Strategic reform directions for social policy

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Strategic reform directions for social policy

1 Core objectives
2 What has happened? Shifting tectonic plates
3 What does it all mean? Implications for social policy
4 Implications for tertiary education

1 Core objectives include

- Income security, through access to
  - Earning opportunities
  - Consumption smoothing
  - Insurance
  - Poverty relief
- Education for personal development and labour-market activity
- Maintenance and improvement of physical and emotional health (though will not discuss this important aspect)

2 What has happened? Shifting tectonic plates

- Social change
- Demographic change
- Advances in economic theory
- Technological change and human capital

2.1 Social change

The world then

- Social policy in 1950 was based on a series of assumptions
  - Independent nation states
  - Employment generally full time and long term
  - Limited international mobility
  - Stable nuclear family with male breadwinner and female caregiver
  - Skills once acquired were lifelong
- Though not true even then, true enough to be a realistic basis for policy

What has changed?

- Increasing international competition (‘globalisation’)
- **Changing nature of work, with more fluid labour markets (‘post-industrialisation’)**
- Rising international mobility
- **Changing nature of the family**
  - More fluid family structures
  - Rising labour-market activity by women
- Shorter half-life of skills (‘information age’)
- Thus the drivers of change are
  - More diverse patterns of work: thus there are problems for coverage of contributory benefits tied to employment
  - Increasingly fluid family structures: thus there are problems basing women’s benefits on husbands’ contributions

2.2 Demographic change

- Two long-term trends
  - Rising life expectancy
  - Declining fertility
- These are more important than shorter-term events like the baby boom

Age pyramids 2050, China, India, USA

Major implications

- If life expectancy rises and fertility falls, while retirement age remains static or declines, something has to give
- A clear implication is that the default retirement age should bear some link to life expectancy

2.3 Advances in economic theory

- Do consumers choose well
  - Lessons from the economics of information
  - Lessons from behavioural economics
- Lessons about targeting

Lessons (1) Information economics

- In many areas of social policy the model of the well-informed consumer does not hold
- In a survey, 50% of Americans did not know the difference between a stock and a bond
- Virtually nobody realises the significance of administrative charges for pensions
- Information problems and information-processing problems

Lessons (2) Behavioural economics

- What conventional theory predicts
  - Voluntary saving to maximise lifetime utility (consumption smoothing)
  - Voluntary purchase of annuities (insurance)
- What actually happens
  - Procrastination: people delay saving, do not save, or do not save enough
  - Inertia: people stay where they are, e.g. bank account, phone company
  - Immobilisation: conflicts and confusion lead people to behave passively (rabbit in car headlight)

Why? Recent lessons from behavioural economics

- Experimental evidence shows high discount rate in short run, much lower (close to zero) in long run
  - Next week's snack: 2/3 chose fruit salad, 1/3 chocolate
  - This week's snack: 1/3 fruit salad, 2/3 chocolate
- Thus people are rational for the future, but not for the present; but when the future arrives it is the present, so the short-term wins
- Examples: start dieting tomorrow; give up smoking tomorrow; but when tomorrow comes ...

Clinical measurement of brain activity

- Two parts of the brain
  - Mesolimbic: old part of brain: impatient – 'eat now, won't last'
  - Prefrontal cortex: newer part of brain: patient and rational – this is rational economic man and woman
- Life is a constant fight between the two parts
- Clinical measurement (experiments while person is in scanner) shows that short-term decisions are made by the mesolimbic system, longer-term decisions by the prefrontal cortex

Lessons (3) Targeting

- Income testing
- Indicator targeting (also called proxy targeting)

Income testing

- Method: identify poor people via their income
- Advantages: can target tightly
- Disadvantages:
  - Labour supply: major disincentives
  - Saving: major and continuing disincentives against saving (especially important given the drive to increase saving)
  - Coverage: low take-up, i.e. incomplete coverage, because of (a) high compliance costs and (b) stigma
  - Administration: demanding in terms of (a) institutional capacity and (b) cost
- BUT: affluence testing (keeping benefits away from the rich) may be useful

Indicator targeting

- Method: identify poor people via indicators other than income
- The ideal indicator is
  - Highly correlated with poverty
  - Exogenous to the individual
  - Easily observable
- Advantages: avoids the most acute ill-effects of income testing
- Disadvantages: targeting is not perfect – some gaps and leakages remain

Major implications

- The conventional model of consumer choice and competition not a good fit for important decisions
  - Education an incomplete solution (information processing problem)
  - Keep choices simple to avoid immobilisation
  - Design policy so that people commit now for action in the future. This makes use of procrastination to assist policy
  - Use mandates or auto enrolment: the latter makes use of inertia to assist policy – once auto enrolled most people will stick
- The advantages of income-testing as a targeting device should not be over-stated

2.4 Technological advance and human capital

- Human capital: always more important: today more important than ever

$$Q = f(K, L, M)$$

- Major implication: need mass, high-quality tertiary education, which needs to be supported by quality earlier education

