
<tr>
<td>1978</td>
<td>‘Contracting out’ maintained in SERPS</td>
</tr>
<tr>
<td>1979</td>
<td>Earnings-link for pensions abolished</td>
</tr>
<tr>
<td></td>
<td>Earnings-related additions for unemployment and sickness benefit abolished</td>
</tr>
<tr>
<td></td>
<td>Invalidity Benefit cut</td>
</tr>
<tr>
<td>1980s</td>
<td>Treasury Supplement cut out to allow lower income tax but higher National Insurance Contributions as contribution conditions are tightened and benefits become less generous</td>
</tr>
<tr>
<td>1988</td>
<td>Future accruals of SERPS cut. Emphasis on means-tested benefits in ‘Fowler reforms’</td>
</tr>
<tr>
<td>1992</td>
<td>Labour lose election with platform including £5 and £8 increase in basic pension financed by higher NICs (above upper limit)</td>
</tr>
<tr>
<td>1996</td>
<td>UB becomes Jobseeker’s Allowance, running only for 6 months and with tighter job-search conditions</td>
</tr>
<tr>
<td>1997-2001</td>
<td>Frank Field’s plans for an expanded contributory system rejected</td>
</tr>
<tr>
<td></td>
<td>Incapacity Benefit partly means-tested</td>
</tr>
<tr>
<td>2003</td>
<td>Pension Credit to help low income pensioners, rather than higher basic pension or State Second Pension</td>
</tr>
</tbody>
</table>
As the changing size of the “territories” in Figure 3 suggest, there have been other victories for both contingent benefits (as well as ways of “crediting in” people who have not paid contributions to insurance benefits) and for means-testing, but more for the latter. The failure of the 1997-1998 Minister for Welfare Reform, Frank Field, to convince the Treasury under New Labour to revitalise contributory benefits may well have represented the last battle for the contributory principle in the UK.

The pattern showed in the table is not accidental. When governments of the Left have been in power, arguments in favour of inclusion have been predominant, non-contributory benefits have been expanded, and contribution conditions have been softened to “credit in” people with low earnings or interrupted work histories. When governments of the Right have been in power, particularly in the 1980s, contribution conditions have been made tougher and the emphasis has been on focussing limited resources on the poorest through means-testing. New Labour has, perhaps characteristically, done both.

IV. The Future?

In the light of this brief history, how do the five arguments summarised in section II for contributory benefits now stack up?

(1) The solidarity argument applied to rights based on full-time work is undermined by the reality of today’s labour market and society. If rights depend only on work records, many are excluded; hence the expansion of “crediting in” within National Insurance and non-contributory contingency-based benefits to avoid this.

(2) The complexity of the system and the obscurity of many conditions make it hard to describe the system as embodying clear rights.

(3) For many, contributory benefits are too low to avoid the need for means-tested top-ups.

(4) The links to work records and actual contributions are in fact so weak that it is hard to argue for strong labour market effects from recognition of the rights earned through contributions. New Labour’s ideology could have been consistent with a revitalised work-based system, but this is a road which has been very firmly not taken.

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5 One might still expect the existence of a state benefit system in itself to affect the labour market, with bargaining behaviour affected by the existence of, say, benefits during times of unemployment or retirement. What is harder to argue in the current UK system that there would be much recognition of the way such rights are “earned” through contributions in a way which is different from other benefits.
(5) There is little link between contributions and benefits, either at the individual or the aggregate level, and the links that exist are incomprehensible to most. Contributions are not in reality earmarked, and there is no truly separate National Insurance Fund. If people are less unhappy about paying National Insurance than income tax, that is more a product of folk memory than of current reality.

There is an obvious – and not very original – conclusion. National Insurance has outlived its usefulness and should be swept away (Dilnot, Kay and Morris, 1984; Webb, 1994). In its place we could either integrate National Insurance Contributions with income tax in a much cleaner, more rational system, or reconstitute them as a Social Security Tax. As far as benefits are concerned, the job should be completed of replacing them with either inclusive contingency-based benefits or, depending on ideological taste, means-tested ones. What remains of Bevland would be carved up between Left and Right. The pages of benefit guides devoted to contribution conditions could be consigned to the bonfire.

The arguments for a reinvigorated contributory system have, for the reasons just described, decisively lost in recent years – including those from John Smith and Sir Gordon Borrie’s Commission on Social Justice (1994), which might have been expected to influence New Labour. But yet nor have the arguments for putting the system out of its misery succeeded either. There are reasons for this as well.

