

## **Social care** A prefunded solution

Danail Vasilev

June 2017

#reformsocialcare



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# Contents

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<b>Executive summary</b>	<b>4</b>
<b>Introduction</b>	<b>6</b>
<b>1 The funding challenge</b>	<b>7</b>
1.1 Rising demand	8
1.2 PAYG and intergenerational equity	10
1.3 Two systems or one?	11
<b>2 The case for prefunding</b>	<b>14</b>
2.1 Intergenerational transfers	15
2.2 Value for money	16
2.2.1 Empirical evidence	17
2.2.2 Social care inflation	19
<b>3 Implementation</b>	<b>22</b>
3.1 Contributions	23
3.1.1 Compulsion or choice?	23
3.1.2 When and who?	24
3.1.3 Managing the funds	27
3.2 Entitlement	27
3.2.1 The level of coverage	28
3.2.2 Eligibility	29
3.2.3 Defined benefits or defined contributions?	30
3.3 Transition	30
3.3.1 Financing the double burden	31
3.3.2 Phasing-in mechanism	33
<b>Conclusion</b>	<b>34</b>
<b>Bibliography</b>	<b>35</b>

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## Executive summary

Policymakers since the 1990s have overpromised and underdelivered on social care. Consultations and policy reviews have come and gone, but little has changed for those needing long-term support in England.

The most recent attempt at reform emerged out of a commission overseen by Sir Andrew Dilnot. A package of measures including a cap on social care liability was scheduled for introduction in 2016, but following the 2015 General Election, this was delayed until 2020. In the 2017 Spring Budget, the Government announced a Treasury-led review of social care funding – a move which effectively reset the direction of policymaking. The new Government re-committed to a green paper in their manifesto, and during the election campaign pledged to consult on implementing a cap – though no indication has been given as to the level it could be set at.<sup>1</sup>

The concerns motivating this green paper – the current funding mechanism's lack of fairness and sustainability – are well-founded. As the population ages, the cost of publicly funded social care in the UK is projected to rise from 1.0 per cent of GDP (£19.0 billion) today to more than 2.0 per cent of GDP (£40.1 billion) in 2066-67.<sup>2</sup> It is this threat to the UK's long-term public finances that led to the Conservative party manifesto commitment that "...those who can should rightly contribute to their care from savings and accumulated wealth" through the introduction of a "single capital floor, set at £100,000".<sup>3</sup> Dubbed the 'dementia tax' during the campaign, it is not yet clear whether the manifesto proposals will in fact be dropped.

This paper makes the case for much more fundamental reform: replacing the current 'pay-as-you-go' (PAYG) approach to financing later-life care with a prefunded arrangement. Under this proposal, working-age people would contribute a percentage of their income into a Later Life Care Fund (LLCF). These pooled savings would then be managed privately, before being used to fund the care costs of those that contributed.

A LLCF compares favourably to the current model on two key issues. First, because invested contributions will appreciate faster than the economy will grow, a LLCF could deliver significant savings. Under a set of baseline assumptions, *Reform* calculates that for every £1 of entitlement financed through a PAYG system, prefunded contributions would need to be just £0.82. These gains will be greater if social care providers respond to their growing wage bills by investing in labour-saving technology, moves which are already underfoot.<sup>4</sup>

Second, prefunding avoids transferring wealth from younger, poorer generations to older, richer ones. *Reform* calculates that according to Office for Budget Responsibility's spending projections, the tax contributions made by those born in 1991 to fund social care will be 34 per cent higher than for those born ten years earlier. The savings generated by prefunding would limit future rises in spending on later-life care, as well as ensuring that, in the long run, no generation is at risk of funding the care of a disproportionately large cohort.

These benefits, however, can only be achieved if a series of implementation challenges are successfully addressed. Designing a contribution scheme would be the first of these. The fact that individuals underestimate the likelihood of needing social care, the benefits of spreading risk across the widest group possible, and the redistributive effects of a pooled savings scheme all speak in favour of making participation compulsory.<sup>5</sup>

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1 The Conservative Party, *Forward, Together. Our Plan for a Stronger Britain and Prosperous Future. The Conservative and Unionist Party Manifesto*.

2 Figures in brackets based on the OBR's estimate of the size of the UK economy in March 2017 Office for Budget Responsibility, *Fiscal Sustainability Report 2017*; "Economic and Fiscal Outlook - March 2017."

3 The Conservative Party, *Forward, Together. Our Plan for a Stronger Britain and Prosperous Future. The Conservative and Unionist Party Manifesto*.

4 Local Government Association, *Transforming Local Services through Digital*.

5 Lloyd, *Gone for Good? Pre-Funded Insurance for Long-Term Care*.

Another important issue policymakers will need to address is the contribution period. If people are required to pay into the system throughout their whole working life, the effects of compound interest would keep contribution rates relatively low. However, life expectancy projections are often subject to significant revisions, creating the risk that the fund may set contributions at the wrong level – either too high or too low.<sup>6</sup> Because predicting future liability can be done more accurately if contributions are collected closer to the age at which entitlement is reached, the LLCF could emulate the Japanese social insurance scheme by asking for contributions to be made between the ages of 40 and 65.<sup>7</sup>

Ultimately, the generosity of support financed through a LLCF will depend on the level at which contributions are set, but Germany's PAYG social insurance scheme – which delivers a comparable level of expenditure to the UK – can offer a guideline.<sup>8</sup> There, the headline contribution rate is 2.55 per cent, equivalent to £60 a month for the median full-time earner in the UK, a fee that would be split between employers and employees.<sup>9</sup>

Yet maintaining the highly means-tested approach to social care support in England under a prefunded arrangement would see many middle and high income earners pay into a system for their entire lifetime, only to then be denied support if they needed care in later life. For this reason, many countries with social insurance schemes offer some level of state-funded support to everyone – regardless of their income. Adopting France's approach, in which assistance ranges from 10 per cent to 90 per cent of assessed care costs depending on the financial means of the person in question, could secure the LLCF's legitimacy without incurring excessive costs.<sup>10</sup>

The most pressing questions regarding implementation, however, concern how to deliver a prefunded system given the current PAYG arrangements. During the transition period, working-age people would be asked to fund their own care as well as the residual care bill for older people, creating a 'double burden'. While this raises the question of whether prefunding answers the challenge of intergenerational equity, paring back on universal pensioner entitlement, scrapping the State Pension triple lock and tapping into the housing wealth of the current retired population, all commitments made by the new Government in their manifesto, could reduce the transition costs borne by working-age people.

In contrast to what the Government has proposed, prefunding later-life care would be a radical departure from the historic approach to welfare policy in the UK. However, such action is essential if policymakers are to resolve the sustainability and fairness questions that have plagued social care services for decades.

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6 Office for National Statistics, "National Population Projections: 2014-Based Statistical Bulletin."

7 Robertson, Gregory, and Jabbal, *The Social Care and Health Systems of Nine Countries*.

8 OECD, *Health at a Glance 2015*; Office for Budget Responsibility, *Fiscal Sustainability Report*.

9 Vergleich-Pflege.Versicherung, "Pflegeversicherungsbeitrag"; Office for National Statistics, *Annual Survey of Hours and Earnings: 2016 Provisional Results*.

10 Forder and Fernandez, *What Works Abroad? Evaluating the Funding of Long-Term Care: International Perspectives*.

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## Introduction

The question of how to fund social care has preoccupied Prime Ministers since the 1990s. John Major, Tony Blair and Gordon Brown all launched consultations or commissions on the subject.<sup>11</sup> At several junctures a consensus was reached, only for progress subsequently to breakdown.

The most recent attempt at reform – the Commission on Funding of Care and Support, launched in 2010 and overseen by Sir Andrew Dilnot – concluded that the Government should expand eligibility for means-tested support and cap the social care costs that individuals face. The then Coalition Government accepted a version of the Commission's package, and scheduled implementation for 2016.

After the May 2015 general election, however, reform was postponed until 2020. In a letter to the Local Government Association, the then Minister for Social Care Alistair Burt MP explained:

*“The proposals to cap care costs and create a supporting private insurance market were expected to add £6 billion to public sector spending over the next 5 years. A time of consolidation is not the right moment to be implementing expensive new commitments such as this, especially when there are no indications the private insurance market will develop as expected.”<sup>12</sup>*

The framing of this announcement led some to believe the Dilnot settlement was dead,<sup>13</sup> which appeared to be confirmed by the 2017 Budget. Noting future demographic challenges, the Chancellor announced the Treasury was investigating options to put the financing of adult social care on a “fair and more sustainable basis.”<sup>14</sup> The Conservative Party's manifesto reinforced this, focusing on aligning the treatment of people requiring residential and domiciliary care, and introducing a single capital floor of £100,000.

After heavy criticism, the Conservatives re-opened the idea of a care cap. However, the debate should not be limited to whether there should be a cap on personal care liabilities or not – a new funding arrangement is needed in order to address the issues of equity and sustainability.

This paper explores one option the Treasury should investigate in its green paper: a prefunded social insurance scheme. It starts by setting out the challenges that are motivating the Treasury's review, before presenting the arguments in favour of moving to a prefunded model. The paper concludes by considering the trade-offs that such a system, once implemented, would have to manage.

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<sup>11</sup> Humphries, *Paying for Social Care: Beyond Dilnot*.

<sup>12</sup> Department of Health, *Written Statement Made by: Minister of State for Community and Social Care (Alistair Burt) on 20 July 2015: Cap on Care Costs*.

<sup>13</sup> Lloyd, *Rebooting the Cap: Improving Protection from Catastrophic Care Costs*.

<sup>14</sup> HM Treasury, *Spring Budget 2017*.

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# 1

## The funding challenge

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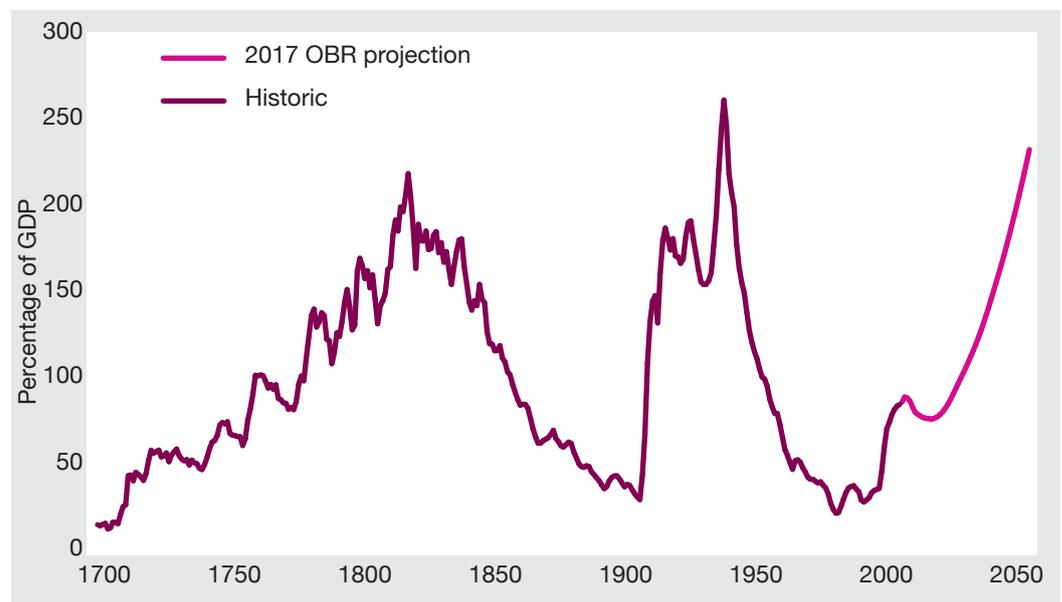
1.1	Rising demand	8
1.2	PAYG and intergenerational equity	10
1.3	Two systems or one?	11

In the Spring Budget 2017, the Government committed to a Green Paper that would set out proposals to put the social care system “on a more secure and sustainable long term footing.”<sup>15</sup> This chapter presents the drivers of long-term demand for social care support, the transfer of wealth between generations they imply, and the case for developing a separate funding mechanism for later-life care.

