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A proposal to fix welfare and fight intergenerational unfairness

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The Resolution Foundation recently proposed to introduce a “citizen’s inheritance” of £10,000 in order to offset the growing wealth gap between generations.

Free-market advocates did not welcome the report with open arms, and for good reason: its authors seem to want to address what is at root a problem of constrained housing supply and low productivity growth with redistribution. Transfers may improve well-being among those made better off by the grant, but it will not meaningfully lower house prices nor increase the economy’s long-run growth potential.

Yet the authors are on to something with a proposal that approaches a direct cash transfer early on in life. Perhaps unwittingly, they have pointed to a more honest and rational way to structure the welfare state.

At present, governments in rich countries provide tax-funded benefits in complex and inefficient ways. Universities are state-owned or heavily subsidised. Pensions nominally operate under the contributory principle, even though pension payments are funded by current expenditure, not the pensioners’ earlier contributions.

On their own, these programmes cause many distortions. The true scale of the pensions commitment to future generations is hidden from public sight by questionable accounting that wouldn’t pass muster among regulators if attempted by a private firm. More transparent analyses have estimated that the UK would need to set aside 12 per cent of all future GDP in order to meet its pension and other welfare commitments. For the United States, the figure is 9 per cent.

Meanwhile, state-sponsored education lures many people into spending time and money, often borrowed, pursuing degrees that do little to boost their future earning potential. Student loan liabilities in the US just passed $1.5 trillion. In Britain, they are £100 billion and increasing rapidly. Those who argue that higher education is a signal of ability rather than a way to gain valuable skills even view public funding as a net waste of resources, since easier access to university only serves to blunt that signal without any real productivity impact.

Some might say that the flaws of existing programmes provide reason enough to abolish them altogether. But consider, as an intermediate measure, taking the funds presently spent on old-age pensions and giving them to people as they enter their adult lives. It could be stipulated that the

money may only be spent on education, job training (such as internships, whether paid or unpaid), retirement saving or, more questionably, a home purchase. Alternatively, people could be left free to decide how to use the funds.

A direct cash grant in replacement of pay-as-you-go pensions offers many benefits relative. First, it is fairer than the present system, which pays out to people according to how long they live rather than how much they contributed. This system would enable accrued wealth to pass to one's heirs in the event of premature death.

Second, an upfront payment would bring into the reach of all the benefits that the welfare state aims to make available, without the paternalism associated with present arrangements. Unlike current policy, what to do with the money would be for the recipient to decide, within the limits defined by the programme.

Third, the reform would bring the welfare state into the government's annual budget, forcing elected officials to grapple with the need to finance any increase in cash outlays. No longer could politicians pay for today's votes with the taxes of tomorrow's voters. In one fell swoop, the policy would make the welfare state fairer, freer and more transparent. What's not to like?

One might object that such a programme would be far too costly to be implemented at a time of budgetary restraint. But the figures don't look quite so daunting when one runs the numbers: assuming a retirement age of 67 and a life expectancy of 87, real growth – after inflation – of the basic state pension of 1.5 per cent, and the Resolution Foundation's own conservative estimate of 3.6 per cent real asset growth, the average lifetime pensioner payments amount to £36,250.

In other words, given the above assumptions, the Treasury would need to transfer £36,250 to each individual in order to assure him or her of an amount equal to pension receipts over an average lifetime.

How much would that amount to in aggregate? The Office for National Statistics estimates that between 700,000 and 800,000 people will turn 25 each year in the coming two decades. This yields an annual outlay of £27.2 billion, which sounds like a lot until we put it in context. It would amount to 10 per cent of the government's current social protection budget. It would be less than annual expenditure on housing or transport policy.

The programme would still account for 3 to 4 per cent of the budget, but remember that it would replace other schemes, such as the state pension and much public support for higher education. In a context of chronically underfunded long-term welfare commitments, this reform would probably save money.

It would doubtless pose short-term challenges. The most salient among them is the transition from the current system, in which people expect future payments in exchange for today's contributions, and what to do with the over-25s who are far from retirement.

One option is to compensate them in proportion to their age and the contributions made so far. However, if the idea is to increase intergenerational equity in a context in which older people have benefited from a constrained housing supply, handing them cash in addition to their home equity growth defeats the purpose.

Another challenge is to ensure that the proposal is a replacement, not a supplement, to the current pension system. It would certainly be undesirable to find ourselves with an additional

expenditure item at a time of high effective marginal tax rates and high spending, without phasing out other costly and distortionary policies.

Yet, even with these hazards, a reform that increases choice, distributes benefits more fairly and forces greater fiscal prudence on politicians will go some way to address the glaring deficiencies of the welfare state.

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