

MPRA

Munich Personal RePEc Archive

Pension Reform in Britain

Whitehouse, Edward

World Bank, Axia Economics

June 1998

Online at <https://mpra.ub.uni-muenchen.de/14175/>

MPRA Paper No. 14175, posted 21 Mar 2009 01:25 UTC



Social Protection Discussion Paper Series

Pension Reform in Britain

Edward Whitehouse

June 1998

Social Protection Unit

Human Development Network

The World Bank

Social Protection Discussion Papers are not formal publications of the World Bank. They present preliminary and unpolished results of analysis that are circulated to encourage discussion and comment; citation and the use of such a paper should take account of its provisional character. The findings, interpretations, and conclusions expressed in this paper are entirely those of the author(s) and should not be attributed in any manner to the World Bank, to its affiliated organizations or to members of its Board of Executive Directors or the countries they represent.

For free copies of this paper, please contact the Social Protection Advisory Service, The World Bank, 1818 H Street, N.W., MSN G8-802, Washington, D.C. 20433 USA. Telephone: (202) 458-5267, Fax: (202) 614-0471, E-mail: socialprotection@worldbank.org. Or visit the Social Protection website at <http://www.worldbank.org/sp>.

Pension Reform in Britain

by

Edward Whitehouse

June 1998

Address of the author:

Edward Whitehouse
Director, Axia Economics
38 Concanon Road
London SW2 5TA
United Kingdom
Tel: 44-171-274-3025
e-mail: edwardwhitehouse@hotmail.com

Pension reform in Britain

Edward Whitehouse

This paper examines the evolution of the pension system in Britain. In particular, it focuses on the shift from pay-as-you-go, state-run defined-benefit pensions to individual, private-sector, funded defined-contribution accounts. It looks at three issues in this reform: the financing of the transition from pay-as-you-go to funded provision; the fiscal impact of voluntary switching and adverse selection; and the question of the degree to which personal pension accounts were 'over-sold' to individuals for whom they were not suitable. The paper examines recent reform proposals and the prospects for reform under the New Labour government elected last year. It concludes that the British system has avoided a future financial crisis arising from the demographic transition, but that problems of incentives and retirement-income adequacy remain.

Table of Contents

Abstract	1
I. The pension system in Britain	3
II. Pension reforms	5
III. The impact of the reforms	8
Effect on current workers	11
IV. Individual choice of pension	14
Personal pension versus SERPS	14
Uncertainty	16
Choice of pension in practice	16
V. Issues in pensions privatisation	19
Transition costs	19
Adverse selection	20
Age-related rebates	22
Over-selling of personal pensions	23
VI. Prospects	28
Basic pension plus	28
Pension reform and New Labour	30
VII. Conclusions	33
Annex. Valuing pensions entitlements	35
References	39

Pension Reform in Britain

Edward Whitehouse¹

Many countries are considering funding pension provision to avoid large rises in social-security taxes as pay-as-you-go pension liabilities mature and the population ages. Funding of pensions might also increase an economy's savings ratio and encourage investment. Pension funds may contribute to the development of a country's capital market. For example, World Bank (1994) argues for a three-pillar system: "a publicly managed system with mandatory participation and the limited goal of reducing poverty among the old; a privately managed, mandatory savings system; and voluntary savings". This report examines the implementation of such a policy in practice.

In Britain pensions have long been provided through a mix of funding and pay-as-you-go, but during the 1980s there was a further shift towards funding. There has been a substantial downgrading of state, pay-as-you-go pension entitlements in a series of reforms beginning in 1981 with the latest in the 1995 Pensions Act. 'Personal pensions' — individual retirement accounts similar to IRAs in the United States — were introduced in 1988. Unlike IRAs, however, these could substitute for social-security pension provision as well as complement state pensions.

The result has been a diminution of the public sector's role in providing pensions. In 1979, the state provided 61 per cent of pensioners' incomes; by 1992, that had declined to 50 per cent. The public sector also withdrew from providing pensions for those currently working: over 5 million people, a quarter of employees, took out personal pensions. As a

¹ Director, Axia Economics, 38 Concanon Road, London SW2 5TA. E-mail: edwardwhitehouse@hotmail.com. I am grateful to former colleagues at the Institute for Fiscal Studies, London and the Organisation for Economic Co-operation and Development, Paris, with whom much of the research in this paper was carried out. Seminar

consequence, the state earnings related pension scheme (SERPS) now covers only around a third of employees compared with over 45 per cent before the introduction of personal pensions.

The switch from pay-as-you-go, state financing to funded, private provision raises a number of issues.

First, the transition costs. Accrued pay-as-you-go liabilities continue to require financing, while money must be paid into the new pension funds. The government paid £17.7 billion into individual accounts during the first eight years of the personal pensions option. At the peak, payments represented around 8 per cent of the annual revenues from social-security taxes, contributing to the large deficit in the social-security fund that appeared at the beginning of the 1990s. This deficit prompted an increase in the employee's contribution rate from 9 to 10 per cent.

Secondly, adverse selection. Those taking out personal pensions were those for whom the subsidy to their savings account was more valuable than the state pension foregone from contracting out of SERPS. Individual lifetime income is therefore higher, but at the expense of the government. Estimates presented below of the eventual savings on SERPS entitlements, discounted back to the present, show a figure of £8.5 billion, or less than half the amount paid into personal pensions by the government.

Thirdly, 'over-selling' of personal pensions. A number of people bought personal pensions that were clearly not suitable. For example, people were too old to benefit from the personal pension, had too low earnings to bear the transactions charges or they were eligible to join an employer scheme and so would lose the value of the employer's contribution if they did not take this option. Others were persuaded to transfer their pension out of an employer's scheme, often at actuarially unfair rates. Under financial-services regulations, pension providers are obliged to compensate those who were mis-sold pensions, but the process is taking a long time. Other criticisms of personal pensions include the size of the

participants at the World Bank and at the International Institute for Public Finance congress provided useful comments.

transactions charges and the fact that they expose individuals' pension entitlements to capital market uncertainty.

The aim of this paper is to assess the changing role of the state in pension provision in Britain and to examine the lessons that can be learned from the reforms. The next section gives a brief history of the pension system and a typology of the current regime. Section II describes the principal reforms affecting the shift from state to private pension provision, and section III shows how these reforms affected the incomes of those currently retired and pension coverage for current workers. Section IV examines individual choice of pension provision. The issues of transition costs, adverse selection and over-selling are addressed in section V. Section VI looks at proposals to advance pension reform and the prospects for change under the new Labour government elected last May. Section VII concludes.

I. The pension system in Britain

In the original Beveridge conception of social insurance², enacted by the National Insurance Act of 1946, the main social-security benefits — pensions, unemployment and disability — were to be available universally subject to the relevant contingency. They would be flat rate, financed by flat-rate contributions on employees.³ The projections for the financing of the scheme were dependent on the introduction of pension benefits over a transitional period, and, based on Beveridge's view of an absolute concept of poverty, on the reduced burden of financing as real earnings' growth outstripped rises in benefits.