## 1.1 Rising demand

The demographic challenges faced by the UK are well rehearsed. Without policy action, the Office for Budget Responsibility (OBR) projects rising age-related expenditure will drive debt above 200 per cent of GDP sometime in the 2050s – levels never seen before in peacetime Britain (see Figure 1).

**Figure 1: Historic data and OBR projections of UK debt (1700 – 2066)**



Source: Office for Budget Responsibility, *Fiscal Sustainability Report 2017*; Bank of England, *Three centuries of macroeconomic data, 2016*

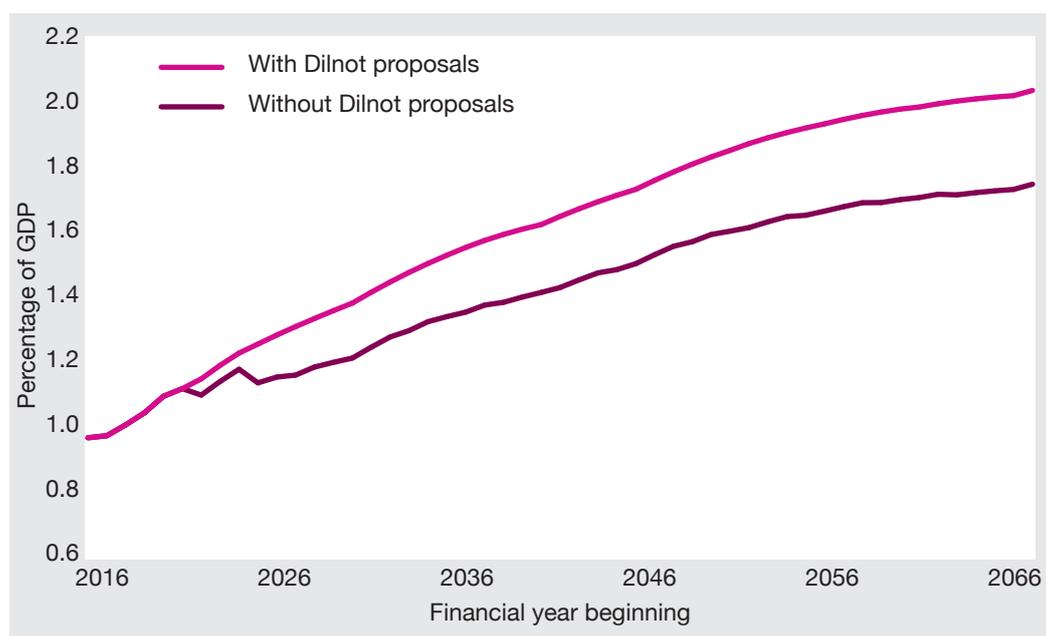
Note: Bank of England data is reported on a calendar-year basis while OBR data is reported on a financial-year basis

Alongside pension and health expenditure, the deteriorating fiscal picture will be driven by rising demand for state-funded long-term care. Publicly funded support in the UK is projected to increase from 1.0 per cent of GDP (£19.0 billion) today to 1.6 per cent of GDP (£30.5 billion) in twenty years' time.<sup>16</sup> While these figures are based on the questionable assumption that the Dilnot proposals will come into force in 2020, these provisions only add 0.3 per cent of GDP to expenditure by the end of the projection (see Figure 2).<sup>17</sup>

<sup>15</sup> Ibid.

<sup>16</sup> Figures in brackets based on the OBR's estimate of the size of the UK economy in March 2017 Office for Budget Responsibility, *Fiscal Sustainability Report 2017*; *Economic and Fiscal Outlook - March 2017*.

<sup>17</sup> Office for Budget Responsibility, *Fiscal Sustainability Report 2017*.

**Figure 2: OBR projections of UK expenditure on long-term care (2016 – 2066)**

Source: Office for Budget Responsibility, *Fiscal Sustainability Report 2013, 2013*; Office for Budget Responsibility, *Fiscal Sustainability Report 2017, 2017*

The cause of rising demand, however, is not just the fact that the UK's population is living longer. Data from NHS Digital indicates that 48 per cent of adult social care spending in England goes to people aged between 18 and 65, increasing from 42 per cent just over a decade ago (see Table 1).

**Table 1: Historic age profile of social care expenditure (2005-06 – 2015-16)**

	Above 65	Below 65
2005-06	58	42
2010-11	55	45
2015-16	52	48

Source: NHS Digital and The Information Centre for Health and Social Care, *Personal Social Services Expenditure and Unit Costs – 2010-11 – Final Release, 2012*; Adult Social Care Statistics and NHS Digital, *Personal Social Services: Expenditure and Unit Costs England 2015-16, 2016*

The rising proportion of social care expenditure going to working-age adults appears to contradict the fact that older people are accounting for an increasing percentage of the population. Yet this trend can be explained by a higher life expectancy for working-age adults with a disability, as well as changes to the eligibility criteria for state support and the improving financial position of older people.<sup>18</sup>

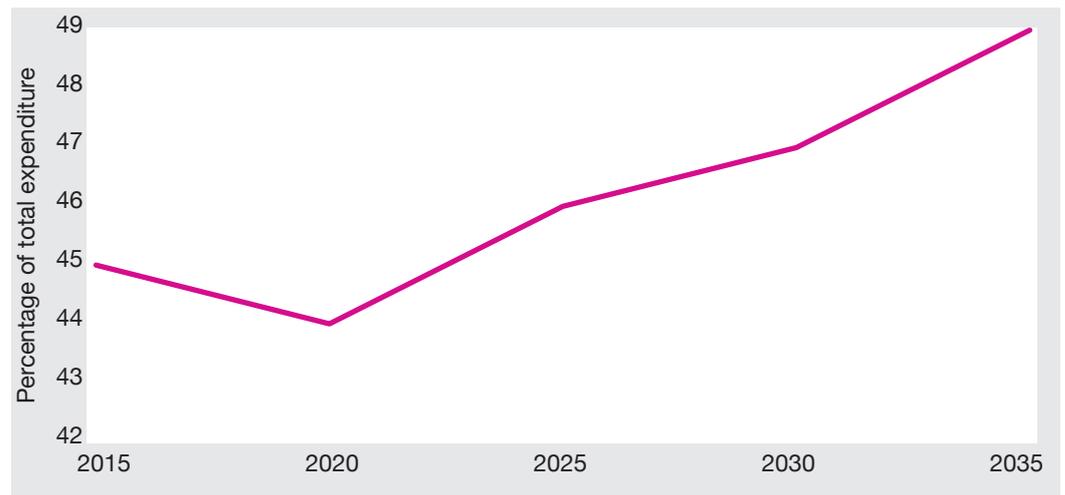
The expectation, however, is that this pattern will soon be reversed. According to the Personal Social Services Research Unit (PSSRU) – the organisation responsible for the OBR's projections of long-term care expenditure – public expenditure on social care for younger adults is projected to rise by 37 per cent in the 20 years to 2035 under baseline assumptions.<sup>19</sup> In part this will be driven by further reductions in the mortality rate for

<sup>18</sup> NHS Digital and The Information Centre for Health and Social Care, *Personal Social Services: Expenditure and Unit Costs – England 2010-11 – Final Release, 2012*.

<sup>19</sup> Raphael Wittenberg and Bo Hu, *Projections of Demand for and Costs of Social Care for Older People and Younger Adults in England, 2015 to 2035* (PSSRU, 2015).

younger people with physical or sensory impairment. Yet spending on state-funded later-life care is projected to grow more rapidly than this, rising 60 per cent in the coming two decades.<sup>20</sup> As a result, the amounts spent on the two groups will equalise by the end of the forecast period (see Figure 3).<sup>21</sup>

**Figure 3: PSSRU baseline projections of social care expenditure on adults over 65 (2015 – 2035)**



Source: Wittenberg, Raphael, and Bo Hu. *Projections of Demand for and Costs of Social Care for Older People and Younger Adults in England, 2015 to 2035*, 2015

## 1.2 PAYG and intergenerational equity

Rising long-term care expenditure is problematic not just because unpopular tax increases or spending cuts will be needed if the country's finances are to remain sustainable, but also because these dynamics represent a transfer of wealth from younger generations to older ones.

Publicly funded social care is currently financed through general taxation under a 'pay-as-you-go' (PAYG) arrangement. The revenue raised from today's taxpayers is used to pay for the social care needs of those currently requiring support, in the expectation that this favour is then returned by the next generation.

This system is equitable when the percentage of people needing social care holds constant over time, but when demand fluctuates PAYG systems can have significant redistributive effects. Take the example of a closed economy in which one generation – Generation A – is large relative to previous and future generations. When Generation A is of working-age, the cost of financing the social care demands of fellow citizens is manageable: a relatively high proportion of citizens are in work, generating income tax for the Exchequer; while a relatively low proportion of the population is old, and in need of care. Yet when Generation A retires, the next generation of taxpayers will find it more difficult to finance social care expenditure: Generation A's retirement means that a relatively low proportion are in work, while demand is higher than in previous years.

In the context of UK expenditure on social care, this effect can be quantified by using the OBR's expenditure projections. Between the ages of 40 and 65, those born in 1981 will contribute tax revenues worth 0.70 per cent of GDP towards the funding of social care (see Table 2).<sup>22</sup> As demand for social care increases, so too will the burden on taxpayers.

<sup>20</sup> Ibid.

<sup>21</sup> Ibid.

<sup>22</sup> Calculation based on tax revenue and long-term care spending profiles for 2021-22. This estimate is based on the OBR's central spending projections, and therefore assumes the Dilnot package will be implemented. Office for Budget Responsibility, *Fiscal Sustainability Report 2017*.

Those born in 1986 will be asked contribute tax revenues worth 0.83 per cent of GDP in later adulthood.<sup>23</sup> For those born in 1991, the required contribution will be higher still, standing at 0.93 per cent of GDP.<sup>24</sup> This means that those born in 1991 will need to pay approximately 34 per cent more in tax to finance the social care needs of the UK's citizens than people born just ten years earlier.

**Table 2: Tax burden borne between the ages of 40 and 65 to fund social care: three cohorts**

	Tax revenue as a percentage of GDP	Tax revenue as a percentage of Cohort 1's contributions
Cohort 1: born in 1981	0.70	100.00
Cohort 2: born in 1986	0.83	118.98
Cohort 3: born in 1991	0.93	133.67

Source: Office for Budget Responsibility, *Fiscal Sustainability Report 2017, 2017*

Notes: Calculation based on tax revenue and long-term care spending profiles for 2021-22. This estimate is based on the OBR's central spending projections, and therefore assumes the Dilnot package will be implemented.

The extent to which this rising burden reflects a transfer of wealth between generations depends on what is causing social care demand to increase. As the PSSRU's projections imply, a significant proportion of rising social care demand will be due to the working-age population.<sup>25</sup> This does not pose a problem with respect to intergenerational transfers because the cohort that is drawing on the rising entitlement is also financing it.

The residual increase in expenditure, however, is due to improving longevity, changes in morbidity, and more importantly, the fact that the baby boomers are now retiring. In the context of these changes, younger generations will receive a poorer rate of return on their contributions to the PAYG social care system than those who have already retired. Population ageing, therefore, "can cause very large and unintended redistribution away from future (younger) generations to earlier (older) generations."<sup>26</sup> In other words, the social care funding debate adds another dimension to the increasingly important question of intergenerational equity.

### 1.3 Two systems or one?

The intergenerational transfers of wealth created by the current PAYG system hints that there should be a different mechanism for funding later-life care. Historically, however, there has been resistance to this idea. As the Dilnot Commission argued:

*"Two systems – one for younger people and one for older people (those over the state pension age) – could lead to unfair outcomes. For example, if there were two systems in operation, a 64-year-old and a 65-year-old with similar levels of need and the same financial position could have to make very different levels of financial contribution and have very different outcomes. We do not think this is sensible or equitable."*<sup>27</sup>

<sup>23</sup> Ibid.

<sup>24</sup> Ibid.