➢ First, despite the extremely low level of public understanding of the system, there does appear to be a relatively strong popular commitment to the basic idea that there is a system which you pay into, and then have rights to benefits from (Stafford, 1998). Indeed, people are aggrieved at perceived breaches of this “contract” through, for instance, the decline in the relative value of the basic state pension (Hedges and Bromley, 2001). It is, if you like, still a good brand name.

➢ The majority of what the welfare state as a whole does is in fact this kind of redistribution across people’s life cycles rather than between people on a lifetime basis (Falkingham and Hills, 1995). In Richard Titmuss’s 1955 Seth lecture he described the public finances as being like Crewe junction, with traffic (transfers) in many directions, rather than like a simple terminus with one-way one-dimensional flows from rich to poor. There is thus much to be said for a system which conveys this idea. Given the imperfection of the system, this is close to saying that the system is a myth, but a useful myth for the population to believe in – putting us in the
uncomfortable position of Dostoevsky’s Grand Inquisitor. But if a clearer, more honest, contract could be salvaged, encapsulating this principle is a point in favour of the system.

- Most concretely, the bulk of what the system does is about pensions. Reinforcing the notion that people pay into pension systems to accumulate later rights has fundamental advantages. More practically, people already have accumulated rights to both the basic and earnings-related pension. Governments have been very reluctant to renege on such rights (as opposed to changing the rules for future accumulation). Such rights can persist for 70-80 years. As we shall see below, adapting them is a very slow process.

- Fourth, the only part of the tax system which registers publicly is the basic rate of income tax. It is hard to see a government of any persuasion – other than the suicidal – agreeing to absorption of National Insurance Contributions into income tax, and a rise of 11 or 24 points in the basic rate of tax (particularly not a government pledged not to increase it). Some form of separately labelled tax mimicking NICs will survive any reform.

- Fifth, within the EU, migrant workers enjoy reciprocal rights to various benefits and pensions. Many of these rest on being an “EU worker”, as witnessed by contributions into the far more heavily contribution-based systems in other member states. We need some system which allows such reciprocal rights both for British workers elsewhere, and for other nationals working here.

- Finally, unless we are to move entirely to a means-tested system, benefits based on contingency have to meet some other test. Would UK residence be enough? So those spending the rest of their lives elsewhere could arrive and receive, for instance, equal pension treatment to those who have “paid in” all their lives? If not, would citizenship be the criterion? But if so, who is excluded despite paying in?

V. State pensions now and in future

So where might we go? Nearly fifty years ago Titmuss (1955) described Beveridge as being a better guide to the 1930s than to the 1950s. He is unlikely
to be a perfect guide to the twenty-first century either, but there are some of his principles which can help us. One may be his commitment to flat rate benefits rather than means-tested ones (which are lower for those with other income) or earnings-related ones (which are higher for those who had higher earnings). As Table 2 shows, the public appears strongly committed to the idea of flat rate benefits. This is particularly true of pensions and unemployment benefits. At the same time, they consistently see the state pension as being too low: not one of the retired respondents to the 2000 British Social Attitudes survey thought it was even a bit “on the high side”; half thought it was very low (Hills, 2001). Four-fifths of all respondents thought it “definitely”, and virtually all the rest “probably” government’s responsibility to provide a decent standard of living for the old.

Table 2: Public Attitudes to Benefits and Earnings, 2001

<table>
<thead>
<tr>
<th>Benefits for a very high earner compared to a very low earner should be:</th>
<th>Higher</th>
<th>Same</th>
<th>Lower</th>
<th>None</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unemployment Benefit</td>
<td>10</td>
<td>76</td>
<td>10</td>
<td>2</td>
</tr>
<tr>
<td>State retirement pension</td>
<td>13</td>
<td>74</td>
<td>9</td>
<td>3</td>
</tr>
<tr>
<td>Disability benefits</td>
<td>4</td>
<td>67</td>
<td>21</td>
<td>5</td>
</tr>
<tr>
<td>Child Benefit</td>
<td>1</td>
<td>55</td>
<td>23</td>
<td>18</td>
</tr>
</tbody>
</table>

Source: Park et al. (2002) based on British Social Attitudes survey

Given the importance of state pensions to the future of the contributory principle, it is worth examining how state pensions are now planned to evolve in the next fifty years – they are after all five-sixths of what National Insurance does. First, Figure 5 shows something quite remarkable. It is the Government’s latest forecast of what share of national income will be spent on state pensions of different kinds over the next fifty years. It takes account of the 2001 Census and the new Pension Credit starting in October. What is remarkable is that the

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7 The relevant questions in the British Social Attitudes survey do not explicitly put the argument that, for instance, those with higher earnings have previously paid more in National Insurance Contributions (or tax) and so might be “entitled” to higher benefits. None the less, they show little sign of an appetite for income replacement as an aim of the state system.