Nevertheless, for political reasons, full benefits were introduced more rapidly and benefit levels rose in line with living standards. By 1965, the benefit level had doubled in real terms since introduction. The flat-rate contributions required to finance increased benefits became a particularly large burden on the low-paid. An element of earnings-relation in contributions was therefore introduced.

Over the same period, employer provision of supplementary pensions grew. By the mid-1960s, almost all public-sector workers were pension members, along with many in the

² Beveridge (1942).

private sector (particularly those in white-collar jobs, those unionised and those working for larger firms⁴). Membership of pension plans rose from around a quarter of employees in the early 1950s to a peak of well over half in the mid-1960s.⁵

While living standards of those reliant on state provision rose in real terms, the incomes of those with private pensions grew faster. Furthermore, in one of the few concessions to fiscal rectitude in the 1946 Act, the pension rate had been set below the rate for National Assistance, the means-tested benefit for those with inadequate private sources of income. Many saw ‘two nations’ of pensioners emerging: those comfortably off as a result of employer pensions, and those reliant on means-tested social assistance. The result was pressure for the state to provide benefits as generous as those in employer-run schemes, financed, as suggested above, by earnings-related social security contributions.

After several false starts, the Social Security Act 1975 introduced the state earnings related pension scheme, SERPS. The pension aimed to pay 25 per cent of average individual earnings in the 20 best years (revalued to the year of retirement in line with average earnings in the economy). As is often the case with pay-as-you-go financing, the benefit level was accelerated so that those retiring just 20 years later would receive full benefits, rather than waiting 45 years for the scheme to mature.

To avoid the opposition of established, mainly employer-provided pension funds, the contracting-out option was developed. This feature of the British pension scheme is unique by international standards. In return for agreeing to pay a ‘guaranteed minimum pension’ (GMP), members of employer provided scheme and the employer could pay a lower rate of social-security contributions. On retirement, the SERPS payable would be reduced by the amount of this GMP. (The value of the GMP is similar, but usually less than the SERPS entitlement.)⁶ The contracted-out rebate was set to reflect the cost of providing the GMP on

³ See Dilnot, Kay and Morris (1984) for a discussion.

⁴ See Disney and Whitehouse (1990).

⁵ Government Actuary (1991) and Pension Law Review Committee (1993).

⁶ If earnings growth outstrips prices growth, SERPS will exceed the GMP and a SERPS pension will be payable even if the individual has spent all their working life contracted out. For example, in 1996 just 46,000 or 0.9 per cent of those potentially eligible for SERPS had no net SERPS entitlement once the GMP had been deducted.

average. Nevertheless, this appeared to provide a strong incentive to contract out. All public-sector pension-scheme members and 80 per cent of private-sector members are contracted out.

The introduction of SERPS with a cross-party consensus⁷ led many to believe that the pension system in Britain had reached a steady state, but it was not to be. SERPS was introduced without long-term projections of its future cost. Forecasts at the Institute for Fiscal Studies⁸ showed a sharply rising cost after 2010: the contribution for SERPS alone reached 11-12 per cent in 2030, compared with the 3-4 per cent estimate of the Government Actuary, which only covered the period to 2008. Adding 13-14 per cent for the costs of the basic pension, with unemployment and disability benefits on top, then there was a serious potential problem as contribution rates would rise from around 15 per cent to over 35 per cent. Many governments might have left this until later, but the Thatcher administration, imbued with an ideology of privatisation and a desire to re-examine all aspects of public spending, decided to act.

II. Pension reforms

The result was a series of pension reforms in the 1980s and 1990s that reduced the generosity of state pension provision and extended opportunities for contracting out.

First, in 1981 the annual uprating of the basic state pension was shifted from an increase in line with the higher of prices' or earnings' growth to pure price indexation. Price indexation was also applied to other state benefit rates, such as unemployment and social assistance. The basic pension is now around £62 a week, or a fifth of average earnings. Since 1981, real earnings have grown on average a little over 2 per cent a year since then, implying a cut of 37 per cent in the pension value compared with the previous policy. The

This peculiar feature, as pointed out by Dilnot *et al.* (1994) Appendix 4.2, was removed by changing indexation procedures in Pensions Act 1995.

⁷ The bill was unopposed at Second Reading by the Conservative opposition. Keith (later Lord) Joseph — Margaret Thatcher's intellectual guru — had proposed a more limited scheme during the 1970-74 Conservative administration. He supported the Labour scheme because of the lack of opposition from occupational pension schemes due to the contracting-out proposal. During the 1980s, many Conservatives regarded the failure to oppose the new scheme as a mistake.

exchequer saving is worth £11 billion a year. These savings will of course continue to compound.

Secondly, in 1985, Norman Fowler⁹ began a review of the whole of the social-security system. The original proposal was to do away with SERPS entirely, and to insist on compulsory private provision instead. Nigel Lawson¹⁰ refused to countenance compulsory provision as inconsistent with the Conservative administration's political philosophy and because of the effect of the move to funded provision on individuals' current income (the transition costs). Margaret Thatcher¹¹ insisted on compulsion to ensure an adequate retirement income, telling Lawson that this had long been the practice in Switzerland. Lawson replied, 'Prime Minister, it is well known that in Switzerland everything that is not forbidden is compulsory'.¹² In the end, Lawson's view prevailed, and SERPS was retained but its cost reduced by Social Security Act 1986 in three main ways. The target replacement rate for SERPS was cut from 25 to 20 per cent of individual earnings. The pension for surviving spouses was reduced from all to half the deceased spouse's pension. The relevant income in the formula was changed from the best twenty years to the average over the working life. The Government Actuary forecast that these changes would reduce the long-run cost of SERPS by over half.¹³

Thirdly, another reform in the 1986 Act consisted of measures to encourage people to leave SERPS. Individuals were permitted for the first time to contract out of SERPS into personal pensions. And employers could use defined-contribution schemes — where the pension benefit depends on the level of contributions and the size of the investment return — as well as the traditional defined-benefit 'final-salary' plans to contract their employees out of SERPS. Personal pensions were offered the same tax treatment as defined-benefit schemes¹⁴:

⁸ Hemming and Kay (1982).

⁹ Sir Norman Fowler was secretary of state for social services from 1981 to 1987.

¹⁰ Lord Lawson was chancellor of the exchequer (finance minister) from 1983 to 1989.

¹¹ Baroness Thatcher was prime minister from 1979 to 1990.

¹² Lawson (1992), p. 590.

¹³ The projections at that time showed a reduction in peak expenditure in 2030 from £22 billion to £8 billion. See Creedy and Disney (1988) for a discussion of these reforms.

¹⁴ Personal pensions are more generous for higher paid workers due to differences in the limits to contributions and benefits in the two types of scheme. See Dilnot and Disney (1989). Dilnot and Johnson (1993*a, b*) and

contributions are deductible¹⁵ against income tax and investment returns accrue in the fund tax-free.¹⁶ A lump sum may be withdrawn tax-free on retirement (up to a limit¹⁷); the annuity part of the pension is taxed.