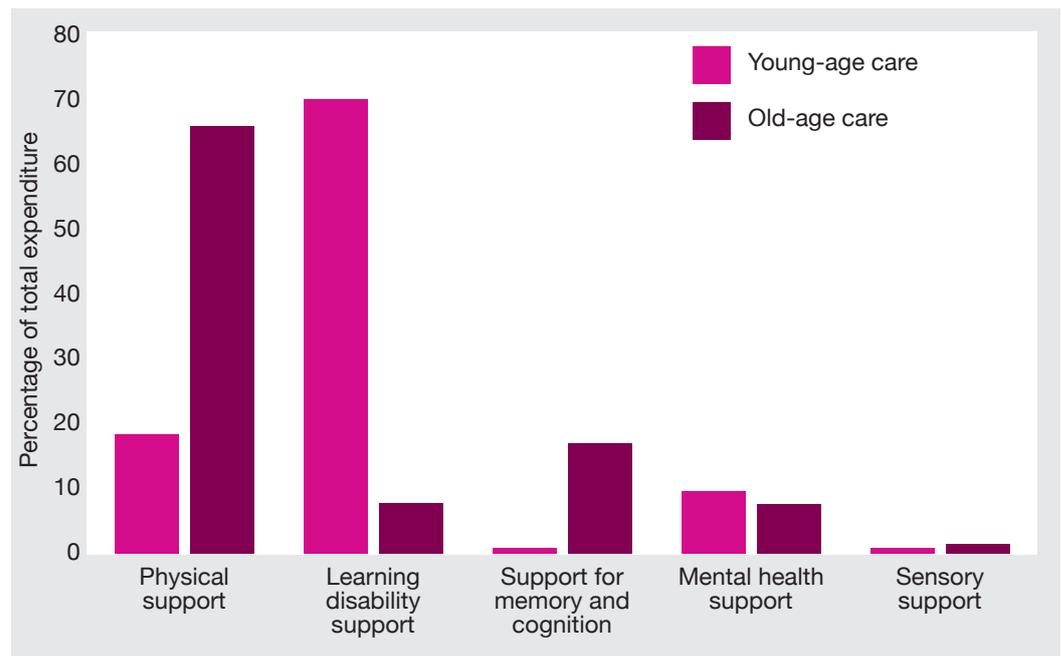
<sup>25</sup> Wittenberg and Hu, *Projections of Demand for and Costs of Social Care for Older People and Younger Adults in England, 2015 to 2035*.

<sup>26</sup> Kenneth House, 'What Has Fairness Got to Do with It? Social Justice and Pension Reform', *Oxford Institute of Ageing*, no. 1 (June 2004).

<sup>27</sup> Dilnot Commission, *Fairer Care Funding: Analysis and Evidence Supporting the Recommendations of the Commission on Funding of Care and Support*, 2011.

Nevertheless, the differences between older and younger people needing care should be recognised. The working-age population is much more likely to need support for learning disabilities, with the bulk of expenditure concentrated on a relatively small number of people with conditions requiring expensive treatment.<sup>28</sup> Meanwhile the majority of spending on the over 65s goes towards physical, memory and cognition support, meaning that the average cost of residential care for older people is significantly cheaper than for those aged 18 – 64 (see Figure 4).

**Figure 4: Expenditure on short- and long-term social care by age and need (2015-16)**



Source: NHS Digital, *Personal Social Services: Expenditure and Unit Costs England 2015-16, 2016*

These divergent characteristics are hugely significant. Acquiring the need for physical support in later life is perceptible; individuals have a lifetime to plan for these risks through accumulating savings, or if an insurance market in the UK existed, the pooling of liabilities; and on average, pensioners are now wealthier, and less likely to be in poverty, than working-age people.<sup>29</sup> All this means that older people should be expected to make at the very least some financial contribution to their care.

The same cannot be said of working-age people with social care needs. Over two thirds of this cohort have a learning, physical or sensory disability, conditions that are difficult to insure against because they are most likely acquired at birth.<sup>30</sup> What is more, given the employment rate for people with learning disabilities is just 5.8 per cent, those with working-age social care needs are unlikely to have the financial capacity to fund their own support.<sup>31</sup>

Several conclusions can be drawn from these observations. First, a PAYG model for working-age care ensures that every young person with potential care needs is protected against the risk that they would not be able to mitigate individually. Meanwhile, a system funded through central taxation ensures that the cost of caring for people with a lifetime disability is spread across the widest pool of individuals, reducing contributions. Finally,

<sup>28</sup> NHS Digital, *Personal Social Services: Expenditure and Unit Costs England 2015-16, 2016*.

<sup>29</sup> Adam Corlett, *As Time Goes by: Shifting Incomes and Inequality between and within Generations* (Resolution Foundation, 2017); Department for Work and Pensions, *Households below Average Income (HBAI) Statistics, 2016*.

<sup>30</sup> National Audit Office, *Adult Social Care in England: Overview, 2014*.

<sup>31</sup> National Audit Office, *Local Support for People with a Learning Disability, 2017*.

because these individuals are working-age, the PAYG nature of these contributions will not create intergenerational transfers.

The opposite holds true for later-life care. Because shifting demographics will see demand fluctuate over time, a PAYG system will lead to transfers of wealth between generations; and given the risk of acquiring social care needs in later life can be anticipated and planned for, it is reasonable to expect individuals to take greater responsibility for financing these costs. A strong case, therefore, can be made for separating the entitlement and funding structures for working-age and later-life social care – as is the case in France and Japan.<sup>32</sup>

This analysis, however, does not address the ‘cliff-edge’ challenge raised by the Dilnot Commission, a problem that would be particularly acute if the level of support offered to people with later-life care needs is different to that for the working-age population.

A preliminary response is that welfare policy cannot work without a network of rules; and when binary distinctions are made, rules can appear arbitrary. The State Pension, for example, offers an income replacement to those above a certain age, but nothing to those falling below it. Working-age adults with disabilities are eligible to receive Personal Independence Payments, while those over 65 receive Attendance Allowance, which guarantees a higher rate.

What policymakers can do, however, is design a network of rules that is as rational as possible. In the instance of funding later-life care, this might require the recognition that the incidence of age-related illness does not appear after a certain cut-off point – individuals below the age of 65 can also develop conditions prevalent in later life. In Japan, for example, the social care system is primarily designed for those over the age of 65, but for adults aged 40 – 64, entitlement can be accessed by those with social care needs because of age-related diseases such as dementia, osteoporosis and Parkinson's.<sup>33</sup> In practical terms, this could mean that someone aged 50 with social care needs due to Alzheimer's might receive support via one funding system, while a working-age adult with a learning disability might be supported through another.

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<sup>32</sup> Forder and Fernandez, *What Works Abroad? Evaluating the Funding of Long-Term Care: International Perspectives*.

<sup>33</sup> *Ibid.*

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# 2

## The case for prefunding

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2.1	Intergenerational transfers	15
2.2	Value for money	16
2.2.1	Empirical evidence	17
2.2.2	Social care inflation	19

Chapter 1 argued that the current PAYG funding model will lead to a transfer of wealth between generations as demand for later-life care rises, and set out the case for separating the funding of working-age and later-life social care. However social care does not need be funded on a PAYG basis: prefunding would avoid the problem of intergenerational transfers of wealth, as well as deliver better value for the taxpayer. Chapter 2 will make this case, before the implementation challenges are addressed in Chapter 3.

## 2.1 Intergenerational transfers

Chapter 1 highlighted the transfer of wealth between generations that will be triggered by the current PAYG system for funding social care. It should, however, be recognised that transfers of wealth between generations are not intrinsically bad. Indeed, one of the goals of the ‘New Deal’ – a PAYG social security system established in the United States in 1934 – was to support older people who had had their savings wiped out by the Great Depression.<sup>34</sup>

Yet defending the transfer of wealth that will be delivered by England’s social care funding arrangements is not so easy. ‘Millennials’, those born between 1981 and 2000, are set to become the first generation in modern history that will be worse-off than its predecessor.<sup>35</sup> This is partly due to the repercussions of the financial crisis, which has seen wages stagnate in real terms over the last decade.<sup>36</sup> Furthermore, millennials are not just poorer than their older peers in terms of income. Rising house prices have led to the emergence of ‘generation rent’, with home ownership among those aged between 25 and 34 falling 36.7 per cent between 2003 and 2014-15.<sup>37</sup> In turn, this will restrict the financial wealth at the disposal of today’s young adults, limiting their ability to pay for care in their later life.<sup>38</sup>

In other words, a transfer of wealth from younger, poorer generations, to older, richer ones, should be of concern to policymakers. This weakness of PAYG systems, however, is well known. In the 1990s and 2000s, as developed economies were coming to terms with the fiscal implications of having an ageing population and PAYG social-security systems, a significant trend towards the ‘prefunding’ of welfare entitlement emerged.<sup>39</sup> Under this model, rather than financing the needs of today’s service users through tax revenue, prefunding sees each generation set aside money to pay for their own entitlement. This capital is then invested, left to appreciate over time, and finally realised to pay for the benefits of the generation that set aside these finances.

To give a practical example of how prefunding by the state works, the Danish Government requires employees aged between 17 and 67 to make contributions into the labour-market supplementary pension (ATP), a state-backed fund. Entitlement is then gained at retirement, either in the form of an annuity – a guaranteed income stream for life – or if the savings are sufficiently small, a lump sum.<sup>40</sup> Similar prefunded pension schemes are operational in Chile, Hungary, Mexico and Poland, but these are typically supplemented by a universal entitlement funded through general taxation, as is the case in Denmark.<sup>41</sup>

While no country at present adopts this approach to funding social care, it is easy to envisage how such a system could work. Policymakers might require individuals above a certain age to contribute to a state-backed Later Life Care Fund (LLCF). This contribution mechanism could mirror the Japanese compulsory long-term care insurance scheme,

34 Vincenzo Galasso and Paola Profeta, ‘Lessons for an Aging Society: The Political Sustainability of Social Security Systems’, *Centre for Retirement Research at Boston College*, 2004.

35 Corlett, *As Time Goes by: Shifting Incomes and Inequality between and within Generations*.

36 *Ibid.*

37 Pete Redfern, *The Redfern Review into the Decline of Home Ownership*, 2016.

38 William Mosseri-Marlio and Danail Vasilev, *Funding Social Care: The Role of Deferred Payment Agreements (Reform, 2017)*.

39 Juan Yermo, *Governance and Investment of Public Pension Reserve Funds In Selected OECD Countries* (OECD, 2008).

40 Pension Funds Online, ‘Country Profiles: Denmark’, 2017.

41 Eduard Ponds, Clara Severinson, and Juan Yermo, *Funding in Public Sector Pension Plans: International Evidence* (OECD, 2011).

Kaigo Hoken, whereby individuals aged between 40 and 64 are required to pay 1 per cent of their income into the fund.<sup>42</sup> However, instead of using these contributions to finance the needs of today's service users – as is the case with Kaigo Hoken – a prefunded system would see these contributions invested, left to appreciate, and then liquidated by the fund's management to pay for the care of those who contributed.

It is important to note here that the LLCF would not create individual social care saving pots, but rather a mutual fund with enough assets to cover the expected liability of the cohort as a whole. Set up in this way, the LLCF would allow people to pool the risk of acquiring social care needs with their peers, and contribute relatively less than if they had to build up an individual pot to cover expected care liabilities.

This preliminary account skates over a number of crucial details which are addressed in greater length in Chapter 3, but it is sufficient to illustrate the benefits of prefunding. Consider again the scenario set out in Chapter 1, in which Generation A is larger than the generations that either precede or succeed it. To recap, under a PAYG system, members of Generation A will bear a relatively low tax burden to fund the social care needs of their elders; but the next generation will need to bear a relatively high tax burden to fund the later-life care needs of Generation A. Under a prefunded system, however, the unequal distribution of contributions and entitlement that can arise from PAYG mechanisms is avoided. Generation A would not pass on the cost of financing its social care entitlement to the next generation. Instead, it would set money aside for its own care, thereby ensuring that no one is put at risk of financing a disproportionate level of social care entitlement.

Prefunding would also bring much-needed transparency into the social care debate. The public has a limited understanding of the support that is currently available, and the cost this entails.<sup>43</sup> A prefunded system, whereby contributions are separated from general taxation, would go some way to resolving this challenge, as well as make clear to the public that expanded entitlement does not come for free. In other words, prefunding would share the benefits of transparency that institutions like the European Commission see in PAYG social insurance models.<sup>44</sup> Both of these approaches help populations understand the cost of long-term care, a feature which is not shared by schemes that are funded through central taxation.

