The Collins Institute

# The Contributory Principle

LINKING BENEFITS TO CONTRIBUTIONS

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*Welfare Reform Series: Paper 3*

| | | |
|---|---|---|
| 1. | The Beveridge Model of Social Welfare | 5 |
| | The Contributory Principle in Ireland | 5 |
| 2. | Strengthening the Contributory Principle | 7 |
| | Stage 1: Introduce Tapered Benefits | 8 |
| | Stage 2: Integrate Welfare around Personal Welfare Accounts | 8 |

# THE COLLINS INSTITUTE

The Collins Institute is a political think tank.[1] It is supported by Fine Gael but operates independently of it.

The Institute's name recognises the crucial role which Michael Collins[2] played in the creation of the Irish state and the special position which he occupies in the affections of many citizens today. Collins has been variously described by current Fine Gael members of the Government as "the father of Irish democracy" (Michael Noonan); an "ideas person, as much as a soldier and a political leader" (Simon Coveney); and a man who "has given us a compelling inheritance of politics and leadership as they should be" (Enda Kenny).

The Institute is examining how a new, more **Just Republic** might be established in Ireland as we approach 2022, the centenary of both the founding of the state and the death of Collins. By Just Republic we mean a modern citizen focused republic which is built around two key Fine Gael propositions: its long held belief that Ireland must become a fairer and more Just Society;[3] and its more recent calls for the creation of a New Republic in our country "where trust is restored in our democratic institutions."[4]

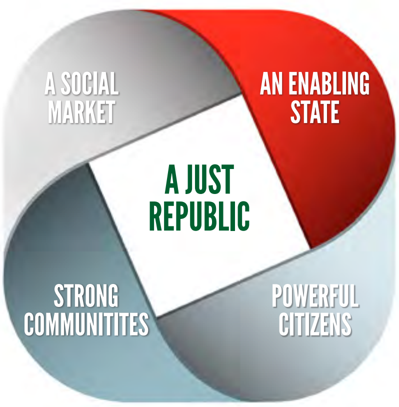
In seeking to explore these ideas the Institute will focus on four key pillars of any modern republic:

- **Powerful Citizens:** In our view the key goal of public policy in any republic should be to create fully empowered individuals who, with the right supports and capabilities, can exercise as much control over their own lives as possible, either as individual citizens or as part of wider communities.
- **A Social Market:** The Institute will examine a range of policy options which can help deliver both a full employment economy and a more just society in Ireland, the two core building blocks of any fair and efficient economic system.
- **An Enabling State:** Public services in a modern welfare state should be judged by the extent to which they help enable and build the capabilities of its citizens, particularly the most vulnerable, and facilitate the provision of cost effective localised and personalised delivery wherever and whenever possible.
- **Strong Communities:** The Institute will suggest different ways to support the growth of a wide range of communities and organisations across Ireland, taking into account the various and differing challenges facing rural and urban citizens, and the potential impact of new virtual communities supported by social media.

As part of its work the Collins Institute has also identified six key principles which we believe can help support the creation of a Just Republic in Ireland. Our starting point is Fine Gael's Just Society document and the three fundamental principles which it promoted: ***Freedom*** of the individual, ***Equality*** of opportunity and social ***Solidarity***. In examining the possible architecture of a Just Republic the Institute will also focus on three more modern principles which were largely ignored during the Celtic Tiger: institutional ***Accountability***, economic ***Sustainability*** and ***Subsidiarity*** within government.

All papers published by the Institute are intended for discussion purposes only and do not represent Fine Gael policy.

*Figure 1: The Just Republic*




1 The Institute's launch document - *The Just Republic* (December, 2014) - can be accessed at www.collinsinstitute.ie.
2 Irish revolutionary leader and Minister for Finance who became Chairman of the Provisional Government and Commander-in-Chief of the National Army in 1922. He was killed in an ambush in August of the same year during the Irish civil war.
3 2015 is the fiftieth anniversary of the publication of Fine Gael's 1965 manifesto, *Towards a Just Society*.
4 Fine Gael's *New Politics* document, published in 2010.