The 1989 Budget took these measures further. An additional 2 per cent ‘incentive’ rebate of earnings for those contracting out for the first time was made available, both to those in personal pensions and in employer-run defined-contribution schemes.¹⁸

Finally, Pensions Act 1995 — although mainly concerned with increasing the state pension age for women and reforming the regulatory structure for employer plans — also included a change to the formula for calculating SERPS entitlements. This reform (essentially a change in the indexation of parameters of the formula) is projected to save around a third of SERPS pension costs in the long-term. Coupled with the increase in the state pension age for women, the long-run cost of SERPS is forecast to have fallen by a further half, to one quarter of the cost originally envisaged.¹⁹

III. The impact of the reforms

The most immediate impact of the reforms has been on the income of current pensioners. Table 1 shows the sources of pensioners’ income²⁰ in 1979, 1989, 1992 and

Whitehouse (1995) offer a detailed analysis of the tax treatment of pensions and Inland Revenue (1996*b*) offers a detailed description of the system.

¹⁵ Employee contributions are limited to 15 per cent of income in defined-benefit plans. Total (employee and employer) contributions to defined-contribution schemes have an age-related ceiling, varying between 17½ per cent for under 35s to 40 per cent for 60-65 year olds.

¹⁶ The changes to dividend taxation in Finance Act 1993 imply some taxation of the investment return: the rate of advance corporation tax and the basic income tax rate on dividends were reduced from 25 to 20 per cent. This reduces the dividend tax credit paid to exempt institutions and results in an effective 7 per cent tax rate on dividends paid to pension funds. The complete abolition of the dividend tax credit was introduced in the new Labour government’s first Budget in July 1997, and the abolition of advance corporation tax from 1998-99 was implemented in the second Budget in March 1998. It is calculated that this will reduce the annual return to pension funds by 0.4 percentage points.

¹⁷ The limit is one quarter of the accumulated fund in defined-contribution plans and one half of final salary in defined benefit.

¹⁸ The introduction of personal pensions is discussed in detail in Disney and Whitehouse (1992*a, b*).

¹⁹ Government Actuary (1994).

²⁰ Incomes of couples where the man is aged 65 or over, single men 65 or over and single women 60 or over.

1994-95. Overall, incomes over the period grew by 60 per cent, around 10 percentage points faster than the increase in incomes of the population as a whole.

The fastest growing component has been occupational pensions, rising by 150 per cent over the period. In 1979, 43 per cent of pensioners had some income from an employer-provided pension, rising to over 60 per cent in 1994-95. The growth in occupational pension income reflects longer tenures in schemes as the increase in coverage up to the 1960s continues to take effect. The reduction in vesting periods²¹ and improvement in the protection of benefits against inflation will also have had an effect.²² The reduced role of earnings reflects the lower rate of participation of those over pensionable age. In the early 1970s, one third of men aged 60-65 continued to work, compared with 12 per cent in the mid 1980s.²³

Table 1. Sources of Pensioner Incomes

£ per week, 1994 prices	1979	1989	1992	1994-95
Benefits	71	81	88	96
Occupational pension	19	35	42	47
Investments	13	29	34	28
Earnings or other	14	12	11	14
Gross income	116	157	175	186
Direct taxes	(15)	(26)	(23)	(25)
Net income	101	131	152	161

Source: Department of Social Security (1997a), table B2.01.

Investment incomes (dividends, interest and private pensions other than occupational plans) also grew strongly, reflecting the increasing affluence of younger cohorts. Between 1979 and 1992, they grew by 185 per cent, but declined after 1992. This reflects the fact that interest rates in 1992 were 14 per cent for most of the year, compared with 7 per cent

²¹ From 1975, pensions rights had to vest after five years, which was reduced to two years in 1988.

²² From 1975, employers were prohibited from simply returning employees' pension contributions if they left before normal retirement age. But the legacy of these earlier regulations persists: retired men in 1988 reported membership of 3.6 occupational pension schemes on average, but were drawing a pension from just 1.2 plans on average (DSS, 1992). Since 1975, benefits have had to be 'preserved' in the scheme, but their value was related to salary at the time of leaving and not adjusted for inflation. The regulations for the GMP ensure that this component of the pension is fully uprated in line with average earnings between leaving the plan and state pension age. Preserved pensions accrued after 1985 were required to be up-rated in line with prices, up to a ceiling of 5 per cent; in 1990 this was extended to the whole pension, not just the part accrued after 1985.

in 1994-95. As with occupational pensions, this results from increases both in the proportion of pensioners with investment incomes and in the average amount received.

Benefit income also increased in real terms over this period — by 35 per cent — but the share of benefits in total income declined from 61 per cent to a little over 50 per cent as a result of the stronger growth in private sources of income.

These trends are likely to continue for several years.²⁴ The incomes of recently retired pensioners (in the first five years after retirement) are 27 per cent higher than incomes of pensioners as a whole. The share of state benefits is significantly lower (41 compared with 51 per cent). Their average occupational pension is 40 per cent higher and investment income 20 per cent higher than for all pensioners. The downward trend in the state's share is, on current policies, likely to accelerate after 1998-99, when maximum SERPS benefits are reached for newly retired cohorts.

Table 2 shows how benefit expenditure breaks down between the basic state pension, SERPS and means-tested benefits such as income support and housing benefit.

Price indexation of the basic pension has meant that there has been very little increase in average receipt of basic state pension over the 1980s: around 3 per cent in real terms. This growth reflected the increased proportion of women who qualify for receipt of the pension in their own right rather than on their husband's contribution record. Prior to 1989, pensioners with significant earnings (more than £75 a week) lost their basic pension entitlement, or could defer taking their pension for up to five years in return for increments when the pension became payable. This rule was abolished in 1989, meaning more pensioners who work can also claim the basic pension.²⁵

²³ See Disney, Meghir and Whitehouse (1994) and Meghir and Whitehouse (1996) for a discussion of retirement behaviour.

²⁴ The government's PENSIM model of the future pensioner income distribution estimates that the average income if single pensioners will rise by 1.8 per cent a year to 2025. Average income from the state is forecast to rise just 0.8 per cent a year, while occupational pensions rise 2.0 per cent, personal pensions by 14 per cent and investment income by 3.1 per cent a year. The income of the lowest quintile of pensioners is predicted to be 10 per cent higher, compared with a 100 per cent rise for the highest income quintile. See Curry (1996).

²⁵ Whitehouse (1990).

Table 2. Principal benefit expenditures on the elderly, 1979 to 1993

	<i>1979-80</i>	<i>1989-90</i>	<i>1993-94</i>	<i>1996-97</i>
Total (£ million)	10 138	25 678	36 568	40 799
of which (per cent):				
Basic state pension	88	79	73	72
SERPS	0	2	4	9
Income support	6	8	11	7
Others	6	11	12	12

Source: Department of Social Security (1993, 1997).