8 But not of unfunded public service pensions, the net value of tax reliefs for occupational and personal pensions, or NIC rebates for those contracted out of the State Second Pension.
total is pretty well constant, at around 5 per cent of GDP, throughout the period despite the forecast that the ratio of the population over 65 to that aged 15 to 64 will rise from 25 per cent in 2000 to 39 per cent in 2050 (DWP, 2002). It also contrasts greatly with the position elsewhere in Europe, as can be seen in Figure 6.

**Figure 5: Forecast Government Spending on Pensions**

![Chart showing forecast government spending on pensions](chart5.png)

Source: DWP (2002)

**Figure 6: Public Pension Spending in Selected EU Countries**

![Chart showing public pension spending in selected EU countries](chart6.png)

How is this remarkable feat achieved? Figure 7 shows a very simplified version of how things were in 1978 – a position which Beveridge would have recognised. The diagram – as do those which follow – shows the position of a single person who had pretty well equal earnings throughout his or her working life as a proportion of adult average earnings each year. Someone retiring in 1978 with a good work record at most levels of earnings over the previous 30 years would receive the flat rate basic state pension, then worth just under a quarter of average adult full-time earnings. On top of that would come any private pension they might be entitled to. At any given earnings level, some would be entitled to a private pension, others not. As drawn, the diagram shows the case where those with half average lifetime earnings or more could receive a private pension of half their own average earnings. In fact many lower paid workers paid just above this level would not in fact receive such a pension, but most of those with nearer to average or higher earnings would. At that time Supplementary Benefit (SB) for pensioners below 80 was fractionally above the basic pension. Anyone with only the basic pension, or with only a partial pension, would have it topped up to this level (shown by the cross-hatched area in the diagram). But – apart from the important issue of Housing Benefit – the effect of the system was that beyond quite a low level, people would benefit in full from the savings they had made through additional private pensions.

However, through the 1950s to the 1970s, a key debate was that many people did not have an earnings-related pension of the kind illustrated at the top of the diagram, or given through Continental social insurance systems. After twenty years of attempts, Barbara Castle’s State Earnings Related Pension Scheme (SERPS) started in 1978. The result, for its biggest beneficiaries, who retired in 1998, is shown in Figure 8, again greatly simplified.

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9 For simplicity, people are assumed – through one route or another – to be entitled to a full basic pension if their earnings at the date of retirement are at or above the Lower Earnings Limit at that date. With the Lower Earnings Limit effectively price-linked, this brings those with progressively lower lifetime earnings into entitlement over time. However, for other parts of the state pension system, the diagrams take account of the way entitlements depend on the relationship between earnings and the Lower Earnings Limit (and other parameters of the system) at the date of accrual of rights.
Figure 7: Retiring in 1978

Pension income as % average adult earnings

Lifetime earnings as % adult average

- Basic Pension
- Private Pension
- SB
Figure 8: Retiring in 1998

Pension income as % average adult earnings

Lifetime earnings as % adult average

- Basic Pension
- AP (SERPS)
- Private Pension
- SB
By then, the basic pension, linked only to prices, had fallen to only 17 per cent of average earnings. But people could – under the accelerated accrual rules which then applied – have accumulated a full “Additional Pension” (AP) under SERPS worth a quarter of their uprated earnings over the previous 20 years. For those with a private occupational pension, they would most likely have “contracted out” of SERPS in return for lower NICs when at work. Their total private pension would have two parts – the equivalent of the Additional Pension, and the rest (shown here as the private pension). Meanwhile Income Support (IS), as the safety net was now called, had fallen to 18 per cent of average earnings – a wider gap than before above the basic pension.