# 1. THE BEVERIDGE MODEL OF SOCIAL WELFARE

Over the last few years the Irish Government has introduced a series of reforms which have sought to make the Irish welfare system both more active and more responsive. While significant progress has been made, it is clear that a great deal more work is required if Ireland is to create a modern, 21st century welfare system. The Collins Institute is publishing three separate papers, including this report, which argue that the goal of future welfare reform should be to replace the current welfare state with a new and more proactive Enabling State. A state which is focused on the idea of Social Capability (the state helps its citizens become more engaged in society by strengthening their capabilities) rather than the more passive and traditional idea of Social Security (the state provides an essential safety net but does very little to actually change people's real prospects within society). Our first paper, entitled *The Enabling State*, outlines how the Irish welfare system can become much more focused on improving the capabilities of its citizens. A second paper, entitled *Jobless Households*, argues that the next Government should deliver an **Action Plan for Jobless Households**, as part of an overall strategy of making work pay, in order to help ensure that some of its most vulnerable citizens can become fully engaged in society. This final paper recommends that welfare reform should link benefits much more directly to contributions, in order to create a system which is both fairer and more sustainable.

## The Contributory Principle in Ireland

Most European social welfare systems impose some link between benefits paid and contributions made. This so called "contributory principle" was also at the heart of the proposals which William Beveridge, the father of the UK welfare state, produced in 1942 and which had an "immediate" impact in Ireland.[5] Welfare, he proclaimed, should provide "benefits in return for contributions, rather than free allowances from the State..."[6] Beveridge knew full well:

> "that unless any welfare system is based on the contribution principle – citizens pay in and earn the benefit as their due desert – the principle of welfare soon gets degraded. The more taxpayers contribute, the more they will ask if welfare beneficiaries really deserve what they are receiving…
>
> Philosophers and psychologists now recognise what Beveridge knew in his bones: that human beings intuitively believe we are all, to some extent, responsible for our actions – the sentiment that the anti-welfare state brigade tap when they want to differentiate between the deserving and undeserving poor. The only way to trump that thinking is a system of social or national insurance, which the … left has been as guilty as the right in allowing to be abused as just another tax."[7]

The potential importance of social insurance, which embodies the contributory principle, was addressed by the Irish Commission on Social Welfare in 1986:

> "We regard the system of social insurance as an expression of social solidarity and citizenship in which the risks, costs and benefits should be shared as widely as possible in the community. Social insurance creates a sense of entitlement to benefits and generates support among the public for their benefits …In our view, the system of social insurance should be as comprehensive as possible, and all income earners should contribute to, and benefit from, the system." [8]

A later review in 1996 noted that social insurance had to be based around two principles, both of which create a healthy tension within any welfare system:

- "The Contributory Principle whereby there is a direct link between contributions paid or credited and entitlement to a varying range of benefits which are payable, if and when particular contingencies arise; and

- The Solidarity Principle whereby contributions paid by insured persons are not actuarially linked to benefits at the individual level but can be redistributed to support other contributors. It is therefore an expression of solidarity between different earning groups and different generations."[9]

5 Adrian Kelly, *Social Security in Ireland, 1922-52*, Phd Thesis, Department of Modern History, St Patrick's College, 1995.
6 Social Market Foundation, *Beveridge Rebooted: Social Security for a Networked Age*, 2013.
7 Will Hutton, *Guardian*, 23 October 2010.
8 Quoted in Department of Social and Family Affairs, *Developing a Fully Inclusive Social Insurance Model, December*, 2014.
9 Ibid.

It is clear that the Irish approach has tended to promote the latter at the expense of the former with the result that Irish welfare system has, as Minister Burton has stated, become "somewhat divorced from this contributory principle."[10] There is, as a result, very little reciprocity in many key parts of Ireland's welfare state. For example, people who are employed for a long time but have lost their jobs, and people who have never worked, are entitled to broadly similar levels of assistance.

The lack of reciprocity in Irish welfare is problematic for two key reasons:

1. There is a risk that higher earners will, over time, become increasingly sceptical of a system where they contribute the great bulk of funds – through both taxation and PRSI – but receive relatively little back (compared to their contributions) when they find themselves requiring assistance. Irish people have traditionally been much more positive about social welfare than their British neighbours. However, developments in the UK should serve as a warning to those who, like the Collins Institute, believe that a strong social welfare system is a key part of any Enabling State. Opinion polls have been charting a slow but steady decline in support for the welfare system in the UK for well over a decade.[11] By contrast, the evidence suggests that welfare systems, where there is some link to contributions, tend to be much more "resilient"[12] as they are perceived to be fairer.

2. Any decline in support for the welfare system in Ireland would be deeply problematic given that demands on the welfare system are likely to increase as our population ages. The last Actuarial Review of the Social Insurance Fund (SIF), which is carried out at five yearly intervals, found that the Fund in 2011 had a shortfall of approximately €1.5bn. This deficit was forecasted to double to €3.0bn by 2019 based on forecasts at the time. In the medium to long-term, pension related expenditure is projected to become the predominant component of Fund expenditure, rising from 57% in 2011 to 85% in 2066.[13] In the absence of major reductions in expenditure significant additional subventions will be required to meet ongoing requirements, either in the form of tax increases or increases in PRSI income.