Note: 'Others' mainly includes housing benefit and local tax benefits (at various times, rate rebate, community charge benefit and council tax benefit). Supplementary benefit shown under income support for 1979-80.

But the main reason for the increase in benefit income in Table 1 is the growth of benefits other than the basic pension. The SERPS scheme has still not matured, and entitlements are increasing rapidly. The proportion of pensioners with a SERPS entitlement has increased from 7 per cent in 1982 to 46 per cent in 1996. The average value of payments increased by a factor of ten: from 97 pence to £10.51 per week.

Means-tested benefits have also grown. In 1996, around 3 million pensioners had some income from this source, compared with the 10 million receiving the basic state pension. In part this also reflects policy changes. For a single pensioner aged over 80, the gap between the income support entitlement and the basic pension is now 22 per cent. Since income support replaced supplementary benefit in 1988 it has increased rather more quickly than prices, increasing the gap between the basic state pension and income support for a couple over 80 (for example) from 12 to 16 per cent. Including other means-tested benefits, a couple both aged 68, for example, paying rent of £40 per week would need private income of around £70 per week to exhaust their housing benefit entitlement.

Increased investment incomes and occupational pensions have not helped all pensioners. While mean income has risen 50 per cent in real terms since 1979, this disguises a broadening of the income distribution of pensioners, matching the broadening of the income distribution of the population as a whole. Table 3 shows that the incomes of the poorest 10 per cent of pensioners rose faster than the median, which in turn rose faster than the top decile of pensioner incomes in both the 1960s and the 1970s. But in the 1980s this

trend reversed. Bottom decile incomes increased only very slowly, while the top decile incomes rose by nearly 60 per cent.²⁶

Table 3. The changing distribution of income among pensioners, 1961-92
(change in equivalent income in real terms)

<i>percentile of income distribution:</i>	<i>10</i>	<i>50</i>	<i>90</i>
1960s	41%	30%	11%
1970s	38%	30%	22%
1980s	10%	26%	57%

Note: 1960s refers to period 1961-62 to 1971-72; 1970s to 1971-72 to 1981-82 etc.

Source: Johnson and Stears (1995), Table 7, based on *Family Expenditure Survey* data.

Effect on current workers

The shift away from state pension provision has affected current workers more dramatically than current pensioners. This is inevitable given the limited degree of freedom to alter past accrued entitlements without resorting to arbitrary retrospection and unreasonable retraction of benefits around which people had made their savings decisions.

Table 4 shows the supplementary pension provision for employees in 1979-80, immediately after the introduction of SERPS, in 1987-88, the first year of the implementation of the 'Fowler' reforms, and in the most recent year for which complete data are available, 1994-95.

Table 4. Supplementary pension provision, 1979-80 to 1994-95

<i>per cent of employees</i>	<i>1979-80</i>	<i>1987-88</i>	<i>1994-95</i>
Public sector defined benefit	30	27	22
Private sector defined benefit	23	21	19
Private sector defined contribution	0	0	1
Personal pension	0	15	25
SERPS	47	37	33

Source: author's calculations based on Pension Law Review Committee (1993), Government Actuary (1981, 1986, 1991, 1994), Department of Social Security (1997a) and *Family Expenditure Survey* data.

²⁶ See Johnson and Stears (1995).

In 1979, supplementary pensions divided evenly between defined-benefit occupational pensions and SERPS. But over the period, the structure of pensions changed dramatically. The biggest change came from allowing personal pensions and defined-contribution occupational schemes to contract out. Together these now cover 26 per cent of employees.

There was a large decline in defined-benefit coverage provided by the public sector for its own employees (the first row of the Table). The main reason was the transfer of some 1.6 million workers out of the state sector as a result of the privatisation of nationalised industries, such as telecommunications, water, electricity and gas.

More people were brought into supplementary pension coverage by the uprating of the lower earnings limit in line with prices and the reduction in the numbers paying the married women's reduced rate from 4.1 million in 1978 to 600,000 in 1992. Many of these lower paid workers probably defaulted to the SERPS option, stemming the decline in SERPS coverage due to people contracting out.

Finally, there is limited evidence of a switch in private-sector occupational coverage from defined benefit to defined contribution. In addition to the one per cent of employees shown in the Table, contracted-in defined-contribution plans cover a further one per cent of employees (and feature under the SERPS row of Table 4). This switch is much less dramatic than 'the stampede' seen in the United States.²⁷ But the trend is likely to accelerate as a result of the increased regulatory burden arising from the Pension Law Review Committee's recommendations implemented in Pensions Act 1995.²⁸ A recent survey commissioned by the Confederation of British Industry (1994) shows that while 81 per cent of plans were defined benefit overall, just 20 per cent of plans introduced since 1988 were of this type.²⁹ With hindsight or if they could start from scratch, just 26 per cent of managers would choose a defined-benefit plan and only 31 per cent expected their firm to offer defined-benefit pensions in 2010.

²⁷ Gustman and Steinmeier (1992).

²⁸ Disney (1995), Disney and Stears (1996) and Department of Social Security (1996).

To sum up, Table 4 shows a large shift in the structure of pension coverage. The state provided three-quarters of supplementary pensions in 1979 compared with 55 per cent now. Similarly, funded pensions have substituted for pay-as-you-go. Defined-contribution schemes, which did not exist in 1979, now account for 26 per cent of pensions. More people in the private sector are covered by defined contribution than defined benefit.

²⁹ A survey by the Department of Social Security (1994) found that 90 per cent of defined-contribution plans were set up after 1978.

IV. Individual choice of pension

Prior to 1988, few individuals had a choice of pension provision. Most firms offering an occupational pension scheme made membership compulsory for eligible employees. Just 8½ per cent of employees were in voluntary plans.³⁰ People who were not members of an employer-provided plan were covered by SERPS by default.

The 1988 reforms prevented employers from making pension provision compulsory, and permitted contracting out into defined-contribution schemes, including personal pensions. All individuals therefore have two or three choices of pension provision: SERPS, personal pension and maybe an employer plan.

This section looks first at the parameters of the choice between a personal pension and remaining in SERPS, and then in more detail than the previous section at the choices people have made in practice.