Note that what the combination of SERPS and the Thatcher government’s abandonment of uprating with earnings growth had achieved was to lower the relative cost of the basic pension, making room for the cost of the earnings-related Additional Pension without pensions spending growing at all in relation to national income, despite there being more recipients. But this was at the cost of those with low lifetime earnings, who lost more from the fall in the relative value of the basic pension than they gained from SERPS. For later generations of retirees, the situation would be worse, as SERPS was made less generous for them by changes in 1988.

New Labour has tried to grapple with this in three ways, as Figure 9 (a) and (b) show. These give the – again simplified – position for a single person retiring around 2018. Under the reforms, a further part of what will come from the state (the “savings credit” part of the new Pension Credit) is affected by any private pension received, so Figure 9(a) shows the position for someone with no private pension at all, and Figure 9(b) the position if there is a private pension of the kind shown before.
Figure 9(a): Retiring 2018 (without private pension)

Pension income as % average adult earnings

Lifetime earnings as % adult average
Figure 9(b): Retiring 2018 (with private pension)

Pension income as % average adult earnings

Lifetime earnings as % adult average

- Basic pension
- AP (SERPS)
- S2P extra
- MIG
- Savings credit
- Private pension
By 2018, a price-linked basic pension would be only 12 per cent of average earnings (although now going to some with lower relative earnings than would have qualified before), and the earnings-related addition will be (mostly) based on 20 per cent of average lifetime earnings. This leaves very low state pensions for those earning below two-thirds of average earnings over their lifetime. So one thing New Labour has done is to boost SERPS – now renamed the State Second Pension – for people earning below £10,500 in 2002 terms, with some gains higher up as well. The effect of this is shown in the diagrams by the horizontally shaded addition (“S2P extra”) to what would previously have been given through the SERPS Additional Pension. The effect of these reforms is intended to be phased in by 2050, but by 2018 the reform is already beginning to flatten out entitlements for those below half average earnings.

The second thing New Labour has done is to boost the means-tested pension – currently called the Minimum Income Guarantee or MIG (but to become the “guarantee credit” in future) – back up to 21 per cent of average earnings. Note that the combination of the basic pension, the Additional Pension, and the State Second Pension top-up is almost but still not quite enough to get a low earner clear of the MIG at the moment of retirement in 2018.

The third reform comes in this October. Under the new Pension Credit, people with small occupational or additional pensions above the basic pension get a bit extra – the “savings credit” (shaded black in the diagrams) – above the MIG so that they do gain something from their additional self-provision (subject to a withdrawal at a rate of 40 per cent on any excess of income over the level of the MIG). Someone with no private pension will still receive savings credit in respect of any State Second Pension rights (under old or new rules), so total state pension rights in the absence of any private pension are flattened further.

Without any private pension at all, the “savings credit” element extends beyond average earnings, potentially extending means-testing over a much wider range than would have been the case before (but at a less rapid rate of withdrawal than under the current MIG). As can be seen in Figure 9(b), however, even a relatively small private pension is enough to remove entitlement to the savings credit – the extension of means-testing is potentially wide, but quite shallow.

By 2038, the basic pension will be even lower (8 per cent of average earnings) but the new State Second Pension will be more fully phased in. This creates the position shown in Figure 10(a) for the case where there is no private pension,

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10 Assuming real earnings growth of 2 per cent in line with recent government projections.
and in 10(b) for the case where there is for those above half average earnings. As with the diagrams for 2018, these projections assume that both the basic pension and the point at which people are credited into the system continue to be price-linked (but that the Upper Earnings Limit stays above 125% of average earnings). Note that the effect of the State Second Pension top-up is again almost, but still not quite enough to carry people clear of the level of the current MIG at the point of retirement.

The net effect of all of this is as illustrated in Figure 11, comparing the total state support being given at different lifetime earnings levels in 1978, 1998 and 2038. In 1978, this was pretty well flat at 25 per cent of average earnings – single people received much the same from the state whether they had little private income and were receiving Supplementary Benefit or had private pensions on top of the basic state pension. As described above, by 1998 those with lifetime incomes below half of the average would receive less from the state than this (as the relative level of the MIG and basic pension had fallen), but those above would receive more (from SERPS).

Two lines are shown for 2038. For someone without a private pension, state support would rise from around 27 per cent of average earnings for those with all but the lowest earnings to nearly 35 per cent for those with the highest earnings shown. In other words, the end of all our exploring through the pages of regulations is to return to much the same point as we began from in 1978, with total support again nearly flat, although at a slightly higher level in relation to future average earnings at the point of retirement (but lower later on in retirement as such benefits are planned to be price-linked, whereas in 1978 the reasonable assumption would have been that they would be earnings-linked after retirement). The end result when the reforms are fully phased in by 2050 effectively unwinds Barbara Castle’s attempt to turn Britain’s state pensions into an earnings-related system along Continental lines.