A prefunded social insurance model, however, would also avoid a significant weakness of these schemes. In the face of rising demand due to population ageing, both Japan and Germany have cut benefits or raised contributions in recent years in an attempt to avoid accumulating deficits.<sup>45</sup> By contrast, a prefunded system would be designed to accumulate the required capital to cover total care liabilities, and therefore the UK's changing age structure would already be taken into account when contribution levels are set. In other words, population ageing alone would not necessitate adjustments to the contribution rate or entitlement of a prefunded scheme, although as Chapter 3 goes on to note, revisions may be required for other reasons.

## 2.2 Value for money

Arguments regarding intergenerational equity are made somewhat more complicated by economic growth. If social care entitlement as a percentage of national income holds constant over time, because economies tend to grow in the long run, PAYG systems ensure every generation gets out more than they paid in. The same, however, is true of prefunded systems: invested contributions will appreciate in value, so when these assets

<sup>42</sup> Forder and Fernandez, *What Works Abroad? Evaluating the Funding of Long-Term Care: International Perspectives*.

<sup>43</sup> Ipsos MORI, *Public Opinion Research on Social Care Funding: A Literature Review on Behalf of the Commission on the Funding of Care and Support*, 2011.

<sup>44</sup> European Commission, *Long-Term Care – the Problem of Sustainable Financing*, 2014.

<sup>45</sup> Pflege-durch-Angehörige, 'Pflegestärkungsgesetz – Die Neuen Pflegeleistungen Ab 2017 Auf Einen Blick Als Tabelle', 2017; Forder and Fernandez, *What Works Abroad? Evaluating the Funding of Long-Term Care: International Perspectives*.

are realised, the capital at the fund's disposal will be greater than the sum of original contributions.

This dimension to the debate, however, uncovers a further argument that can be advanced in favour of prefunding. In a formal analysis of these systems, the cost of PAYG and prefunding ultimately depends on two variables.<sup>46</sup> The capacity of PAYG systems to finance higher levels of entitlement for future generations is constrained by the pace at which real wages and the population grow: in other words, real GDP growth. For prefunding, the crucial factor is the return on contributions invested in equity and debt, which will be referred to as the interest rate. If the interest rate is greater than GDP growth, then fully funded systems will be able to deliver a fixed amount of entitlement at a lower cost than PAYG systems, and vice versa.

### 2.2.1 Empirical evidence

Economic theory suggests that, while output growth can temporarily exceed the interest rate, this cannot hold true in the long run.<sup>47</sup> If the interest rate stays below the growth rate for a prolonged period of time, the incentive to borrow would trigger an accumulation of debt, which in turn would push up the interest rate.

As the International Monetary Fund recognises, the empirical evidence supports this theoretical assessment – and therefore the case for prefunding.<sup>48</sup> Dimson, Marsh and Staunton found that real equity returns in the UK averaged over 5 per cent a year in the 20<sup>th</sup> century, compared to less than 1.4 per cent for growth in real GDP per capita.<sup>49</sup> An analysis from the World Bank across selected OECD countries reported that real wage growth, which tracks closely real GDP per capita, averaged 2.2 per cent annually between 1971 and 1990. By contrast, government bonds returned 1.4 per cent over the same period, equities 7.2 per cent, and a portfolio split evenly between equity and bonds 4.9 per cent.<sup>50</sup>

This analysis, however, only goes so far. First, by looking at earnings and GDP per capita, the above does not account for the effects of population growth, which can contribute to the financial appeal of PAYG systems. Second, these datasets do not cover the dot.com bust or financial crisis, periods in which equity performed very poorly. Third, while the historic performance of equity and debt can provide a guideline regarding the expected returns of funds managed by the LLCf, the World Bank's example of a portfolio split evenly between these two asset classes is somewhat crude.

The last problem can be easily addressed. A better proxy for the rate of return that could be expected from invested contributions is the performance of pension funds. Pension fund managers are presented with a similar task to those who would be responsible for overseeing the LLCf's capital: delivering high returns over a prolonged period of time, without taking on too much exposure to risky asset classes.

When the performance of pension assets is compared with real GDP growth – which takes into account population growth – further support is given to prefunding. Data from UBS indicates that, between 1962 and 2015, pension funds appreciated at 4.7 per cent annually, compared to 2.4 per cent for GDP growth.<sup>51</sup> Over a 53-year period, this premium has seen pension assets outperform the economy by 332.9 per cent (see Figure 5).

46 World Bank, *Averting the Old Age Crisis*, 1994.

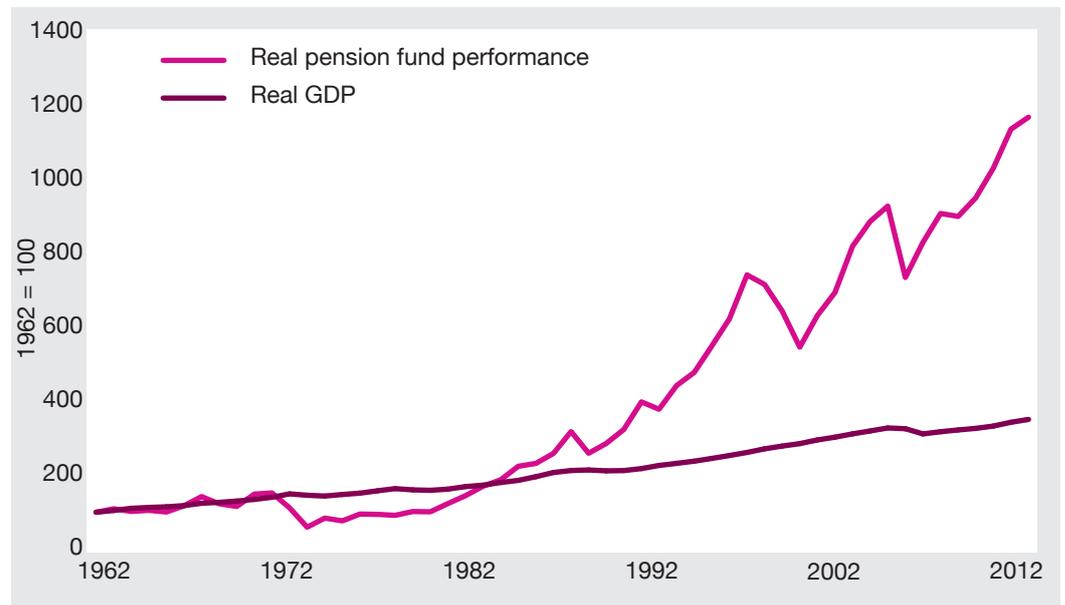
47 Stanley Fischer and William Easterly, 'The Economics of the Government Budget Constraint', *The World Bank Research Observer* 5, no. 2 (July 1990).

48 Richard Hemming, *Should Public Pensions Be Funded?* (IMF, 1998).

49 Elroy Dimson, Paul Marsh, and Mike Staunton, *Triumph of the Optimists: 101 Years of Global Investment Returns* (Princeton University Press, 2002).

50 World Bank, *Averting the Old Age Crisis*.

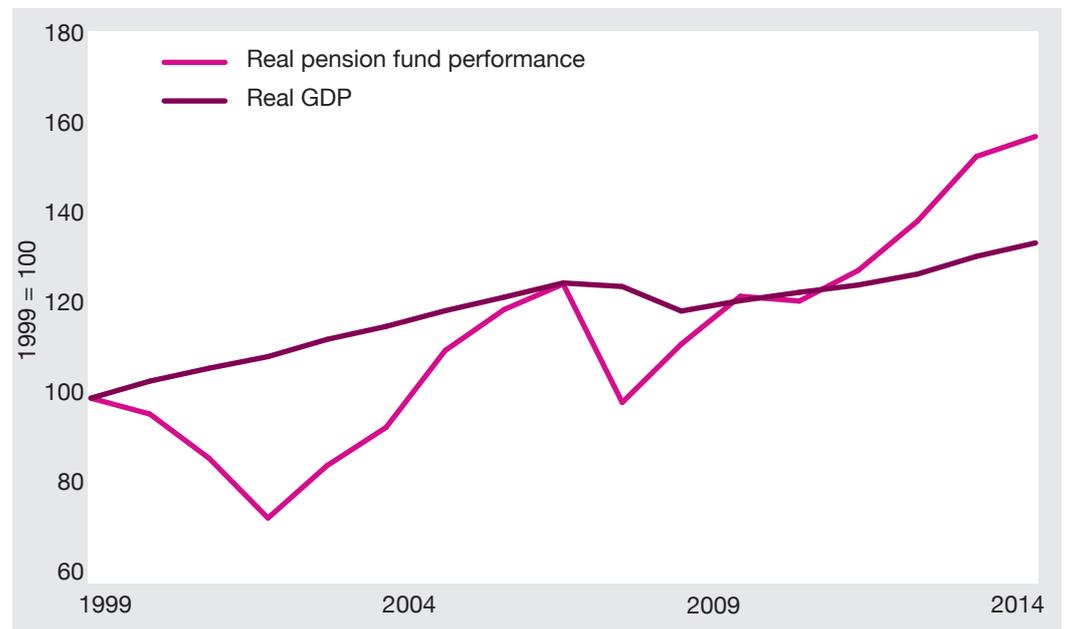
51 Reform calculations using UBS, *The Right Ingredients: Pension Fund Indicators 2016*, 2016; Bank of England, *Three Centuries of Macroeconomic Data*, 2016.

**Figure 5: GDP growth and pension fund returns (1962 – 2015)**

Source: UBS, *The right ingredients: Pension Fund Indicators 2016*, 2016; Bank of England, *Three centuries of macroeconomic data*, 2017

Figure 5 confirms, however, the additional risk of switching to a prefunded arrangement. In the late 1990s, and again in the 2000s, convulsions in the equity markets wiped out a significant portion of pension funds' assets. The dominance of interest rates over growth ensures that in the long run, an equivalent level of coverage can be supplied at a lower average cost. In certain periods, however, the assets held in these funds may fall below the total liabilities they need to cover.

The fact that private sector pension funds are, by and large, able to handle volatility in the equity and bond markets indicates this is not a fundamental problem with prefunding. What is more, even if the data is rebased to a particularly difficult period for equity – 1999, the year before the effects of the dot.com crash started to feed through – the relative performance of pension funds is still strong. Seven years after the crash, pension funds recouped all the ground they had lost to GDP growth, a remarkable feat given the UK economy was then in the middle of an unprecedented period of economic expansion. Then the financial crisis hit, at which point both GDP growth and pension fund returns fell. This time, however, pension funds regained the lost ground within two years, and have outstripped GDP growth since 2011. Indeed, even in this period, pension assets appreciated by 2.7 per cent in real terms, compared to 1.7 per cent for GDP growth (see Figure 6).

**Figure 6: GDP growth and pension fund returns (1999 – 2015)**

Source: UBS, *The right ingredients: Pension Fund Indicators 2016*, 2016; Bank of England, *Three centuries of macroeconomic data*, 2017

In summary, the balance of evidence indicates a prefunded system would be cheaper than the current PAYG approach. Returns on equity and debt have consistently outperformed GDP growth in the UK. This is true even when an unusually difficult period for financial assets is assessed; and the international literature indicates that the UK is not an anomaly in this regard.<sup>52</sup> If a centrally managed LLCF can secure these returns, substantial efficiency gains will be made.