Personal pension versus SERPS

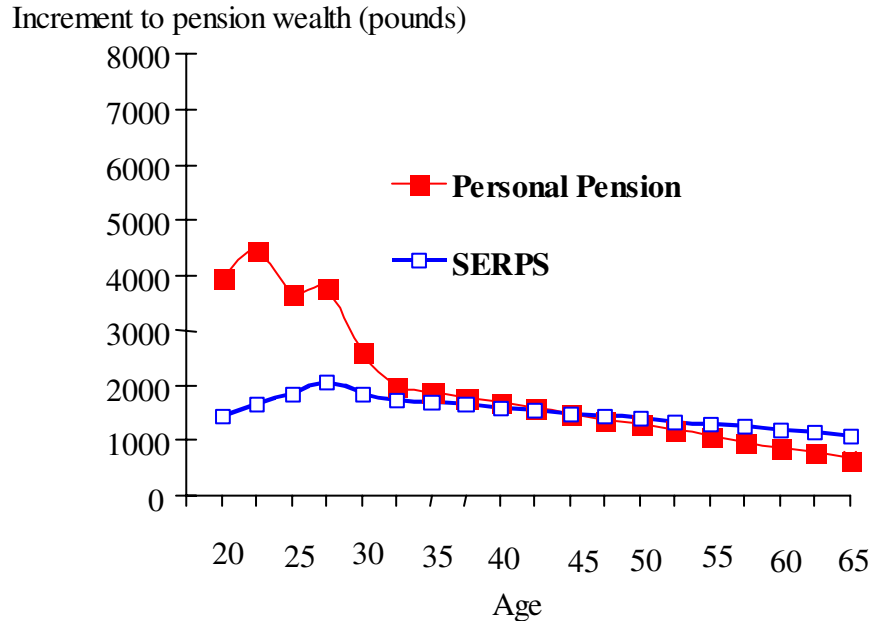
Opting for a personal pension need not involve any current cost to the contracting out individual. The minimum he or she must pay is the rebate of social-security contributions. These continue to be deducted at source, and the rebate, together with the appropriate tax relief, is transferred to the pension provider after the end of the financial year. The choice between a personal pension and SERPS depends on an assessment of the relative benefits offered by each plan, and people are free to contract out of SERPS in each fiscal year, and contract back in later. The choice is not over lifetime pension income, but the marginal increment from each year in the scheme. Most parameters of the calculation of pension benefits are defined by the system. Of the others, simulated individual lifetime earnings' profiles are developed from a large micro data set and assumptions are required for the future path of economy-wide earnings and the real rate of return.

Figure 1 shows the marginal pension benefit in 1992 prices of the additional pension contributions and associated investment returns, and the extra earnings-related SERPS

³⁰ Government Actuary (1986).

entitlement converted to a lump-sum using a standard annuity factor. Real interest rates of 4 per cent and real earnings' growth of 2 per cent are assumed. (Elsewhere we have considered the sensitivity of the results to both assumptions.) The details of the formulae used to make the calculations are described in the Annex.

Figure 1. **Marginal increment to personal pension and SERPS by age**



The Figure shows that increments to personal pensions are greater early on in life. This weighting represents both a compound interest effect and the declining value of the contracted out rebate over time as the SERPS scheme matures. The latter is also responsible for the discontinuities in the curve. The SERPS curve, in contrast, is almost horizontal. This results from the revaluation of individual earnings in early years in line with economy-wide earnings: prices uprating, for example, would give an upward tilt to the curve. The Figure shows optimum pension choice across the life cycle. The individual would improve their pension by contracting out of SERPS: indeed, at age 20, the value of the rebate for that year is worth four times the amount of SERPS foregone. Over time, the gap between the two closes and after age 50 the personal pension yields a smaller benefit than SERPS. At this

point, the individual is better to contract back in to SERPS. This optimum switching strategy would result in a pension of £9 000 a year, compared with £5 000 from staying in SERPS. Figure 1 relates to the position prior to 1993. Since then the structure of the rebate has changed (see Section V below).

Uncertainty

The analysis above takes no account of uncertainty of returns, which given the differing insurance properties of the two types of pension. The main risk affecting SERPS is ‘social insurance’ uncertainty: the tendency for instability in the scheme as frequent policy changes occur, sometimes with retrospective effect on the value of the pension. Although since it is earnings related, SERPS is subject to some uncertainty related to future earnings, the use of average earnings compared with final pay in most occupational schemes offers some insurance. Personal pensions are subject to capital market risk. The key issue is not the uncertainty *per se*, but whether a fund manager by suitable portfolio choice can eliminate or reduce forms of return risk. At its simplest, an individual can invest in government bonds to ensure a certain, although historically low return. More complex hedging strategies, often using derivatives can be devised that reduce risk for a lesser sacrifice of return.

Choice of pension in practice

Table 5 shows survey evidence on coverage of different types of pensions by sex and age. Coverage of both types of pension is much lower for the under 25s, probably reflecting lower youth earnings and myopia. Above 25, the vast majority has some type of private pension coverage, with the residual covered by SERPS. Computing the take-up rates of personal pensions as a proportion of those eligible (*i.e.* those not covered by occupational plans), for men between 25 and 55 these are 80-90 per cent. Coverage among women is much lower.

Table 5. Pension coverage among full-time employees from survey data, 1995

<i>Age</i>	<i>Occupational pension</i>	<i>Personal pension</i>	
	<i>per cent of total</i>	<i>per cent of total</i>	<i>per cent of eligible</i>
<i>Men</i>	58	28	67
18-24	25	15	20
25-34	53	37	79
35-44	67	29	88
45-54	70	28	93
55-64	59	21	51
<i>Women</i>	41	17	28
18-24	14	5	6
25-34	55	25	56
35-44	47	17	32
45-54	45	18	32
55-59	31	13	20

Source: author's calculations based on *General Household Survey* data

Table 5, however, overestimates switching substantially for a number of complex reasons. Table 6 uses administrative data to show the percentage of employees with a personal pension in each year since their introduction by age group. The administrative data show that no more than 9,000 people over age 55 have ever had a personal pension, compared with the 15 per cent of this age group who reported they had a personal pension to survey investigators.³¹

Under the original scheme in 1987-88 and 1988-89, an individual could have 5.8 per cent of eligible earnings transferred to a personal pension. From 1989-90 to 1992-93, there was an additional 'incentive' payment which took this to 7.8 per cent. From 1992-93 onwards, people under age 30 received just 4.8 per cent and people aged 30 and over, 5.8 per cent. The initial schemes gave a particularly strong incentive for younger workers to switch (they increased their pension by up to 3.5 times at a reasonable rate-of-return assumption).

³¹ This group may be mistaking other pension contracts (e.g. voluntary, 'third-pillar' pensions) for a personal pension.

Workers above a cut-off around age 45-50 would be neutral over switching. Women had a smaller incentive at every age to switch.³²

This incentive structure is strongly reflected in the take-up figures. Initially, take-up rates of 20 per cent or more were recorded for the under 35s with virtually zero take-up among over 50s. The average age of personal pension holders was 29, and take-up among men was twice as high as among women. However, the average age of personal pension members has tended to increase since their introduction, by 4.2 years over a seven-year period. Take-up among the under 20s has dwindled from 20 per cent to under 2 per cent. Thus, while the very young were persuaded initially to take out personal pensions, this is no longer the case.