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11 Recent policy on the level of the Upper Earnings Limit has been ambiguous, having been price-linked for many years, and so falling in relation to average earnings, but then increased significantly in 2000 and 2001. If the limit was linked only to prices, it would fall to 92 per cent of average earnings by 2018, and further still by 2038. This would limit – and further flatten – accruals of rights to state pensions for those with higher earnings levels, below those shown in the diagrams. It would also have major – and perhaps unlikely – implications for the structure of direct taxation unless there were further changes to the treatment of earnings above the limit.
Figure 10(a): Retiring 2038 without private pension

Pension income as % average adult earnings

Lifetime earnings as % adult average

- Basic pension
- AP (SERPS)
- S2P extra
- MIG
- Savings credit
Figure 10(b): Retiring 2038 with private pension

Pension income as % average adult earnings

Lifetime earnings as % adult average

- Basic pension
- AP (SERPS)
- S2P extra
- MIG
- Savings credit
- Private pension
Figure 11: State support: retiring 1978 - 2038

Pension income as % average adult earnings

Lifetime earnings as % adult average
But how does this cost the state the same proportion of national income as now if there are going to be nearly 60 per cent more people over 65 in relation to the working age population? The often unappreciated answer lies in the fourth line – the cost to the state for those who are in private pensions and are “contracted out” of the State Second Pension (as most are). This is much lower – partly because of the way in which those with significant private pensions will not benefit from the Pension Credit, but also because contracted-out private pensions pay part of what would otherwise come from the State Second Pension. In one sense, what is being done is in public finance terms surprisingly noble. Through the sacrifice of lower tax revenue today – achieved by “contracting out rebates” – we are stabilising the future costs of state pensions, despite the ageing population. The reward for today’s fiscal sacrifice is that private pensions pick up part of the cost of future pensions which would otherwise have been carried by the state.

In many ways it’s a neat trick. If they are implemented as described, the recent reforms return state support to something much closer to a flat rate system (at a more generous level for low earners than in recent years) while keeping overall spending to a fixed share of GDP despite an ageing population.

Why then does it seem unlikely that the reforms as presented here will survive unchanged? First, the combination of the different parts of the future state system as just described appears rather hard to explain in simple terms. This is potentially problematic in a field such as pensions when there are advantages to people understanding clearly what the state will provide in making decisions about what they should add to it by way of private provision.

Second, while current understanding is very foggy, people do know that there is a flat-rate basic state pension and have a rough idea of its level (Hedges, 1998). While the emerging system is in fact designed to mimic something not unlike a flat rate pension of more than 25 per cent of average earnings, the bit people understand is planned to fall to a third or less of this total. Most people under 40 interviewed in 1998 no longer counted on getting a state pension at all. This is not popular. As Alan Hedges summarised the results of his 1998 research,

“Hardly anyone wants the state to withdraw. They not only feel that obligations to those who have already ‘paid in’ should be

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12 Whether the terms of this deal are a good one for the state or those contracting out is rather complex, and depends on both personal circumstances and future developments. Ward (2002) quotes estimates that for those in “defined benefit” occupational schemes, every £1 of rebate paid out in the late 1990s only generated 88 pence-worth of later savings in SERPS costs.
honoured, but beyond that the great majority of participants would prefer the state to stay in the pensions business long-term” (1998, p.2).

Well, it is doing so, but that is not what people believe. This does not seem good salesmanship.

Third, as colleagues at CASE have discussed in some detail (Rake, Falkingham and Evans, 1999; Agulnik, 1999; Falkingham and Rake, 1999), the effect in my illustrations for 2018 and 2038 of the state second pension almost (but not quite) getting people clear of the MIG level only applies at retirement. After that, during retirement, state pensions are linked to prices only, while the means-tested minimum is planned to be linked to earnings. Ten to fifteen years into retirement many with small pensions would be pulled into sharper means-testing. Here the new Pension Credit will help – but only by spreading shallower means-testing over a wider range. The same problem will apply even at the point of retirement after the fifty years phase-in of the new system in 2051, as the base of the whole system – the basic pension – slips further in relative value.