**Recommendations**

We propose that Ireland should deliver further long term reforms of the welfare system by directly ***Linking Benefits to Contributions*** in two distinct stages:

- **Stage 1: Introduce Tapered Benefits.** This is essentially a reform of the current welfare system; and
- **Stage 2: Integrate Welfare around Personal Welfare Accounts.** This would require a much more significant reform of the existing model of welfare.

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10 Joan Burton, *Welfare in a Time of Austerity*, Tom Johnson Summer School, 2 July 2012.

11 Six in ten people in the UK think that benefits are "…too high and discourage [the unemployed] from finding jobs", more than twice the proportion that thought the same thing 20 years ago. Policy Exchange, *A Welfare Manifesto*, 2014.

12 Ian Mulheirn, *Guardian*, 26 May 2013.

13 2010 Actuarial Review of the Social Insurance Fund.

# 2. STRENGTHENING THE CONTRIBUTORY PRINCIPLE

Recent research strongly suggests that reforms which incorporate the contributory principle can strengthen the link between work and welfare, boost workforce productivity, and facilitate economic change while limiting painful social consequences. [14] However, it must also be acknowledged that such reforms would require significant remodelling of the current system. For that reason we are proposing that they should be introduced gradually in two distinct stages.

## Stage 1: Introduce Tapered Benefits

Ireland, as the OECD has found, is unusual in having a system where payments do not fall over the length of the claim.[15] In the majority of countries benefits are cut as the unemployment spell lengthens until the social assistance minimum is reached. There are two main arguments in favour of this approach:

1. Higher benefits to start with can better cushion the individual from the initial financial impact of losing their job, while lower rates later can incentivise people to find work; and
2. Higher initial rates can also have a potentially positive economic benefit in the early stages of a recession, as the spending power of those recently made unemployed is better maintained through initially higher benefits.

In order to move Ireland towards the OECD norm we propose that:

- Benefit payments for people who have lost their jobs should be higher in the initial stages of unemployment and then fall over time to a social minimum, i.e., they should become more tapered.
- The taper period should also be linked to the unemployment rate, i.e., the higher the unemployment rate the longer the taper period should be to reflect the greater challenge in finding a new job; and
- Citizens with a strong history of contributions should be subjected to a more favourable taper regime, e.g., their benefits should better reflect their contributions either through higher initial payments and/or a longer taper period.

The risk of introducing such a system is that it could increase the overall cost of welfare. The key is to design the system so that any higher payment costs are offset by a more rapid return to work for many recipients. We suggest that detailed modelling of a tapered system should be commissioned by the Department of Social Protection in order to determine the optimum configuration of this new approach.

## Stage 2: Integrate Welfare around Personal Welfare Accounts

Welfare systems are redistributive in two very different ways:

- Vertical Redistribution: This is essentially redistribution from richer to poorer. It is about one group of citizens (the better off) supporting other citizens (the less well off) as part of a fairer and more just society.
- Horizontal Redistribution: This is where the welfare state takes money from an individual at certain points in their life – normally when they are employed - and returns it to them at other times when they are potentially more dependent, e.g., when they are retired or sick. In Ireland about 55% of the taxes levied to finance social transfers in Ireland are paid back to the individual taxpayer as part of horizontal distribution.

While both forms of redistribution are absolutely vital they have very different policy goals. Yet the current system in Ireland makes little or no distinction in how these goals are achieved. Revenues to the state in the form of taxation and PRSI are paid into a national pot, including the Social Insurance Fund, and then redistributed. For any individual citizen there is very little link between the money that they have paid in and the benefits which they receive, as part of horizontal redistribution. For the state there is a clear lack of transparency about the extent to which policy is delivering the two separate goals – vertical and horizontal redistribution – in the most effective and efficient way possible.

14 See, for instance, Policy Exchange, *Something for Nothing*, 2011; Institute for Public Policy Research, *National Salary Insurance*, 2011; Demos, *Something for Something*, 2013.

15 Pina, *Structural Reforms to Reduce Unemployment and Restore Competitiveness in Ireland*, OECD Economics Department Working Papers, No. 910, 2011.