Table 6. Personal pension coverage from administrative data

Take-up (%)	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95
16-19	20.7	15.1	14.5	13.1	11.2	8.4	4.6	2.1
20-24	26.9	27.7	32.6	37.0	41.0	41.5	36.9	29.6
25-34	20.3	21.3	25.8	29.9	35.0	38.7	40.8	41.2
35-49	9.5	10.6	12.9	15.1	17.5	19.4	20.3	20.9
50-59/64	0.1	0.2	0.4	0.6	1.0	1.6	2.1	2.3
Average age	28.9	29.7	30.0	30.5	31.1	31.8	32.4	33.1
Women (%)	32.8	33.2	34.7	35.9	36.8	37.3	37.1	36.8
Total (000s)	3 203	3 396	4 169	4 806	5 333	5 668	5 733	5 639

Note: author's calculations. Administrative data on numbers of personal-pension members based on 1 per cent sample of employees; see Department of Social Security (1997a). Data on employment from the quarterly *Labour Force Survey*.

Table 7 looks at take-up rates by earnings based on the survey data used for Table 6. Occupational pension coverage is strongly linked with earnings: coverage among those earnings over £15 000 a year is around 80 per cent compared with a third for men and a quarter for women at lower earnings levels.³³ Personal pension coverage, in contrast, is virtually flat across the age range. This is despite the fact that pension charges have a heavy

³² Life expectancy for women is higher and their retirement age earlier. This is reflected in the annuity rates for personal pension but not for the calculation of pension benefits in SERPS.

³³ This effect remains even when education, occupation and industry are taken into account. There is no empirical proof in the UK that current wages adjust to take account of 'deferred pay' in the form of occupational pension (Disney and Whitehouse, 1990a).

flat-rate component, which means that few earning under £10 000 would benefit from switching. Taking account, however, of higher occupational coverage among higher-paid workers, personal pension coverage as a percentage of eligible workers (*i.e.* not covered by occupational plans) will be more closely correlated with pay.

Table 7. Pension coverage by sex and earnings from survey data

Earnings	Men		Women	
	Occupational	Personal	Occupational	Personal
0-5,000	52	24	39	21
5-7,500	33	29	23	24
7,500-10,000	35	29	44	22
10-12,500	52	33	59	24
12,500-15,000	61	28	72	18
15,000-	77	28	83	23

Source: *General Household Survey*

V. Issues in pension privatisation

The rebate paid into personal pensions can be worth as much as three or four times the discounted present value of the SERPS benefits foregone as a condition of contracting out. Given 5.7 million people had taken out personal pensions, the aggregate implications for the government's finances of the figures given in the previous section are large.

Transition costs

Table 8 shows the cost of the rebates paid into personal pensions in respect of the first eight years since their introduction.³⁴ As the numbers with personal pensions rose, from 1.9 million in 1987-88 to 4.8 million in 1990-91, the cost of the rebates reached a peak of £3 billion in the latter year. This was partly attributable to the introduction of the 2 per cent incentive rebate and because individuals newly contracting out could transfer retrospectively the rebate since the introduction of personal pensions. In 1990-91, the cost fell as this option was no longer possible, but subsequently rose again as a further 1½ million people contracted out into personal pensions.

³⁴ Note that the rebate is not paid into the personal pension until after the end of the relevant fiscal year. The budgetary cost is therefore borne in the year after that shown on the figure.

The Table illustrates the problem of the transitional costs in switching from pay-as-you-go to funded provision. Existing pay-as-you-go liabilities continue to require financing while the burden of building up the new fund must also be borne. At its peak, the rebates amounted to some 8 per cent of total revenues from national-insurance contributions. With existing commitments still to be met from a diminished pool of revenues and the effects of the economic downturn on unemployment-related benefits, the national-insurance fund moved into a substantial deficit totalling £8.4 billion over the two years, 1991-92 and 1992-93. Legislation was required to re-introduce the ‘Treasury supplement’ — a subsidy to the fund from general taxation — which had been abolished in the late 1980s. In 1994-95, the employees’ contribution rate was increased from 9 to 10 per cent to offset further the deficit.

Table 8. Costs of contribution rebates and estimated saving on SERPS expenditure, 1988-89 to 1995-96

£ billion	<i>Rebates</i>	<i>SERPS</i>	<i>Net cost</i>
1988-89	0.3	0.1	0.2
1989-90	2.4	1.0	1.5
1990-91	3.1	1.2	1.8
1991-92	2.5	1.0	1.5
1992-93	2.7	1.1	1.6
1993-94	2.9	1.8	1.1
1994-95	2.0	1.2	0.8
1995-96	2.0	1.2	0.8

Source: author’s calculations. Department of Social Security (1997a), Table H1.01 data for rebates, Table H2.04 for take-up rates by age.

Note: for each age group an ‘excess return’ is calculated as the ratio of forecast personal pension benefits divided by SERPS. These excess returns are then weighted by take-up rates by age. Dividing the cost of the rebates by the weighted excess return gives the estimate of the eventual savings on SERPS. Rows may not sum due to rounding.

Adverse selection

The ability to contract out of the state pension is likely to lead to a problem of ‘adverse selection’, where only those who gain from contracting out do so. Elsewhere we have argued that this feature is likely to undermine the redistributive function of the state

pension system.³⁵ Here the concern is that the ability to contract out has an adverse effect on the exchequer.

The previous section showed that younger men in particular gained the most from contracting out into a personal pension, and that these were predominantly the people who took this option. The second column in Table 8 shows an estimate of the discounted present value of the eventual savings on SERPS costs. For individuals contracting out in 1991-92, this was worth £1.2 billion. Comparing this figure with the total rebates paid out — £2.7 billion — shows the scale of the adverse selection problem. The final column shows the net cost to the government's balance sheet, the difference between the first two columns. Over the eight-year period shown, £17.7 billion was paid in rebates, 'buying' savings of £8.5 billion on SERPS, giving a net total loss of £9.2 billion to the exchequer.

The estimates presented in Table 8 may be compared with those of the National Audit Office (1991). Their actuarial calculations predicted a £9 billion cost in rebates, a £3 billion discounted SERPS saving, and so a £6 billion net cost covering the first five years of personal pensions. The slightly higher figures in Table 8 for the same period (£11 billion for the rebates, £4.4 billion SERPS saving, £6.6 billion net cost) reflect the fact that personal pension membership continued to grow beyond the 4 million at the time of the NAO report. They assumed take-up would remain constant at this level.

Since 1993-94, the sums in Table 8 will have improved from the perspective of the exchequer. First, the baseline rebate has been reduced by 17 per cent, from 5.8 to 4.8 per cent. Secondly, the incentive rebate has been reduced from 2 per cent for all personal pension optants to 1 per cent limited to those aged 30 or over (who made up 2.8 million of the 5.7 million total optants in 1992-93). As a result, the cost of the incentive rebate has fallen from £810 million in respect of 1992-93 to £210 million for 1993-94. Thirdly, the population of people with personal pensions is now rather older. In 1991-92, 52 per cent of the total were under 30, but this had fallen to 41 per cent by 1994-95. As Figure 1 showed,

³⁵ Disney and Whitehouse (1993*a*).

the rebate costs and SERPS savings are closer for older people with personal pensions, notwithstanding the additional rebate for over 30s.