It is, of course, too early to tell what the effect of the recent batch of reforms on public beliefs, understanding and behaviour will be, but it looks unlikely that we have reached the end of the journey. But nor does a simple “Back to Beveridge” restoration of a more valuable and earnings-uprated basic pension look likely either. Compared with current plans, that would obviously mean far higher future spending. Fair enough, you might say, with a larger elderly population, but the benefits of that spending would accrue to those with higher, not lower, lifetime earnings who would be eating their cake through lower contracted out NICs now, but still having it through higher pensions later on. Those below two-thirds of average earnings – including many women – would gain little.

There is, however, a way to navigate through this. Oddly perhaps, it would be to be honest and explicit about what the system is trying to achieve – getting a minimum contributory state pension which people can build on as close as possible to the current MIG levels, while not giving extra to those with higher earnings. In effect what is going on is an attempt to restore something closer to Beveridge by other means, and to unwind our belated excursion into earnings-related state pensions. If we were explicit about it, the next stage of reform could be, in effect, an alignment or integration of the State Second Pension and

13 Unless a government was to take the highly contentious step of reneging on already accrued rights to the State Second Pension (as opposed to changing rules for future accrual, which has been done before).
the minimum guaranteed by the Pension Credit (or Minimum Income Guarantee as was).

Figure 12 illustrates what the system could look like for those retiring in 2018. This shows what would result if the State Second Pension top up was set not as a complicated function of accrued earnings, but simply to bring the total of the basic pension and any rights through SERPS up to a minimum level at the point of retirement. The minimum is shown here at 25 per cent of average earnings for an individual by way of illustration. As time went by, the basic pension would become less important and the top-up more important. Eventually the total would become completely flat rate – except that the “Additional Pension” part could continue to perform the functions of both pre-funding future costs (through contracting out) and ensuring that those who can afford to provide for part of the costs of this minimum do so through their own contributions. Once calculated at retirement, the total (either from the state or promised in return for contracting out) could be adjusted each year to keep up with growth in general incomes.

An outcome of this kind would have a number of advantages:

- A clear message could be given that the total “state pension” would be at least the set percentage of earnings (unless people had chosen to fund part of this themselves in return for lower contributions).
- Eventually the “state pension” would again become a flat rate amount. Indeed rules on future accrual of the State Second Pension could be adapted to accelerate this process.

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14 See Curry (2002) for a more detailed proposal for a “State Pension Guarantee” along similar lines.

15 This is close to what we are heading for on average by 2018 and 2038, for those not contracted out, allowing for assumed post retirement indexation only with prices under current plans. Here post retirement indexation of the total topped-up to is assumed to be earnings-linked. What level was actually set would depend on what costs were seen as acceptable, and on other issues such as whether state pension age remained at its equalised 65 which are beyond the scope of this paper. The logic of the argument here also suggests that the minimum pension should be set on an individual basis (so that a couple with full “participation” records would be entitled to a minimum totalling 50 per cent of average earnings between them). As the Pension Credit is means-tested on a joint basis for couples, this would mean that there would be less of an offsetting saving from its absorption into the State Second Pension for them than for single people, which would also increase net costs for any given minimum.
Figure 12: Integrating State Second Pension and Pension Credit (2018)?

Pension income as % average adult earnings

Lifetime earnings as % adult average

- Basic pension
- AP (SERPS)
- S2P extra
- MIG
- Private pension
This amount could be maintained both over time and after retirement, so that the part of pensioners’ living standards based on it would not slip back in relative terms.

Over time the effect of the price-linked shadow Lower Earnings Limit would mean more and more of those with relatively low earnings being credited in, as well as carers for children or disabled people, or those unable to work because of disability. In effect, it would turn into a “participation pension” rather than a contributory pension. If the recommendations of the recent select committee report (2000) were followed, and the lower limit for entitlement frozen in cash terms, this process could also be accelerated.

With the minimum state pension set at retirement, the variable part of people’s private pension receipts would return to being an add-on to the flat rate state pension (apart from the fixed part which was being promised in return for contracting out, the funding advantages of which would remain). This could leave clearer incentives for additional private provision.

VI. Conclusions

In conclusion, where does that leave us for the future of the National Insurance system as a whole? Perhaps surprisingly, given the discussion at the start of the paper, it does leave it with a future – albeit in a rather different form from that envisaged by Beveridge or familiar to people used to Continental social insurance.