3 What does it all mean? Implications for social policy

3.1 Poverty relief

- A universal basic pension
- Child benefits

A universal basic pension

- Arguments for contributory pensions
  - Microeconomic: explicit representation of the insurance principle
  - Macroeconomic: augments tax base
  - Political economy: link to employment can help to maintain middle class support
- But
  - Coverage can be incomplete because of fragmented careers, women, self-employed, informal sector, and compliance problems
  - The system can be regressive
    - If it needs many years of contributions to qualify for any pension
    - If a universal benefit end up going to urban middle class not rural poor
  - Administration may be costly or ineffective

Arguments for a non-contributory basic pension (1)

- Coverage:
  - Contributory principle assumed workers with long, stable employment, thus coverage would grow. History has not sustained this argument
  - Universal benefits can cover everyone, including women, informal etc.
- Distribution:
  - Avoids tendency of contributory benefits to create low-quality jobs
  - Avoids tendency to be regressive
- Adequacy:
  - Capable of providing poverty relief
  - But low enough to be fiscally sustainable

Arguments for a non-contributory basic pension (2)

- Targeting: age is a useful indicator of poverty
- Incentives for work and saving are better than with income-tested benefits
- Broader social benefits:
  - Some evidence that universal benefits contribute to family solidarity
  - Can improve access to other services, e.g. health
- Adjusting to fit a budget envelope: three instruments
  - Size of the pension
  - Age at which pension is first paid
  - Perhaps also an affluence test

Country examples

- These factors help to explain why countries are reducing reliance on the contributory principle for poverty-relief benefits
  - UK: illustrates problems of coverage
  - OECD countries with non-contributory basic pensions
    - Australia
    - Canada
    - The Netherlands
    - New Zealand
  - Other examples
    - Chile
    - South Africa

Child benefit

- Benefits for children are generally well-targeted
- This is no accident:
  - Parents are young hence not at the peak of their earning power
  - The arrival of children often reduces second-earner income
  - For life-cycle reasons, families with children *systematically* have low income relative to needs
  - Pointing to exceptions is like arguing that heavy smokers who live into their 90s disprove the ill-health effects of smoking
- Separately, benefits targeted via the mother can have broader social benefits

Country examples

- UK
- South Africa

3.2 Consumption smoothing

- There are many approaches to consumption smoothing; will briefly mention one:

Implications of theoretical advances for policy design

- Mandatory membership or auto-enrolment
- A small number of simple choices
- Decouple fund administration from fund management
  - Centralised administration
  - Fund management: wholesale, competitive, e.g. PPO-type mechanism

Country examples

- The US Thrift savings plan (www.tsp.gov): small number of simple funds, central administration, voluntary
- Sweden: large number of funds, central administration, mandatory
- New system of personal accounts in the UK: small number of simple funds, central administration, auto-enrolment

3.3 Labour force participation

- Increasing labour force participation at all ages
- Later retirement

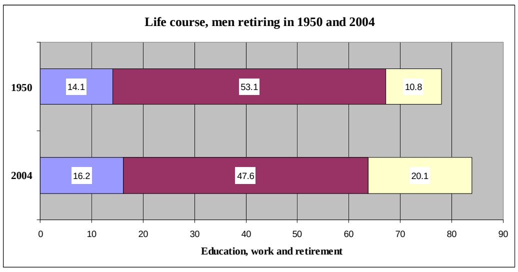
Increasing labour force participation

- Activation policies include:
  - Improved information about job availability
  - Improved access to training
    - General arguments for investment in human capital
    - Finance, e.g. are loans feasible?
  - Conditional transfers that create incentives to participate (US EITC, UK Working Tax Credit)
    - Potential conflict: may increase participation but reduce hours of work of those already participating
    - Significant problems of income-testing (even in UK)

Later and more flexible retirement

- There is neither an ‘ageing problem’, nor a ‘pensions crisis’
- The good news: people are living longer – the great untold good news story; not a problem but a triumph
- The problem: longer life + constant or declining retirement age creates problems of pension finance
- The solution: pensionable age should rise in a rational way as life expectancy increases

The UK as an illustration



3.4 Conclusion

Shifting tectonic plates provide food for thought

- A universal basic pension
  - With or without an affluence test
  - Payable at an age that makes adequacy compatible with fiscal sustainability, and that rises as life expectancy increases
- Simple individual funded accounts
  - Mandatory or with auto-enrolment
  - Worker choice constrained to a small number of simple funds
  - Centralised administration to contain costs and charges
- A combination of universal basic pension and child benefit reduces the need for income-tested social assistance

4 Implications for tertiary education

4.1 Unpacking the objectives

- Quantity matters: need mass tertiary education
- Quality matters
  - In tertiary education
  - And earlier in the system
- Equity matters
  - Equity of access
  - Equity of finance

Thus

- To promote quantity and quality
  - Finance matters
    - Public finance of tertiary education needs to be supplemented by private finance
    - Incentives matter, e.g. UK QAA, RAE
  - Competition matters
  - Accountability matters
- To promote access
  - Redistributive finance matters
  - But that alone is only a small part of the picture

4.2 Lessons from economic theory

Lessons rooted largely in the economics of information, i.e. the arguments are largely technical, rather than ideological

