Progressive Economics Group (PEG)
Policy Brief

Social Security and the Labour Market

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Policy Issue

The UK's social security system is both dysfunctional and unjust, not to mention coercive and harsh, in its mode of operation.

How can we reform the social security system to make it both more efficient and fairer?

Policy Analysis

All countries beyond a certain level of development have social security systems whose principal task is to manage risks of interruption to income from employment. These can arise from contingencies such as unemployment, sickness and invalidity; life cycle effects, including old age; and family responsibilities. It is no accident that Britain, the first country to industrialise, should have developed, through its 'poor law', one of the earliest national social security systems. It's no accident either that in today's China, the largest ever transition to a market economy is being accompanied by large-scale planning around the issue of social security.

The British poor law was often coercive and stigmatising, and many of the features of what became the welfare state began through workers and communities pooling their own resources to manage risks. One policy option for restoring fairness and dignity to unemployment compensation systems would be to devolve this power back to trade unions and bodies similar to the mutual societies of the nineteenth century. There is, however, a limit to what can be achieved in social security without state intervention. Private insurance markets are not good at protecting high-risk, that is, low-income, groups.

Social insurance schemes around the world continue to operate on the principle of the pooling of contributions, and hence of risks, within the working population, and, by extension, across generations. Just how egalitarian such schemes are depends on matters such as the level of financing, the division of the burden between workers, employers and the state, the strength of the link between contributions and payments, and the conditionality attached to benefits. Also, social insurance schemes can be more or less gender-egalitarian, depending on such factors as how far they assign contribution credits for periods when employment is interrupted by child rearing or other family responsibilities, and whether they are individual or household based.

When we compare the UK's current system of social security to how it operated in the relatively recent past (the late 1980s was the turning point), and to systems operating elsewhere, certain features stand out.

Firstly, the contributory principle is very weak in the UK. Wage earners in the UK pay national insurance contributions which are high by international standards in return for benefits which are relatively low as a proportion of income from employment.

Secondly, and relatedly, contributory benefits fail to provide any real income security. As a result, a major role remains for benefits paid according to need ('means-tested' benefits). Because means testing is complex and can be stigmatising, take-up rates are lower, and transaction costs higher, than would be the case if the contributory system worked effectively. Household means testing also replaces dependency on the state by dependency on a partner, tending to reinforce traditional gender inequalities.

Thirdly, the UK devotes more resources than most other countries do (the USA aside) to benefits to support those in employment. The tax credit system, introduced by Conservative governments in the 1980s and significantly expanded by New Labour, provides a supplement to many household incomes. This is a problem because it shifts the cost of providing a living wage from employers to the state.

There are many problems with means testing. It unavoidably means taxing poor households at high marginal rates, as households with rising incomes experience the withdrawal of benefits while, at the same time, their members become liable to pay income tax on their earnings. This both deters low-income earners from seeking out higher paid work, and is unfair, in the sense of inverting the principle, still widely accepted in most of the world, that tax rates should rise progressively with income.

The effect is exacerbated by tax credits which were designed, through supplementing them, to allow wages to be reduced over time, lowering firms' costs. But tax credits send the wrong signal to employers, removing pressure to train workers and deterring capital investment which might increase productivity. While the full story of tax credits has yet to be told, and analysis of their effects continues, they would seem to combine the worst of all worlds, which may account for their lack of take-up outside the UK and US.

Universal credit (UC), currently being introduced in stages, will not help. On the contrary, it will exaggerate and amplify all the negative features of the regime it is gradually replacing. UC has been designed to make employment more 'attractive' by ensuring that benefit recipients are never better off than those in employment. This logic, for example, is behind the rule delaying the allocation of UC payments to new claimants: because salaries are paid in arrears, to pay UC 'on demand' would, it is argued, treat claimants as a 'privileged' group.

The danger here is that as conditions attaching to the receipt of state support become more unattractive, the terms and conditions offered by employers to low-wage workers are dragged down in their turn. It was precisely to avoid this kind of downward spiral that social insurance began to replace the poor law at the start of the twentieth century.

Universal credit is going to cause other very severe problems as it is rolled out. At present, sanctions are applied to those receiving benefits, for example, if they unreasonably refuse an offer of work, fail to comply with job-search instructions, or leave employment without just cause. Recently benefit sanctions have been running at the rate of over a million cases in some years. Since sanctioning can involve a claimant going without income for several weeks, it is a highly coercive (or, as its designers might say, effective) remedy for perceived failures of labour market 'discipline'.

Under UC, sanctioning will be extended for the first time to those who have jobs, as well as the unemployed. For example, credits will be lost if claimants earning below a threshold, based on full-time employment at the National Minimum Wage, do not seek out additional employment. In practice this will mean more bureaucratic micro-management of work-life decisions of low-income households, additional pressure on terms and conditions of employment for already vulnerable groups, and, most likely, a further proliferation of casualised forms of employment including zero hours contracts.

Thus the UK's harsh and dysfunctional social security system is also one of the main causes of low paid, precarious and casual work. Policy-makers defend the system on the grounds that it has contributed to the UK's much vaunted labour market flexibility. That defence is correct as long as it is remembered that 'flexible' is really just another way of saying 'precarious', and that precarious employment, while profitable for some employers, is costly for workers, families and the state.

Policy Framework

There are two routes to changing this unfair but also inefficient system. One, increasingly advocated by some researchers and popular in the media, is the idea of a universal basic income (UBI). There is a case for some universal benefits; child benefit was until recently paid for all children irrespective of parental income and had near-universal take up. Universalism avoids the imposition of high marginal tax rates on poorer recipients, while necessitating their imposition on the better off (as this is the most effective way to finance it).

Merging all existing benefits into a 'general' UBI would be a very different step. As the policy brief 'Universal Basic Income' (by Stewart Lansley and Howard Reed on the PEG website) shows, income tax would have to rise very steeply to support a UBI that was sufficient to provide a level adequate for all households to live on. Most worryingly, in the absence of universal collective bargaining or a minimum wage set at an unprecedentedly high level, a UBI would send the wrong signal to employers, who would use it to justify cutting wages. A general UBI, replacing employment-based social security, is just not plausible in an economy characterised by wage labour, which, for the foreseeable future, is the reality which policy-makers must confront.

The alternative to a general UBI is a revived social insurance system. This would entail restoring the link between contributions and earnings, phasing out means-testing, and withdrawing the subsidy effect of tax credits and UC. This could work if, at the same time, there was a restoration of effective wage regulation through sector-level collective bargaining, and a return to a demand-led macroeconomic policy which had stable employment as its goal.

Far from being unattainable or alien to British conditions, this mix of policies was precisely what lay behind the Beveridge report of 1942 and the Full Employment White Paper of 1944. The gendered assumptions of the Beveridge report would not survive scrutiny today. But as noted above, social insurance schemes can be designed to be gender neutral, or, going further, to offset the effects of discrimination in employment. Since social insurance and full employment policy together delivered three decades of economic growth alongside steady redistribution of incomes and wealth, perhaps it is time to take a fresh look at them.

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