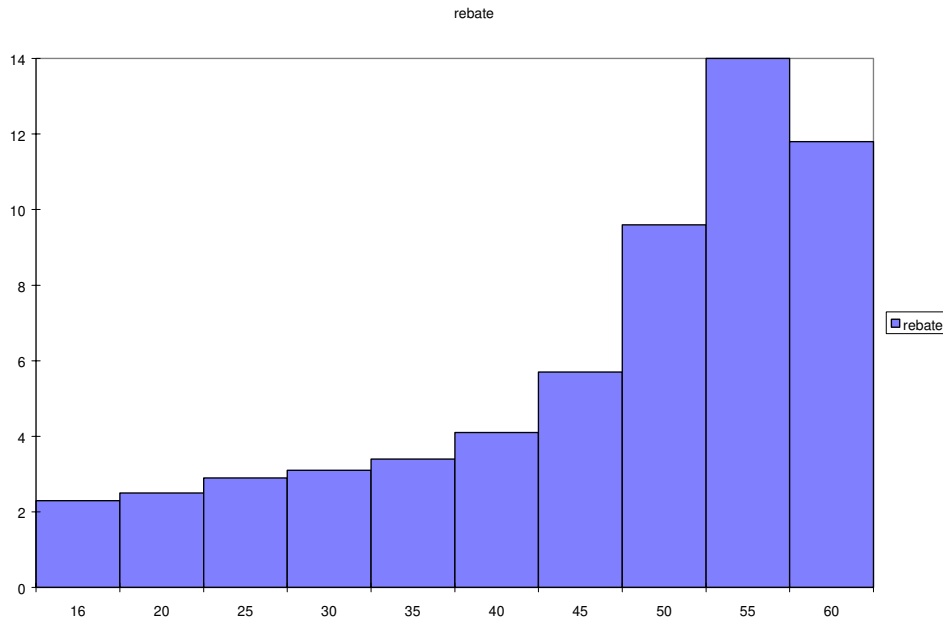
Age-related rebates

This adverse selection effect forms the case for relating the contracted out rebate more closely to age than in the present structure, to bring the costs and savings in respect of each individual closer into line.³⁶ While contracting out was restricted to defined benefit employer plans, the fact that the flat rebate for contracting out benefits younger workers relative to older did not matter to the governments finances, since most schemes contracted out anyway. With personal pensions and individual choice over whether to contract out, sizeable intramarginal subsidies are paid to younger workers.

Figure 2 shows the neutral rebate at each age. This is the amount that would be sufficient to finance a pension equal to the part of SERPS foregone as a result of contracting out. The increase in the rebate with age reflects a number of factors, as discussed above. The compound interest effect makes pension financing in a defined contribution scheme cheaper when younger, the accelerated accrual structure that makes SERPS more generous to older cohorts and the phased reduction in SERPS as a result of the 1988 and 1995 reforms. The age-related rebate structure introduced in April 1996 is the same as that in Figure 2, with the exception that the maximum rebate payable is capped at 9 per cent. Thus, SERPS continues to give a higher expected benefit than a personal pension for people aged 55 or over.

³⁶ The case is argued in more detail in Disney and Whitehouse (1992*a, b*) and Dilnot *et al.* (1994), Chapter 7.

Figure 2. Neutral rebate by age



Source: Government Actuary (1994a).

Note: Figures are for women up to age 55 and for men from age 60 (since the current state pensionable age for women is 60). Includes a margin to cover expenses of 6 per cent of the initial rebate, 0.8 per cent per annum reduction in the real return and a 2 per cent annuity charge on the total fund at retirement. A real return of 3½ per cent per annum and real earnings growth of 1½ per cent per annum are assumed.

Over-selling of personal pensions

Personal pensions were sold heavily both in government information campaigns and, particularly, by private-sector providers. Given the abolition of life-assurance-premium relief from income tax in 1984, personal pensions proved an ideal new product for the financial services industry. Both the income tax relief and the ‘money-for-nothing’ aspect (whereby the pension does not require any current contribution from the optant, merely the transfer of the national-insurance rebate) are attractive selling points. At least in part this explains the unexpectedly rapid take-up of personal pensions: the government expected only 500,000 to contract out within two to three years, although a contingency plan adopted in 1986 allowed for up to 1.75 million optants. With 5.7 million optants, take-up exceeded expectations by a factor of over ten.

The extent to which this represents over-selling — to people for whom personal pensions are not suitable — is difficult to determine. There are four main examples of where mis-selling may have occurred:

- Those who were too old, so SERPS offered a better option than personal pensions.
- Those who had too low earnings, so the contributions were too small to bear the transactions charges, which usually have a large fixed component as well as being related to the contributions. As a rough guide, earnings of £10 000 are regarded as the minimum level to make contracting out worthwhile, although this will of course be lower for younger workers and higher for older due to the incentive structure of the rebate.
- Those who were persuaded not to join an employer's pension plan and take out a personal pension instead.
- Those who transferred their pension out of a current or previous employer's plan into a personal pension.

On the first case, Table 6 showed little evidence of men over age 50 and women over 45 taking out personal pensions. Figure 1 shows that at least in comparison with SERPS, these people are likely to be better off in a personal pension.

Surveys of charges suggest that these reduce the final value of the pension between 8 and 29 per cent³⁷ depending on the provider and that charging structures also vary enormously.³⁸ Many firms charges have a fixed component, which bears particularly heavily on the low paid. Statistics on the earnings of personal pension members are available, although these are point-in-time rather than annual estimates. In 1992-93, for example, 60 per cent of men in personal pensions earned over £10 000 (excluding those with zero earnings recorded).³⁹ Although this suggests that a large proportion earned below the

³⁷ Money Management (1996).

³⁸ See, for example, Bacon and Woodrow (1996).

³⁹ Department of Social Security (1997a), Table H2.03.

threshold where a personal pension is worthwhile, the earnings figures are not annual earnings and so it is not possible to infer the degree of mis-selling.

Since 1985, the proportion of full-time women not joining an employers' pension scheme has risen from 21 to 29 per cent, and of men from 12 to 20 per cent.⁴⁰ Around 45 per cent of employees not joining their employer plan take out a personal pension, the rest default to SERPS.

Whether those taking out a personal instead of an occupational pension were badly advised is a complex question. Determining the value of occupational-pension rights foregone is extremely difficult, since these depend on future job tenure and the future path of individual earnings, neither of which is known *ex ante*.⁴¹ The main reason why personal pension optants may lose out is that employers usually contribute to an occupational plan, but they will usually not contribute to a personal pension on behalf of an employee when they offer an occupational scheme. Around 17 per cent of employees contribute to a personal pension plan (in addition to the rebate of social security contributions provided directly by the DSS). Just 2 per cent of employees have a contribution from their employer in addition to the contribution they make, and 0.3 per cent record an employer contribution only (*i.e.* 13 per cent of personal pension members have an employer contribution).⁴² Among private sector employers who provide an occupational scheme, just 5 per cent will pay into a personal plan as an alternative.⁴³ Some also withdraw non-pension benefits from employees opting out of the employer pension plan: just 38 per cent will give life insurance benefits to non-joiners. In 1991, employers contributed £7.4 billion to occupational funds, compared with £3.3 billion from employees.⁴⁴ Thus, the cost for someone not joining their employer's scheme and taking a personal pension instead is the loss of the employer's contribution, worth 70 per cent of the pension *on average*.