As an illustration of the practical implications this would have for the cost of funding social care, assume that the Government created a LLCF, the fund appreciated in line with pension fund performance, and all adults were required to contribute between the ages of 40 and 65. Each pound invested under this system would be worth £3.12 in 25 years. By contrast, a PAYG system that was underpinned by an economy that grew in line with recent performance would see entitlement increase from £1 to £1.79 over a 25-year period. To put this analysis another way, for every £1 that is paid into a PAYG system, a prefunded system would require a contribution of just £0.57.<sup>53</sup>

## 2.2.2 Social care inflation

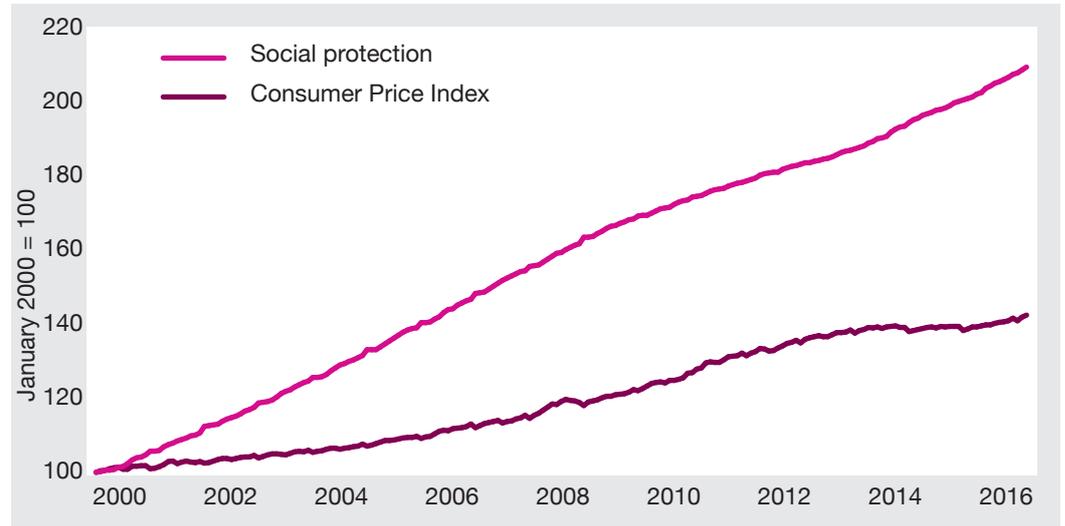
Much of the above analysis has been drawn from the extensive literature on the competing merits of prefunded and PAYG models for financing pensions. There is, however, one fundamental difference between the provision of social care entitlement and pension income. To ensure the value of recipients' income is not eroded through inflation, pensions need to keep pace with the changing price level. For social care, the case is somewhat different. Annual inflation in 'social protection' – which includes home care assistants and residential home care, but also products unrelated to social care – has been 2.2 percentage points higher than increases in the general price level since January 2000 (see Figure 7). If this trajectory reflects future trends in the unit cost of social care, governments and individuals will have to increase expenditure in real terms to deliver the

<sup>52</sup> Dimson, Marsh, and Staunton, *Triumph of the Optimists: 101 Years of Global Investment Returns*; World Bank, *Averting the Old Age Crisis*.

<sup>53</sup> This calculation is based on the strong assumption that the unit cost of social care holds constant in real terms. Feldstein, 'Transition to a Fully Funded Pension System: Five Economic Issues'.

same level of entitlement over the long run.<sup>54</sup> It would also mean that, because care today is cheaper than care tomorrow, the intergenerational transfers of a PAYG system will be less significant.

**Figure 7: Consumer Price Index and inflation in social protection (2000 – 2017)**



Source: Office for National Statistics, *Consumer Price Inflation time series dataset (MM23)*, 2017

Social care is a labour-intensive industry, with wages accounting for 60 per cent of residential care costs.<sup>55</sup> This can explain recent real-terms rises in the unit cost of providing these services, while policy decisions – such as the rising minimum wage – will put yet more pressure on prices in the medium term.<sup>56</sup> However, these dynamics will also give providers a strong incentive to bear down on their growing wage bills – a tactic that many are already pursuing. Some, for example, are seeking to harness the power of online labour platforms to cut operating costs and respond to users’ needs more flexibly.<sup>57</sup> By promoting self-care and supporting prevention, assistive technology and social care apps could stimulate productivity.<sup>58</sup>

In other words, recent above-inflation rises in the unit cost of social care may not continue indefinitely. However, even if social care inflation ran at 1.5 percentage points above increases in the general price level – the assumption made by the Dilnot Commission – this would not be sufficient to wipe out the higher returns that would be delivered through prefunding.<sup>59</sup> Taking into account the effects of social care inflation, the difference in returns between a PAYG and a prefunded system would fall to 0.8 per cent. When compounded over a 25-year period, even this smaller discrepancy can lead to significant savings: for every £1 paid in through a PAYG system, a prefunded arrangement would require contributions worth just £0.82.<sup>60</sup>

Indeed, the benefits of prefunding are resilient to even the upper bound estimate of social care inflation. If the unit cost of social care grows at 2.2 per cent in real terms each year – the rate at which real wages are assumed to appreciate – prefunding is still 3 per cent

54 Julien Forder, *Long-Term Care for Older People in Jersey*, 2008.

55 The Wanless Social Care Review, *Securing Good Care for Older People: Taking a Long-Term View* (The King’s Fund, 2006).

56 Sean Farrell, ‘Mitie Withdraws from Healthcare as It Issues Second Profit Warning’, *The Guardian*, 21 November 2016.

57 Alexander Hitchcock, Kate Laycock, and Emilie Sundorph, *Work in Progress: Towards a Leaner, Smarter Public-Sector Workforce* (Reform, 2017).

58 Local Government Association, *Transforming Local Services through Digital*.

59 Dilnot Commission, *Fairer Care Funding: Analysis and Evidence Supporting the Recommendations of the Commission on Funding of Care and Support*.

60 Reform calculations based on Feldstein, ‘Transition to a Fully Funded Pension System: Five Economic Issues’.

cheaper than PAYG over a 25-year period (see Table 3).<sup>61</sup> This should be viewed as a worst-case scenario because, as already noted, providers of social care face costs other than labour – for example, maintenance, insurance and food – that would not typically increase at the same pace as wages.<sup>62</sup>

**Table 3: Contribution required under prefunding to pay for £1 of entitlement under PAYG**

	Lower bound	Central	Upper bound
Social care inflation	CPI	CPI + 1.5 per cent	CPI + 2.2 per cent
Cost of prefunding	£0.57	£0.82	£0.97

Source: *Reform* calculations based on Feldstein, *Transition to a fully funded pension system: five economic issues*, 1997

61 Wittenberg and Hu, *Projections of Demand for and Costs of Social Care for Older People and Younger Adults in England, 2015 to 2035*; Reform calculations based on Feldstein, 'Transition to a Fully Funded Pension System: Five Economic Issues'.

62 CIPFA et al., *Working with Care Providers to Understand Costs: A Guide for Adult Social Care Commissioners*, 2016.

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# 3

## Implementation

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3.1	Contributions	23
3.1.1	Compulsion or choice?	23
3.1.2	When and who?	24
3.1.3.	Managing the funds	27
3.2	Entitlement	27
3.2.1	The level of coverage	28
3.2.2	Eligibility	29
3.2.3	Defined benefits or defined contributions?	30
3.3	Transition	30
3.3.1	Financing the double burden	31
3.3.2	Phasing-in mechanism	33

Chapter 2 set out the case for prefunding later-life care. While reform will not prevent demand from rising, prefunding could deliver savings to the taxpayer and guard against transfers of wealth between generations. In this final section, the trade-offs when implementing this model are explored, including the nature of contributions, the form of entitlement that would be delivered through a LLCF, and how transitioning from the current PAYG system would work.

### 3.1 Contributions

The most immediate questions regarding implementation concern contributions. While at present there are no prefunded social care systems from which lessons can be drawn, the extensive literature on pensions policy can offer some guidance.

#### 3.1.1 Compulsion or choice?

There are at least two significant challenges for state-backed insurance schemes where contributions are voluntary. First, individuals underestimate the likelihood of requiring social care in later life, a misconception that results in the underconsumption of insurance.<sup>63</sup> Second, by giving people the option of not participating in the LLCF, the healthiest individuals are likely to exit the scheme and consume or invest their care contributions elsewhere. This is a classic example of adverse selection.<sup>64</sup> If the pool of people left in the insurance scheme is generally more predisposed to disability than the total population, contributions will have to increase so that the system remains sustainable.

By pooling risk among the whole population, compulsion ensures that the average cost is kept low, while avoiding underconsumption. Yet much like in systems that are funded through central taxation, individuals may be forced to consume a product that they would not have otherwise purchased. The trade-off between compulsion and choice, therefore, is one between lower contributions and personal freedom.

Policymakers in several arenas have recently resolved this dilemma through the introduction of ‘default options’. The textbook example of this is automatic enrolment in the UK. Since 2012, working-age adults have been ‘defaulted’ into a workplace pension. This is not compulsion – employees are free to opt out of the saving scheme – but the effect of inertia is such that participation rates have jumped considerably since the policy’s introduction.<sup>65</sup>

Automatic enrolment, however, operates on the basis of individual savings accounts, so there is no distributional dimension to the question of whether to opt in or out. Yet under a LLCF – much like in the existing, tax-funded arrangement – individuals would pool finances with the rest of their generation, rather than saving for personal consumption. This approach ensures that even the poorest are offered protection against social care costs. But if contribution rates are fixed as a percentage of incomes, this policy would have a redistributive effect: wealthier individuals would pay in more than those on lower incomes, but receive the same (or even less) support (see 3.2.2). In other words, there would be a strong incentive for wealthier individuals to opt out of a LLCF; one that could overcome the power of inertia.

For these reasons, compulsion is a feature of any successful system. Out of the nine countries examined in a King’s Fund report on foreign social care systems, five are funded through general or local taxation, while four have hypothecated income tax, shared between employee and employer.<sup>66</sup>

63 Lloyd, *Right Care, Right Price*.

64 George Akerlof, ‘The Market for “Lemons”: Quality Uncertainty and the Market Mechanism’, *The Quarterly Journal of Economics* 84, no. 3 (August 1970).

65 Department for Work and Pensions, *Workplace Pension Participation and Savings Trends of Eligible Savers Official Statistics: 2005 to 2015*, 2016.

66 Ruth Robertson, Sarah Gregory, and Joni Jabbal, *The Social Care and Health Systems of Nine Countries* (The King’s Fund, 2014).

Nonetheless, policymakers can ensure that within a system of mandatory contributions individual choice is still supported. In Germany, for example, people over a certain income threshold can opt out of the government scheme provided they purchase a private insurance product.<sup>67</sup> Similarly, France gives tax breaks to those who purchase private insurance that offers more extensive coverage than the state scheme, an intervention that partly explains why France has the most developed private insurance market for long-term care in the world.<sup>68</sup>

Both of these interventions would first require a resurrection of the private long-term care insurance market in the UK, which closed in 2010.<sup>69</sup> Yet an even more basic way to promote choice within a compulsory framework is to design entitlement around the idea that state support should not cover the full cost of care, as is the case in Germany.<sup>70</sup> By providing only a baseline level of coverage, and expecting supplementary financing from individuals, the potential that people will be forced into purchasing a level of insurance they would not otherwise buy is reduced.

In sum, the international evidence suggests that effective reform relies on the widest pool of contributors possible. The LLCF would therefore require a system of compulsory contributions, but choice could still be supported by giving individuals the option of privately insuring, either as a substitute or supplement to public support.

### 3.1.2 When and who?

The question of whether people should be given the choice to opt out of the LLCF entails some normative judgements regarding the division of responsibility between individuals and the state. A more pragmatic, but equally challenging, question concerns who would be required to contribute into the LLCF, and for how long.

The optimal funding level would see the assets held in the LLCF exactly equal future liabilities: people would have their care needs covered, but without forgoing consumption as a result of over-insuring. The actuarially fair level of contribution, therefore, will be determined by the future morbidity and longevity of today's working-age people. However, longevity has consistently outperformed Office for National Statistics (ONS) projections in the past 50 years, a fact that would have caused significant problems if a prefunded system had been operational over this period (see Figure 8).