## The Basic Income Concept: Two Major Problems

There has been considerable debate in Ireland over the last few decades about whether and how the state should radically reform its welfare system, including the way in which it deals with vertical and horizontal redistribution. NESC in 1978, for example, reviewed three different major options: A "non-refundable tax credit";[16] a "refundable tax credit";[17] and an "individual grant and tax scheme", which is essentially an unconditional basic income.[18] The latter has been recommended by a number of analysts in Ireland while the Green Party argued, very unsuccessfully, for a basic income in the last UK general election. Fianna Fail has also pledged to introduce such a system in Ireland.

The basic income concept has a long history in the economic thinking of both the left and the right. For those on the right it is a way of "radically cutting the administrative costs of means-tested benefits, and subsidising low-paid work. For those on the left, who embraced it after the 1960s, it is seen as a way to alleviate inequality."[19] One of the more recent arguments in favour a basic income is that it provides everyone with a guaranteed income as automation potentially destroys more jobs than it creates globally.[20]

A 2002 Green Paper examined the feasibility of introducing a basic income in Ireland. While pointing to a number of positives - improved income for people in lower income deciles and increased participation by certain groups (e.g., women working in the home) – it also highlighted a number of negatives: increased costs, higher marginal tax rates, reduced work incentives and potential falls in employment and productivity.[21] More recent work by the Nevin Economic Research Institute has estimated the cost of a basic income system at €27.9 billion a year in Ireland, compared to last year's Social Protection budget of €20.3 billion. A basic income system would, however, generate administrative savings of an estimated €100 million, as well as delivering a boost in domestic consumption.[22]

The basic income concept has two major problems in our view, apart from the very important issues of affordability:

1. It negates the contributory principle, since there is no link between what people pay and the benefits which they receive; and
2. It also breaks the link between employment and income for many citizens. Given that Ireland appears to be moving towards full employment, it is unclear why the state would want to institute such a reform at this time.

Our recommendation to introduce Personal Welfare Accounts, by contrast are designed to tackle both of these issues, among others.

## Personal Welfare Accounts

Under a system of Personal Welfare Accounts (PWAs) each citizen would be required to pay a share of their income into an individual account, with their income tax liabilities/PRSI reduced accordingly:

- When an individual claimed one of a range of benefits under existing eligibility criteria (e.g., short term unemployment, sickness benefits, parental leave, etc. Long term unemployment and care benefits would not be covered[23]) their account would be debited by the amount received. Adjustments would be made for couples to ensure gender equity. A key feature of the model would be that an individual could claim these entitlements under existing eligibility criteria even when their individual account was in deficit.

- If, on retirement, an individual had a positive balance this would be used to supplement their basic state pension (either converted into an annuity or paid as a lump sum). For an individual with a negative balance at retirement age, the account would be set to zero and they would receive only the basic state pension.

16 Tax credits are used to reduce the tax calculated on a person's gross income. A non-refundable tax credit is a credit that can't reduce the amount of tax you owe to less than zero.

17 A refundable tax credit is a credit which is treated as a payment. If the credit is large than a person's tax bill the taxpayer receives the difference (Amount of Credit minus the Tax Calculated).

18 A basic income is a system where citizens or residents receive an unconditional sum of money from the state in addition to any income received elsewhere.

19 Paul Mason, *Guardian*, 1 February 2015.

20 "In every previous technological upsurge, deskilling and job destruction went alongside the creation of new, high value jobs and a higher-wage consumption culture. But automation disrupts that pattern: it reduces the need for work in one sector without necessarily creating it in another." Ibid.

21 Government Green Paper, *Basic Income*, 2002.

22 See Joe Humphreys, *Irish Times*, 6 June 2015.

23 Some have argued that benefits for long term unemployment should also be included. See, for instance, Stiglitz and Yun, *Integration of Unemployment Insurance with Retirement Insurance*, 2002.

The potential benefits of such an approach are many:

- **Greater Transparency:** There would now be a clear and transparent link between contributions and benefits, potentially increasing support for "a more sustainable, legitimate system of vertical (between household) and horizontal (within household) redistribution of public expenditure."[24]

- **Encourage Greater Personal Responsibility:** PWAs would help citizens take on greater responsibility for managing risks throughout their lives by providing them with real time information as to some of the taxes / PRSI they have paid, the savings they have collated and the benefits / services to which they are entitled.

- **Greater Incentives to Work:** Individuals with their own accounts would be incentivised to minimise their withdrawals since any positive account at retirement would go towards a larger pension.[25] There would still need to be, however, a range of activation policies for those who face major barriers in returning to work.

- **Administrative Savings:** A great deal of the state's machinery is dedicated to collecting taxes from an individual – and then paying them back in the form of various benefits. PWAs should reduce the amount of back and forth payments made by the state, although there would be costs in managing the PWAs.