A first conclusion is that what we have today results from a series of battles which the “contributory principle” has lost over the last sixty years. Contribution-based entitlements have excluded too many, and benefits related in size to contributions have not taken root. Restoring what was intended by Barbara Castle’s reforms in the 1970s seems politically out of the question. But outright abolition of the system also seems politically unlikely, particularly given that the overwhelming bulk of it relates to pensions, accrued rights to

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This would create, in effect, a limited form for those above pension age of the “participation income” suggested by Tony Atkinson (1995, ch.15) for the whole population, or a step towards an “Old Age Basic Income” (Atkinson, 2002). Note that the form of top-up suggested here differs from – and is less ambitious than – his (1995, ch.16) suggestion of a “Minimum Pension Guarantee”, as the minimum state pension suggested here takes account of compulsory second pension accumulation as well as the basic pension.
which last for decades. However, as it stands the system is widely misunderstood and very hard to explain.

As far as pensions are concerned, I have suggested that a possible way forward is to be more explicit about what recent reforms are trying to achieve and to adapt them to allow a clearer message about how the system works to get through. At the heart of this would be acceptance that one of Beveridge’s principles – of flat rate benefits – has proved of enduring – even strengthening – popular appeal.

The recent invention of the “shadow Lower Earnings Limit” giving pension rights to low earners without contributions comes on top of credits for people in education, training, caring and in other recognised circumstances. Recent reforms to maternity allowances have equally credited in low earners (albeit with different rules). These reforms open up a new way of looking at “National Insurance”. It could become a system based on “participation” records, not “contribution” records. Of course, once looked at this way the question of “what is participation?” arises. For instance, if low paid work without contribution counts, as it now does for the state second pension, why not self-employment (perhaps with higher contributions)? Should caring for children of any age (as in the basic pension) or only those aged under six (as in the state second pension) count as participation? A series of questions of this kind would have to be answered, but in answering them we would be making explicit choices which are already being made, but in some obscurity.

What of the remaining sixth of National Insurance benefits? Here there is a choice. One option would be to argue that times have changed since social insurance was developed to cope with the “risks” which “interrupted” earnings through unemployment, sickness, and old age. Today, looking on retirement as a “risk” like the others seems anomalous: in today’s labour market, retirement is something which is anticipated and planned for. This puts it in a different category from the others, and could be argued to make the case for dissociating pensions from the other “insurance” benefits, absorbing the latter into the rest of social security. National Insurance Contributions could then be seen more clearly as what they mainly are, “state pension contributions” (or “state pension and health contributions”). Non-means tested Jobseeker’s Allowance could become clearly run together with other benefits and measures for the unemployed, and maternity allowances similarly absorbed into the rest of social security.

There is a logic to this separation which would match other recent reforms to benefits for the working age population. But it does not solve all the problems. In particular, where would Incapacity Benefit lie – as part of unemployment,
and so with working age social security, or treated as effective early retirement, and so part of the pensions system? Many of those receiving it may indeed have started retirement, but for others it has been damaging to treat them as never likely to work again. Drawing this boundary is not straightforward.

An alternative option would be to combine the direction of reform to pensions discussed above with the recommendations made by the House of Commons Social Security Select Committee (2000) when it examined the contributory principle. This was to extend the recent maternity allowance reforms – with entitlement depending on a (low) level of previous earnings rather than contribution records to the other insurance benefits. In effect, this would maintain the scope of National Insurance, but with it all run on a “participation” system, abandoning the residual (and increasingly obscure) remnants of links to actual contributions. This would, however, cost more, and the present government at least showed little enthusiasm for it in its response to the committee. Taking the cost on would require a judgement that a reinvigorated National Insurance system of this kind could be successfully marketed politically – this might be optimistic in the light of recent history.

The Beveridge Report has just celebrated its sixtieth birthday. A prior expectation given the decline of National Insurance in recent years might have been that its 65th birthday in 2007 could mark a good moment for retirement of the system it established. But this might not match the spirit of the times: under age discrimination legislation compulsory retirement ages will, after all, be illegal by 2007. “Flexible retirement” is on its way in. Similarly, some of the original principles of National Insurance have undoubtedly already gone, and others are on their way out, but those which underpin an inclusive, flat rate system for large parts of our social security system may still have some working life in them yet, if only we can pull them clear of the tangles of what we have now.
References