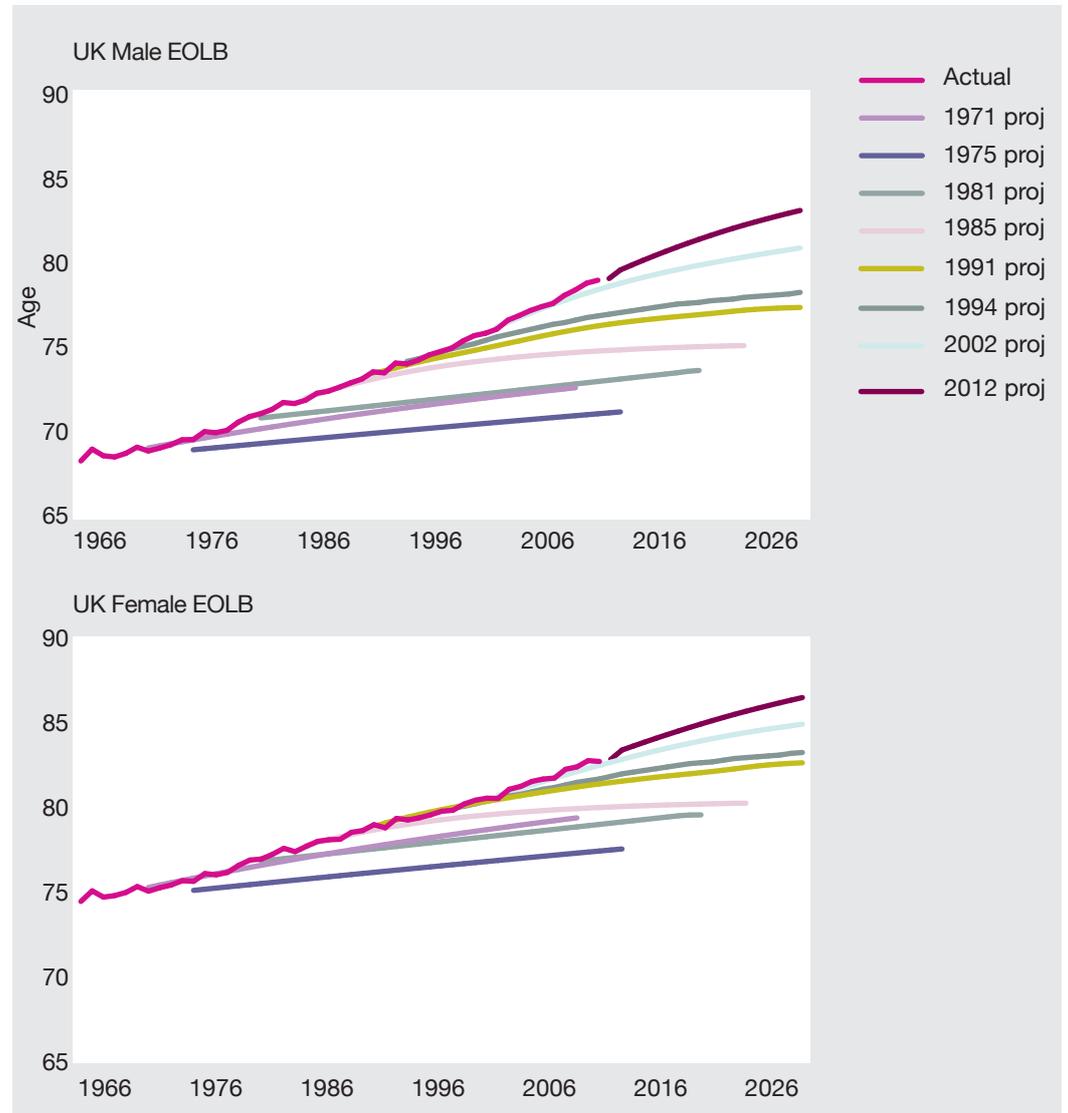
67 Forder and Fernandez, *What Works Abroad? Evaluating the Funding of Long-Term Care: International Perspectives*.

68 Ibid.

69 Lloyd, *Gone for Good? Pre-Funded Insurance for Long-Term Care*.

70 Forder and Fernandez, *What Works Abroad? Evaluating the Funding of Long-Term Care: International Perspectives*.

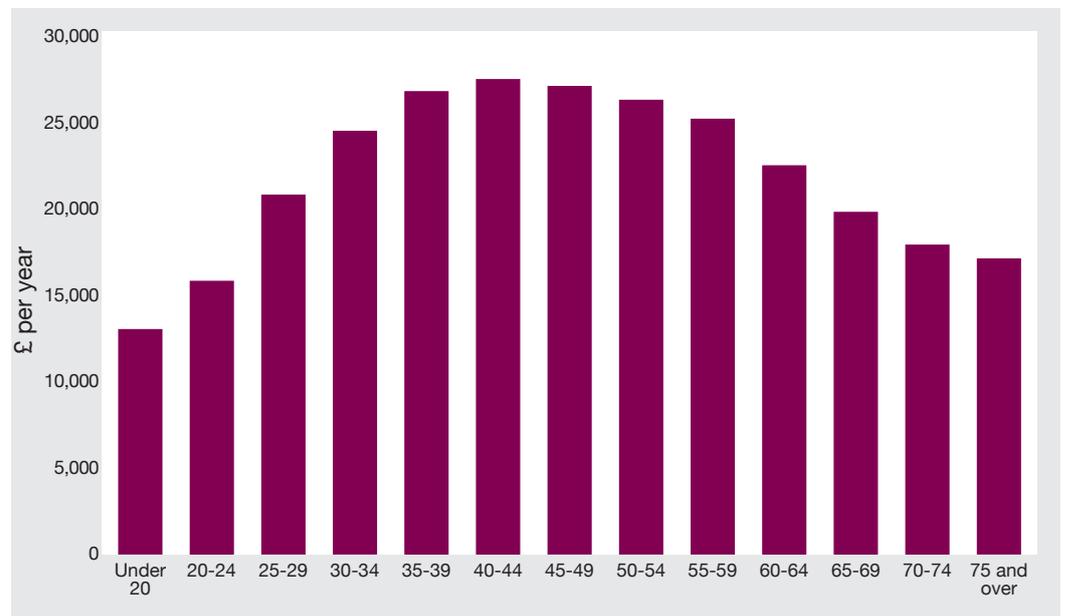
**Figure 8: Actual and projected period expectation of life at birth for UK males and females, selected years (1966 to 2030)**



Source: Office for National Statistics, *National Population Projections Accuracy Report, 2016*

Since it is more difficult to predict longevity in 50 years' time than in ten years' time, prolonging the contribution period exacerbates this problem. Collecting contributions closer to the age at which individuals would become eligible for entitlement – much like Japan's approach to social insurance – would go some way to mitigate this threat.

Yet constraining the contribution period means that annual payments would have to be set at a higher level compared to a scheme in which individuals contribute throughout their working lives. This is true for the straightforward reason that to save a fixed amount over a shorter period means that annual contributions will need to increase. It is also the case because the benefits of compounded interest diminish the more that the contribution period is reduced. Under the interest rate assumptions used in Chapter 2, £1 becomes £3.12 after 25 years of appreciation, but after 40 years, £1 becomes £6.18. This is problematic not only because higher costs reduce disposable income. Restricting contributions to older working-age adults would entail the addition of a financial burden just when incomes start to decline (see Figure 9), and the need to save for retirement becomes more acute.

**Figure 9: Median income before tax by age group (2014-15)**

Source: Office for National Statistics, *Distribution of median and mean income and tax by age range and gender, 2017*

There are, however, ways of balancing the benefits of compounded returns with the risks associated with errant projections. Regular adjustment of statutory contribution rates according to the latest longevity and morbidity projections would help. This practice was used by private long-term care insurers in the UK, but frequent adjustments of contribution rates makes it more difficult for individuals to plan their finances.<sup>71</sup> Given the duration of time over which contributions would accumulate and the tendency for these debates to become partisan, the process of setting contribution levels might also benefit from external oversight. A parallel here is the manner in which the State Pension age is determined. Legislation laid down by the Coalition now requires an external review every Parliament, although the authority to amend the State Pension age is still ultimately retained by Parliament.<sup>72</sup>

In addition to determining an age band within which individuals would contribute to the LLCF, policymakers would need to consider who would be required to pay in. Levying contributions on all those in work via the existing tax network is the most obvious answer to this question. Employees would pay a fixed percentage of annual income via PAYE, while the Self Assessment tax return could be used by the self-employed. Undoubtedly there are drawbacks to this approach. By asking only those in employment to contribute, LLCF charges would disincentivise labour, compounding an issue that many already see with the UK's tax code, and running counter to recent attempts to stimulate employment in later life.<sup>73</sup>

Yet the alternatives are no more appealing. LLCF contributions could be levied on everyone within a certain age bracket, but this would also create labour market disincentives because a means-testing system would need to be put in place. On a more practical level, if LLCF contributions were not processed through the tax system, policymakers would need to construct a completely new payments system – a task that would entail significant cost. Therefore, while there would be downsides to administering LLCF contributions like a payroll tax, this approach appears to be the most promising.

<sup>71</sup> Lloyd, *Gone for Good? Pre-Funded Insurance for Long-Term Care*.

<sup>72</sup> HM Government, *Pensions Act 2014*, 2014.

<sup>73</sup> James Mirrlees et al., *Tax by Design: The Mirrlees Review* (Oxford University Press, 2011); Department for Work and Pensions, *Fuller Working Lives: A Partnership Approach*, 2017.

### 3.1.3 Managing the funds

A final consideration is who would be responsible for investing the public's contributions. The international evidence suggests that public funds managed by the private sector tend to outperform those under central management.<sup>74</sup> Iglecias and Palacios argue that financial incentives for private managers and protection from political influence can explain the relatively strong performance of state funds with less bureaucratic oversight and more independence.<sup>75</sup>

Recognising the advantages of decentralised management, several countries liberalised the governance structures of their pension funds around the turn of the century.<sup>76</sup> In 2001, Sweden created four different pension funds (AP1 – AP4) with independent governance structures. To ensure investment decisions are guided by financial considerations alone, the Government passed legislation which explicitly stated the sole aim of the funds would be to maximize return subject to risk. In addition, it stipulated that at least 10 per cent of assets should be managed externally.<sup>77</sup>

Liberalisation has coincided with strong performance. Over the last five years, the four funds have posted annualised returns after expenses of between 10.0 per cent and 12.0 per cent.<sup>78</sup> In comparison, Swedish GDP grew 1.9 per cent over the same period.<sup>79</sup> Unsurprisingly, the funds fared less well over the financial crisis, but even so, AP4 has returned 5.6 per cent after expenses since its inception in 2001.<sup>80</sup> These figures are significantly higher than the 2.1 per cent that Swedish GDP growth averaged over the same period, indicating that public funds under independent management can deliver better value for money than a PAYG system.<sup>81</sup>

Ireland is another example where private management has led to success. A 1998 review suggested the state pension should be partially funded, with investments guided exclusively by market principles. By 2001, the fund held assets totalling €7.5 billion and in 2015, the fund reported 39.1 per cent exposure to equity.<sup>82</sup> Again, the financial crisis had a significant impact on performance. Nevertheless, in the ten years after its establishment, the pension fund posted annualised returns of 3.3 per cent compared to 2.7 per cent for GDP growth.<sup>83</sup>

To be clear, there are pitfalls with bringing in the private sector, such as the costs associated with setting up the requisite regulatory functions. Nevertheless, ensuring that investments are guided by market principles, and that political goals are kept out of investment strategies, will go a long way to ensuring the LLCF delivers the returns needed to support prefunding.

74 Augusto Iglecias and Robert J. Palacios, 'Managing Public Pension Reserves Part I: Evidence from the International Experience', *World Bank*, January 2000.

75 The metric used by Iglecias and Palacios to measure fund performance was annualised returns less returns on bank deposits. For the countries that had private management of funds, the excess return was found to be on average 3.8 percentage points higher.

76 Robert Palacios, 'Managing Public Pension Reserves Part II: Lessons from Five Recent OECD Initiatives', *The World Bank*, 2002.

77 Clara Severinson and Fiona Stewart, 'Review of the Swedish National Pension Funds', *OECD Working Papers on Finance, Insurance and Private Pensions* No 17 (2012).

78 Första AP-fonden, 'Annual Report 2016', 2016; Andra AP-fonden, 'Second Swedish National Pension Fund Annual Report 2016', 2016; AP Third Swedish National Pension Fund, *Annual Report 2016 with Integrated Sustainability Report*, 2016; Fjärde AP-fonden, *Annual Report 2016*, 2016.