Lesson 1: Competition between universities helps students

- Does competition work? Yes when consumers are well informed
- Are consumers well informed?
  - Students mostly a savvy, streetwise bunch
  - Much information is available and more can and should be made available
  - Good information is a central source of quality assurance:
    - On the student experience
    - On teaching
    - On employment outcomes
- Are all students well informed? No. Students from poorer backgrounds face information problems which policy needs to recognise and address
- The same body of theory leads to a very different conclusion for school education

Lesson 2: Graduates (not students) should share in the costs of their degree

- Higher education creates external benefits:
  - Growth, social participation
  - Thus right that society (aka taxpayer) should contribute
- But also significant private benefits in financial terms, and *also* in nonmonetary terms, e.g. job satisfaction
- Thus right that beneficiaries should share some of the costs
- BUT students generally cannot afford to pay
- Thus need a way that students can get it free, but graduates repay – loans

Lesson 3: Well-designed loans have core characteristics

- Income-contingent repayments, i.e. calculated as *x*% of graduate's earnings
  - For efficiency reasons, to reduce uncertainty
  - For equity reasons, to promote access, since loans have built-in insurance against inability to repay
  - A genuine loan
- Large enough to cover all fees and realistic living costs; thus higher education free at the point of use
- An interest rate related to government's cost of borrowing

4.3 A policy strategy

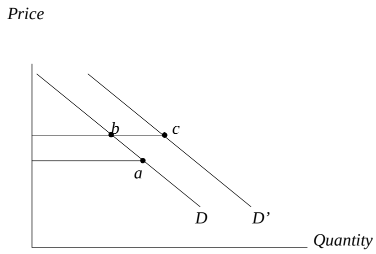
Leg 1: paying for universities: deferred variable fees

Variable fees

- Promote quality
  - by bringing in more resources, and
  - by strengthening competition, creating incentives to use those resources efficiently
- Are fairer than any other method

Mistake to avoid: ‘big bang’ liberalisation

The twofold strategy to promote access



Leg 2: student support: free at the point of use

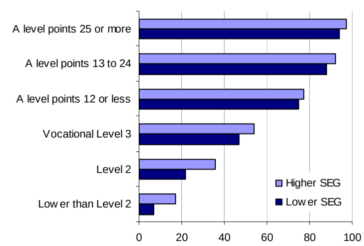
- Loans should be
  - Adequate, i.e. large enough to cover all fees and all living costs
  - Universal: all students should be entitled to the full loan
- As a result
  - Higher education is free at the point of use
  - Students are no longer poor
  - Students are not forced to rely on parental contributions
  - Students are freed from expensive credit (credit cards, overdrafts)
- Mistake to avoid: blanket interest subsidies

Leg 3: active measures to promote access

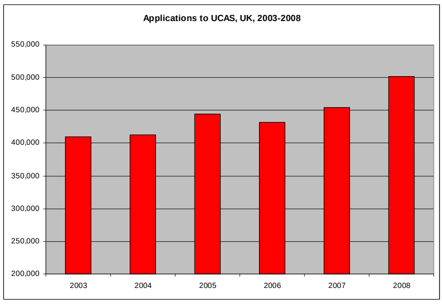
- Policies to address the attainment constraint
  - Increased emphasis on early child development
  - Improved school outcomes
  - Improving information and raising aspirations
- Policies to address credit constraints
  - Financial support at age 16
  - Income-contingent loans that make higher education free at the point of use
  - Policies that respond to genuine debt aversion
  - Make part-time study easier

Who goes to university? It’s school attainment, stupid

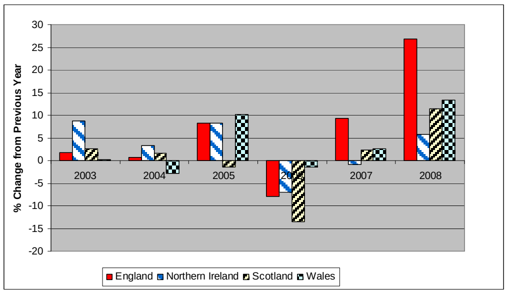
Source: Office for National Statistics (2004, Figure 2.15)



What happened to applications?



Year on year change in applications from the three lowest SEGs



Why not finance through taxation?

Over-reliance on taxation fails to achieve any of the main objectives

- Failure 1: quality
  - Shortage of resources
  - Lack of competition
- Failure 2: access (in most, though not all, countries)
  - UK: 81% professional/15% manual, so tax funding fails the poor
- Failure 3: regressive
  - The real barrier to access: staying on beyond 16
  - If raise €5bn, should spend it on nursery education; improving schools; staying-on post-16; grants
  - Early child development is central

A regulated market not a free market

In this strategy there is a major and continuing role for government

- To provide taxpayer support for higher education
- To regulate the system
  - A fees cap
  - Ensuring that there is effective quality assurance
- To set incentives
  - Establishing the degree of competition (can vary by subject)
  - Larger subsidies for certain subjects
- To ensure that there is a good loan scheme
- To promote policies to widen participation

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