A substantial amount of research has been carried out on the idea of welfare accounts, looking at their potential impact on wealth accumulation, unemployment protection and incentives to work and save. Crucially, this research "has been able to cross ideological boundaries."[26] Within the US work has been led by Martin Feldstein at Harvard and by the Nobel laureate, Joseph Stiglitz, while a range of European studies have examined how welfare accounts could be integrated into Nordic welfare system. The UK Treasury is also currently considering the establishment of welfare accounts,[27] while a number of UK research institutes have also been arguing strongly for such an approach.[28]

> "In summary, the literature suggests that compared with traditional welfare systems there are clear advantages to individual social accounts, especially in managing intrapersonal redistribution. They benefit individual citizens by enhancing the flexibility and control to adapt support to their particular circumstance and life goals. They benefit the collective by reducing risks of moral hazard, strengthening incentives to work and lowering tax rates overall. Finally, as fiscal constraints intensify distribution questions all the more, greater transparency of individual accounts could offer a more secure basis for continued social solidarity.
>
> "Variations of the model can incorporate explicit interpersonal redistribution and, properly designed, can satisfy most equity concerns without compromising the gains in efficiency. However, it is the efficiency benefits of intrapersonal social accounts that seem to be driving interest in the approach."[29]

While there are a large number of different ways in which welfare accounts can be constructed, a Danish study which looks at a system which is relatively similar to that being proposed by the Collins Institute, found that the impact on Government revenues would be a net positive. The study models the total effect on net revenue of welfare accounts that include provisions for unemployment, early retirement in addition to leave for sickness, parental, education and child caring. "It estimates that the total effect on net Government revenues of the proposed accounts could be worth over 6 per cent of the income tax base."[30]

The Table below breaks down our proposed approach to PWAs. A number of points should be noted:

- If account holders are exposed to a temporary income loss or a temporary increase in their spending needs, they are eligible for social benefits under the same rules and criteria which apply under a traditional welfare system.

- No individual contributes a larger amount overall as the contribution to the PWA is matched by a corresponding cut in the labour income tax bill.

- Given that the contribution to the individual welfare account is mandatory, the account system protects individuals who may not save for the future.

24 2020 Public Services Trust, ibid., 2009.
25 One UK analysis has suggested that, under their particular proposals, someone "with a full working life and relatively few spells of unemployment" could receive well in excess of £10,000 on retirement. Policy Exchange, ibid., 2014.
26 Elina Lepomäki, *Literature Review: Personal Welfare Accounts*, 2013.
27 *Guardian*, 3 February 2015.
28 Policy Exchange, *Making Contributions Count*, 2014; Civitas, *Beyond Beveridge*, 2013; Social Market Foundation, *Beveridge Rebooted*, 2013;
29 2020 Public Services Trust, Ibid., 2009.
30 The Scottish Government, *Re-Thinking Welfare: Fair, Personal and Simple*, 2014.

- The system helps those who have low lifetime incomes and end up in negative welfare account balance given that these individuals will continue to receive the normal public pension when they retire. Individuals 'borrow' from their accounts only when they meet existing eligibility criteria.
- Since the PWAs are a system of bookkeeping and not a funded (investment based) system of social insurance, the welfare account system does not require taxpayers to set aside additional funds before they can draw benefits from the system.

*Figure 2 Personal Welfare Accounts*

| Component | Description |
|---|---|
| Notional Personal Welfare Account | For each citizen within the current established age requirements for working age benefits, a notional personal welfare account should be established. |
| Mandatory Contributions | Each period, a mandatory social security contribution is credited to the individual welfare account. The contribution is proportional to the account holder's income. |
| Lowering of Income Tax | The basic tax rate on labour income should be lowered so that the sum of the labour income tax bill and the new contribution is the same as current taxes. |
| Debiting of the Account | The account holder's receipts of the social transfers included in the account system (e.g. unemployment benefits) are debited to the individual welfare account. |
| Use Existing Eligibility Rules | The social transfers included in the individual welfare account system can only be paid out subject to current eligibility rules. |
| Married Couples | Contributions are credited in equal amount to the welfare account of each spouse and any benefit paid is debited by half the amount on the account of each spouse. |
| Unmarried Parents | For unmarried parents, any child-related benefits are likewise debited by half the amount on the individual welfare account of each parent. |
| Interest Rate | Each period, an interest rate equal to the average after-tax interest rate on government bonds is added to positive accounts and subtracted from negative |
| Retirement | Upon retirement, any account surplus is added to the ordinary public pension or if account balance is negative, it is set to zero and the holder receives basic public pension. |