79 World Bank, 'GDP Growth (Annual%)', 2017.

80 Fjärde AP-fonden, 'Management', 2017.

81 Ibid. World Bank, 'GDP Growth (Annual%)'.

82 National Pensions Reserve Fund Commission, *Annual Report and Financial Statements 2011*, 2011.

83 National Pensions Reserve Fund Commission, *Annual Report and Financial Statements 2011*; World Bank, 'GDP Growth (Annual%)'. National Pensions Reserve Fund Commission, *Annual Report and Financial Statements 2011*, 2011; World Bank, 'GDP Growth (Annual%)'.

## 3.2 Entitlement

The question of how social care entitlement in England should be configured has received lengthy treatment in the past decade. In 2006, Sir Derek Wanless proposed a partnership model, whereby everyone is entitled to a minimum level of free care, after which individuals' contributions to social care costs would be matched by the state.<sup>84</sup> Gordon Brown tabled a comprehensive and universal care system to mirror the NHS in the final days of his administration.<sup>85</sup> Most recently, Sir Andrew Dilnot recommended the implementation of a cap on the social care liability individuals face, thereby offering protection against the risk of catastrophic care costs.<sup>86</sup>

All of these entitlement structures – by and large – are consistent with prefunding. After all, this is a mechanism for financing entitlement, rather than a prescription regarding how entitlement should be configured. Nevertheless, the choice of funding mechanism does have implications for the applicability of some forms of social care entitlement.

### 3.2.1 The level of coverage

Ultimately, the generosity of support financed through a LLCF will depend on the level at which contributions are set – the more individuals pay in collectively, the more they can expect to get out. A brief assessment, however, of countries in which hypothecation takes place can offer some guidance regarding the trade-off between coverage and cost.

In Japan, 90 per cent of social care costs are covered by Kaigo Hoken, the social insurance scheme, with individuals asked to finance the residual 10 per cent.<sup>87</sup> This comprehensive coverage, however, comes at a price. Contributions for workers aged between 40 and 64 are set at 1 per cent of income, with half of this cost financed by the employer, but this income stream only accounts for a third of the public budget. Premiums from those aged over 65 and general taxation account for one sixth and one half of spending respectively.<sup>88</sup>

Germany, by contrast, has a headline contribution rate of 2.55 per cent of earned income – a fee which is split between employees and employers – with an additional charge levied on those without children to reflect the diminished pool of informal care these individuals have at their disposal.<sup>89</sup> The scheme's benefits, however, are not designed to cover the full cost of care.<sup>90</sup> In 2015, those with the highest care needs received just €1,550 a month in insurance payouts, which is just under half the €3,300 monthly cost of residential care.<sup>91</sup> To finance the remaining gap, as well as the cost of accommodation, individuals are urged to buy supplementary private insurance, although only 3.5 per cent had a plan of this type in 2009.<sup>92</sup> For those that are unable to cover non-insured costs, the federal government offers assistance.<sup>93</sup>

These policy choices are reflected in the international data on long-term care expenditure. With its comprehensive network of support, Japan spends 2 per cent of GDP a year on long-term care. In Germany, despite similar dependency ratios, social care expenditure is 1 per cent of GDP, just under the UK's 1.2 per cent (see Figure 10).

84 The Wanless Social Care Review, *Securing Good Care for Older People: Taking a Long-Term View*.

85 The Labour Party, *The Labour Party Manifesto 2010: A Future Fair for All*, 2010.

86 Dilnot Commission, *Fairer Care Funding: The Report of the Commission on Funding of Care and Support*, 2011.

87 Robertson, Gregory, and Jabbal, *The Social Care and Health Systems of Nine Countries*.

88 Forder and Fernandez, *What Works Abroad? Evaluating the Funding of Long-Term Care: International Perspectives*.

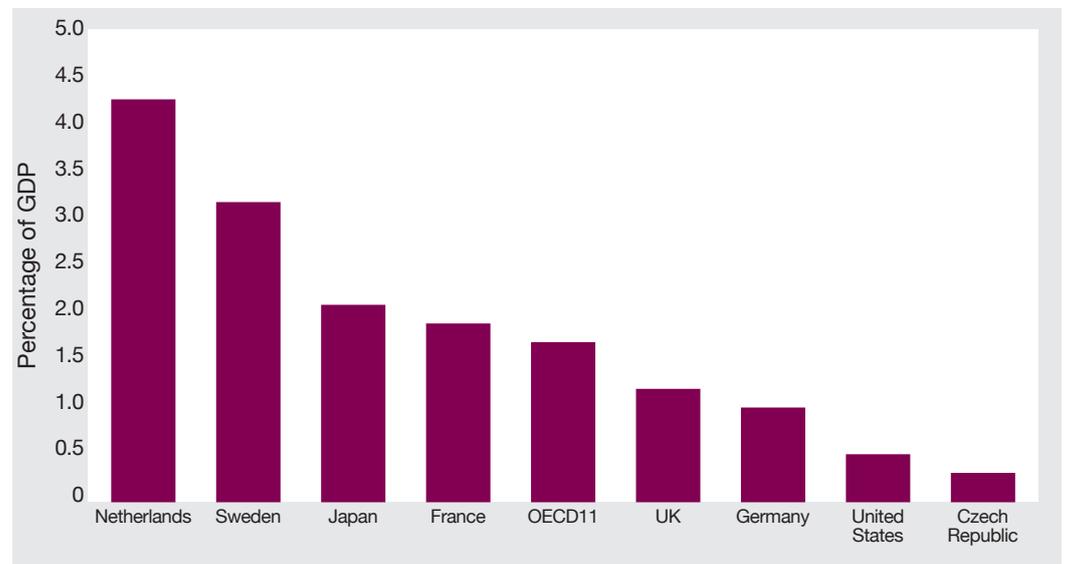
89 Vergleich-Pflege.Versicherung, 'Pflegeversicherungsbeitrag'; Robertson, Gregory, and Jabbal, *The Social Care and Health Systems of Nine Countries*.

90 Robertson, Gregory, and Jabbal, *The Social Care and Health Systems of Nine Countries*.

91 Pflegestufen, 'Pflegekosten', 2017.

92 The Commonwealth Fund, *International Profiles of Health Care Systems*, 2013, 2013.

93 Robertson, Gregory, and Jabbal, *The Social Care and Health Systems of Nine Countries*.

**Figure 10: Expenditure on long-term care, selected countries (2013)**

Source: OECD, *Health at a Glance: 2015, 2015*; Office for Budget Responsibility, *Fiscal sustainability report 2014, 2014*

Note: Japan data is from 2012

Given the comparable expenditure levels of Germany and the UK, the 2.55 per cent contribution rate provides a guideline as to how much individuals would need to pay into a prefunded system to deliver the same level of social care expenditure as today. For the median full-time earner in the UK, this would be equivalent to £30 a month coming from the employee, with a further £30 paid by the employer.<sup>94</sup>

This parallel comes with some significant caveats, however. Germany's PAYG system means that contribution rates will have to increase as the population ages and demand rises. It should also be noted that all adults are required to pay into Germany's social insurance scheme, and any reduction in the contribution period would lead to an elevated contribution rate.<sup>95</sup> These cost pressures, however, would be offset by the better value for money that prefunding represents, although the magnitude of this saving will depend on the duration over which contributions can accumulate (see 3.1.2), and the degree to which the cost of social care increases in real terms over time (see 2.2.2).

### 3.2.2 Eligibility

One of the benefits of prefunding would be to create a more transparent link for citizens between contributions and entitlement. Yet maintaining the highly means-tested approach to social care support in England under a prefunded arrangement would see many middle and high income earners pay into a system for their entire lifetime, only to then be denied support if they needed care in later life. To be clear, the existing tax-funded approach to social care entitlement has exactly this same feature, but the transparency of a prefunded settlement would underscore this reality, making the prospect of prefunding without entitlement reform unlikely.

For this reason, social insurance schemes typically deliver universal entitlement; in Germany and Japan, support is not made contingent upon having income or assets below a certain level.<sup>96</sup> There is, however, a middle ground between the binary approach to entitlement in England, in which only those with savings of less than £23,250 can be eligible for support, and the universality of social insurance models. In France, for

<sup>94</sup> Office for National Statistics, *Annual Survey of Hours and Earnings: 2016 Provisional Results*.

<sup>95</sup> Vergleich-Pflege.Versicherung, 'Pflegeversicherungsbeitrag'.

<sup>96</sup> Robertson, Gregory, and Jabbal, *The Social Care and Health Systems of Nine Countries*.

example, everyone is eligible for state-funded social care support, but funding can range from 10 per cent to 90 per cent of assessed care costs, depending on the financial means of the person in question.<sup>97</sup>

Alternatively, policymakers could pair a universal system with a series of policies to curb expenditure. The German social insurance scheme restricts entitlement to those who have had social care needs for at least six months. Recipients are then eligible to receive either services in kind, or cash totalling half of this entitlement – another tactic that has saved funds money, particularly if the service user is already receiving informal care from a family member.<sup>98</sup> Such arrangements do not undermine the universality of the systems – individuals with care needs still receive support regardless of their income – but they do ensure demand is adequately managed. In the context of a prefunded system, this approach could be used to reconcile the aims of providing a universal entitlement with fiscal sustainability.

### 3.2.3 Defined benefits or defined contributions?

As with the provision of pensions, social care entitlement can be offered on either a defined benefit (DB) or defined contribution (DC) basis. Under DB, policymakers promise taxpayers a given level of coverage at some time in the future. The Dilnot cap is one such arrangement, but universal free coverage and the co-funding of care costs on a sliding scale are also examples of DB entitlement. Under a DC arrangement, however, the level of support granted by the state depends on the assets accumulated in the LLCF. This would make managing the LLCF easier because fund managers could reduce benefits as well as adjust contributions if deficits start to accumulate.

What DC schemes gain in flexibility, however, they lose in predictability. People are averse to uncertainty, while fluctuating levels of state entitlement make it difficult for individuals to financially plan for their social care liability. This is one of the reasons why the Dilnot Commission recommended a cap on personal care liabilities.<sup>99</sup> The Department of Health estimated that the ‘piece of mind’ benefits that individuals would derive from not having the anxiety of facing unlimited care costs would be equivalent to £510 million in the first year of implementation.<sup>100</sup> For these reasons, a DB scheme under prefunding may be the preferable option. It is not only more politically feasible; DB also generates security for those planning for their finances for later life.

## 3.3 Transition

With a better idea of how contributions and entitlement might be configured under a prefunded arrangement, consideration can finally be given to the crucial question of how to reach this new settlement.

When transitioning from a PAYG system to a funded model, a ‘double burden’ is created. Take the example of a government that moves from a PAYG mechanism for funding social care to a prefunded one. A contribution is levied on working-age people, but to reflect the fact that central government no longer funds social care, taxes are also cut. Under this arrangement, working-age people become responsible for financing their own care, not the care of older cohorts. In the short term, however, the care of those who have accrued rights through the old system also needs to be financed through taxes on the working-age population. This double burden eventually declines as the PAYG system is phased out, while the better value for money represented by prefunding means that, in the long run, transitioning away from the PAYG system will reduce the costs that would have been born by taxpayers in the absence of reform (see Figure 11).<sup>101</sup>

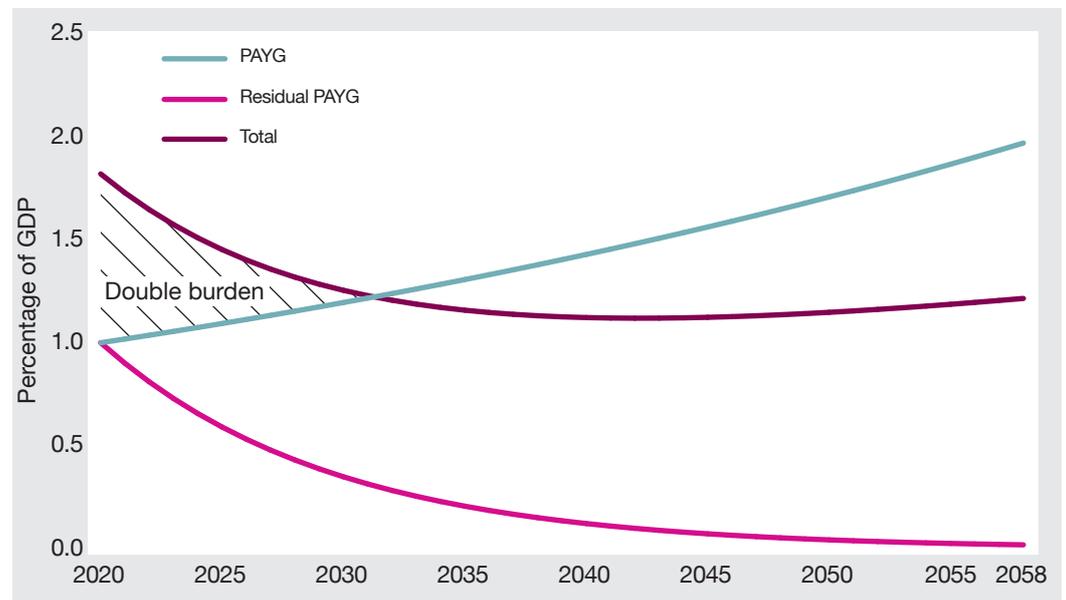
<sup>97</sup> Forder and Fernandez, *What Works Abroad? Evaluating the Funding of Long-Term Care: International Perspectives*.

<sup>98</sup> Robertson, Gregory, and Jabbal, *The Social Care and Health Systems of Nine Countries*.

<sup>99</sup> Dilnot Commission, *Fairer Care Funding: The Report of the Commission on Funding of Care and Support*.

<sup>100</sup> Department of Health, *Social Care Funding Reform Impact Assessment*, 2015.

<sup>101</sup> World Bank, *Transition: Paying for a Shift from Pay-as-You-Go Financing to Funded Pensions*, 2005.

**Figure 11: Transitioning from PAYG to prefunding: a stylised example**

Source: World Bank, *Transition: Paying for a Shift from pay-as-you-go financing to funded pensions, 2005*

### 3.3.1 Financing the double burden

The extent of the problem posed by the double burden is determined by how it is financed, and the phasing in mechanism that is used. In a briefing note on transitioning to prefunded systems, the World Bank sets out four ways to finance the double burden: issuing debt; selling government assets; cutting spending; and raising tax.<sup>102</sup>

The first two options will not be applicable. Even if in the long-term transitioning to a prefunded arrangement reduces government borrowing, issuing debt in the short term would be politically infeasible in the current fiscal and political climate. And while the second strategy may be possible in developing economies, the majority of British government-owned industries were privatised in the 1980s.

The final two options are more realistic. Pensioner households, after housing costs are taken into account, are now better off than working-age people.<sup>103</sup> In this context, it is increasingly difficult to defend the 6.1 per cent of GDP that is currently spent on the State Pension and pensioner benefits.<sup>104</sup> The Winter Fuel Allowance cost £2.1 billion in 2015-16, but nearly 90 per cent of recipients are not in fuel poverty and only 41 per cent of payments are spent on fuel costs.<sup>105</sup> Further generosity is delivered through the ‘triple lock’ on the State Pension. This uprating mechanism ensures the State Pension increases each year in line with the highest out of earnings, inflation, or 2.5 per cent. As *Reform* has argued previously, this measure is expensive – costing over £4 billion a year in 2016-17 compared to earnings indexation – and is unnecessary in view of recent changes to pensioner incomes.<sup>106</sup> Indeed, the additional cost to the State Pension delivered by the triple lock nearly mirrors growth in expenditure on social care in the long run (see Figure 12).

<sup>102</sup> Ibid.

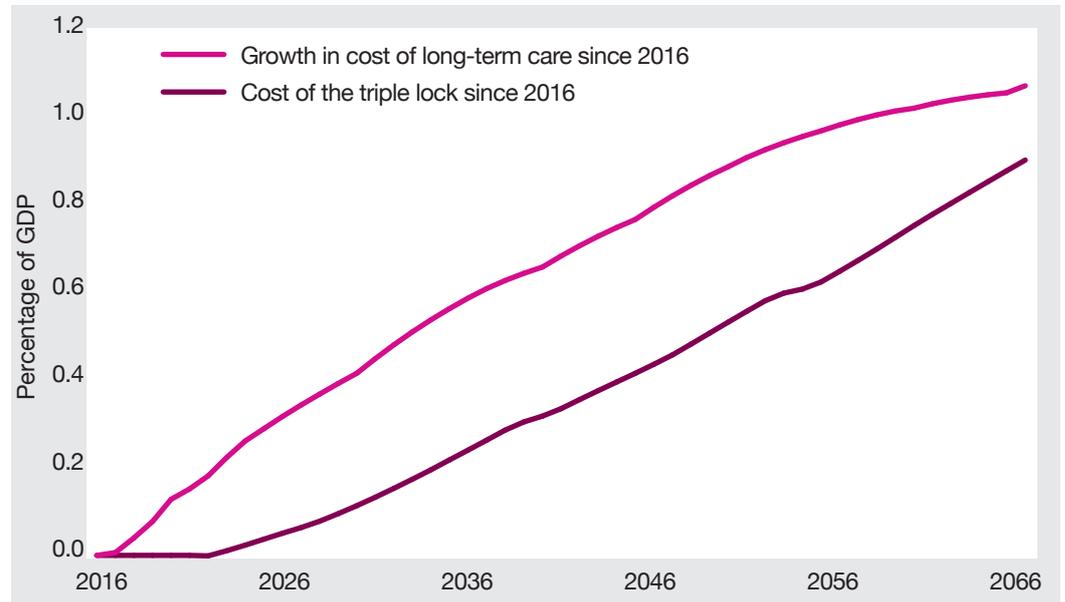
<sup>103</sup> Corlett, *As Time Goes by: Shifting Incomes and Inequality between and within Generations*.

<sup>104</sup> Office for Budget Responsibility, *Fiscal Sustainability Report 2017*.

<sup>105</sup> Department for Work and Pensions, *Benefit Expenditure and Caseload Tables 2016, 2016*; House of Commons Environment, Food and Rural Affairs Committee, *Energy Efficiency and Fuel Poverty: Third Report of Session 2008-09, 2009*; Timothy Beatty et al., *Cash by Any Other Name? Evidence on Labelling from the UK Winter Fuel Payment* (Institute for Fiscal Studies, 2011).

<sup>106</sup> William Mosseri-Marlio, ‘Cost of the Triple Lock Is Set to Surpass £20 Billion’, *The Reformer Blog*, 26 October 2016; Alexander Hitchcock et al., *Updating Uprating: Towards a Fairer System* (Reform, 2015).

**Figure 12: Change in the cost of long-term care and the State Pension due to the triple lock (2016 – 2066)**



Source: Office for Budget Responsibility, *Fiscal Sustainability Report 2017, 2017*

If implemented, the propositions in the Conservative manifesto would remove these spending commitments. This would open up fiscal space to fund the legacy cost of the PAYG social care system. The move would spread the burden more equitably between working-age people and pensioners.

These savings, however, will not be sufficient to fund the entire double burden. In 2015-16, local authorities in England spent £7.05 billion on later-life care.<sup>107</sup> Scrapping the winter fuel allowance would cover less than a third of this expenditure, and while the triple lock is a hugely expensive financial commitment in the long run, its removal is not expected to deliver savings in the immediate future.

Policymakers, therefore, could turn to the substantial housing and non-housing assets at the disposal of pensioners to fund this transition period. The Conservative manifesto pledged to do that by restricting eligibility for council support for home-owners and extending Deferred Payment Agreements. Previous research by Reform showed that the decreases in eligibility for home-provided care proposed in the manifesto could generate up to £832 million in savings a year.<sup>108</sup> Reform also found that DPAs can have a significant impact on alleviating the pressure on local councils in the medium run.<sup>109</sup>

If the cost of transitioning to a prefunded system cannot be fully covered by spending cuts or tax rises levied on older individuals, reform will entail additional costs for the working-age population in the short term. On the other side of the ledger, however, long-term care will no longer be financed through central taxation, a development that will open up fiscal space to either cut taxes or increase expenditure on those that will no longer benefit from PAYG-assistance.

The combined effect of these measures – the introduction of LLCF contributions, tax cuts, and offsetting measures to fund the transition – will depend on the specifics of each proposal. Given the pressures working-age people are already under, and fiscal transfer implied by the long-run state of the country's finances, asking working-age people to pay

<sup>107</sup> NHS Digital, *Personal Social Services: Expenditure and Unit Costs England 2015-16*.

<sup>108</sup> Danail Vasilev, 'Are Conservative manifesto proposals for social care still relevant to the policy debate?', *The Reformer Blog*, 22 June 2017.

<sup>109</sup> Mosseri-Marlio and Vasilev, *Funding Social Care: The Role of Deferred Payment Agreements*.

for the transition singlehandedly is untenable. Yet by moving to a prefunded approach, future generations will benefit from a cheaper and more equitable mechanism for funding later-life care.

### 3.3.2 Phasing-in mechanism

A final consideration regarding the transition period – one that also affects the distributional consequences of reform – concerns the phase-in mechanism. Transitions can be done in several ways, but the most obvious approach is to require new labour market entrants (or people who are at the statutory age from which contributions are to be paid) to pay a prefunded contribution, while retaining the PAYG system for those who are past the statutory contribution age. This graduated approach means that the fund would not be fully functional until the first cohort has gone through the entire contribution period, but it would also spread out any cost of the double burden if spending cuts cannot not fully offset the transition cost.

An alternative would be to use prefunding to only partially cover the liabilities of workers who are close to the end of their working lives. For the first few cohorts, the fund will not be big enough to cover all care liabilities, so a PAYG supplement would be needed. Gradually the composition of expenditure would shift towards the prefunded system until the PAYG component is altogether phased out. Allowing the fund to partially cover liability would create administrative challenges, but it would also mean that the cost of financing the legacy system would be eradicated much faster.

The speed of transition, therefore, will have a significant impact on how the double burden is financed, but the most appropriate division of this cost is a question that needs further analysis. Too high a burden on the current young risks dampening economic growth, while older people are less able to respond to additional costs by engaging in the labour market. Nevertheless, through a combination of measures, some compromise on the problem caused by the double burden can be reached.

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## Conclusion

In recent months, social care has become one of the most high-profile domestic policy issues – and for good reason. Under significant financial strain, local authorities have cut the number of people receiving state-funded social care support.<sup>110</sup> Partly as a result, unmet needs are on the rise, while 73 per cent of older people requiring support were not adequately provided for in 2011-13.<sup>111</sup>

Yet the drivers of increasing demand – improving life expectancy, the ageing of baby boomers, and the rising number of people with long-term conditions – are only beginning to emerge. The OBR projects that demand for long-term care in the UK will double over the next 50 years, an assessment that throws into sharp relief the scale of the current and future challenge. An honest discussion with the electorate is now needed about how to support the growing ranks of people needing social care.

This paper set out a solution to the long-term funding crisis in social care. It started by noting rising demand under the existing system will see wealth transferred from younger, poorer generations, to older, richer ones. Prefunding would avoid this type of redistribution, while delivering better value for money.

Implementation entails a series of policy trade-offs which were explored in the final chapter. A compulsory system of contributions, levied on those who are aged between 40 and 65, and used to finance a DB scheme of entitlement, offers an appealing vision of how prefunding could function in practice. To pay for the transition period, policymakers could cut universal pensioner entitlement and remove the triple lock – although these measures would need to be supplemented by tax rises, deficit financing, or other spending reductions, at least in the short term.

Given the recent stagnation of real wages, any reduction in the disposable income of working-age people is an unappealing prospect. Yet in exchange for the short-term cost of transitioning to a prefunded settlement, policymakers would finally put social care on a firm footing, avoid inequitable transfers of wealth between generations, and set up a system that will eventually reduce the expense borne by working-age people to pay for social care entitlement – valuable policy objectives that have eluded governments for decades.

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111 Age UK, '1.2m Older People Don't Get the Social Care They Need', 17 November 2016; NatCen Social Research, *Predicting Unmet Social Care Needs and Links with Well-Being: Findings from the Secondary Analysis*, 2016.

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