⁴⁰ It is not possible to exclude those who are ineligible to join the scheme (for example, because they are too young, too old or because their tenure is too short) from these figures. The totals therefore do not wholly represent people *choosing* not to join their employer plan. Source: *General Household Survey*, various years.

⁴¹ See Disney and Whitehouse (1996).

⁴² Source: General Household Survey data.

⁴³ Source: National Association of Pension Funds (1994).

⁴⁴ Source: Government Actuary (1994).

However, as shown in Disney and Whitehouse (1996), the value of individual pension accrual is not proportional to earnings as contributions are. Younger workers who do not expect to stay with their employer long may be better off taking out a personal pension, even if they lose the employer contribution by doing so.

This last point also explains why firms are reluctant to make contributions to personal schemes. Since occupational plans generate a sizeable redistribution of lifetime income from short- to long-tenured workers, from low- to high paid workers and from women to men, allowing people to opt out will generate an adverse selection problem. Those who lose out from the redistribution will leave, and the costs of providing pension for the remainder will rise without the cross-subsidy. There is some evidence of this happening anyway from the increase in non-joining rates since occupational plan membership could no longer be made compulsory. The tying of the employer contribution to the occupational plan will limit the extent to which adverse selection may occur. However, the policy issue remains that the tying of the employer contribution in this way significantly reduces individual choice.

The fourth reason for suspecting mis-selling of personal pension was the issue of transfers. The newspapers have found numerous examples of redundant mineworkers who were persuaded to leave the British Coal pension scheme and transfer into a personal pension. Again, it cannot be entirely certain that people lost out as a result of these transactions. The so-called 'transfer value' given to people leaving schemes is the result of an actuarial calculation of the costs of providing the benefits prescribed by the occupational plan. People lose out from the transfer for three reasons. First, the transaction charges for the personal pension may be onerous (as discussed above). Secondly, the return on the personal pension may be lower than the return assumed in the actuarial calculation. Finally, some occupational plans use an actuarially unfair means of computing the current value. Most firms, for example, use a different calculation when accepting a transfer into a scheme than for a transfer out.

Personal pension providers are currently reviewing all cases of personal pensions sold to find evidence of mis-selling under the guidance of the Financial Services Authority

(FSA), the new regulator. The review and compensation process has proved much slower than expected, not least because of the complexity of the issues involved.⁴⁵ The latest figures suggest 645,000 cases of potential mis-selling have been identified. Of these, 255,000 have been settled, with compensation paid by the personal pension provider. Compensation so far has totalled £1.2 billion, an average of £5,300 per case (FSA, 1998).

There has been some criticism of this compensation process, and not all of it from personal pension providers.⁴⁶ First, in other cases where the financial services industry sold clearly unsuitable products such as ‘low-cost’ endowment mortgages or home-income plans, compensation has not been offered or imposed by regulators. Normal rules of *caveat emptor* (buyer beware) seem to have been suspended in this case. Secondly, there has been an increase of eight percentage points in the proportion of employees who are not members of their employers’ pension plan since it was no longer possible for employers to make membership a condition of the employment contract. Employees may have a number of rational reasons for not wishing to join their employer pension plan. They may only intend to stay a short period with that employer, and so would lose from the redistribution inherent in occupational schemes. Or they may wish to maximise current income by avoiding the employee contribution to the occupational plan (*i.e.* they have a high discount rate). In either case, as the analysis in Figure 1 showed, if they are young enough and earn enough, they would be better off in a personal pension. Yet the provider who sold them a personal pension could be liable to pay compensation to such an individual unless they can prove that they advised them to join the occupational plan and that the individual rejected this advice.

VI. Prospects

⁴⁵ See SIB (1996, 1997) and PIA (1997*a, b*).

⁴⁶ Lex (1998) and Riley (1998)

Pension reform in Britain has been a revolutionary process. Its major milestones, such as the introduction of SERPS in 1978, prices uprating of the basic pension in 1981 and personal pensions in 1986, were fundamental changes in the philosophy and structure of the pension system.

Basic pension plus

The then Conservative government proposed at the May 1997 election another pension revolution, one that eventually would have seen the state withdraw entirely from direct pension provision.⁴⁷ Both SERPS and the basic pension, already much reduced in importance, would have been replaced by compulsory private provision. Initially, this would have applied to people below age 20 and to new labour-market entrants. Older workers could be brought into the new system, to be called ‘basic pension plus’, if and when the new regime was seen to be a success.

The basic pension would be replaced with a flat £9-a-week payment into an individual’s pensions account during the working life, SERPS with 5 per cent of earnings between the national-insurance earnings limits (£62 to £465 a week). As with personal pensions, the government would continue to collect contributions from employees and employers in the normal way, and transfer the pension contribution to the chosen pension provider at the end of the year. The £9 a week would be paid by the exchequer even when this exceeded total social-security contributions.⁴⁸

For someone earning around the average income, it was expected that a total fund of £130,000 would accrue from these contributions, roughly half each from the fixed £9 and the variable 5 per cent.

Basic pension plus, like any other proposal to switch from public, pay-as-you-go, to private, funded, defined-contribution provision is subject to a number of criticisms:

⁴⁷ See Whitehouse and Wolf (1997) and DSS (1997*b*).

⁴⁸ For example, contributions for someone earning £62 a week would be just £1.24 from the employee and £1.86 from their employer.

- Transition costs: one generation has to pay for the pay-as-you-go pensions of its parents and its own funded pensions.
- Capital-market uncertainty: retirement income becomes inordinately vulnerable to the vagaries of financial markets.
- Distributional effects: those with low earnings or interrupted employment will be unable to save for an adequate pension.
- Transactions charges: excessive administrative expenses might erode pensions.

But basic pension plus included several ingenious attempts to get round these criticisms.

First, new-generation pensioners would not be able to deduct contributions to any pension plan from their income tax, including existing occupational and personal schemes. Instead, their pensions in payment would be tax-free. Bringing forward this deferred taxation would offset much of the transition cost. The overall effect, including the tax changes, would be to add a cumulative £160m a year to public spending. So spending would be £320m higher after two years, £480m after three years, peaking at £7 billion in 2040. But this is a negligible sum: around ½ per cent of forecast gross domestic product, or 12 per cent of forecast total pensions spending in that year. The time profile of these costs would be unfortunate, because they would peak exactly at the time that population ageing puts further upward pressure on pensions spending.

Overall, the pre-paid expenditure tax regime would raise slightly more tax for the government. First, the double tax relief enjoyed in the current system (tax-free contributions and tax-free withdrawal of lump sums) would be eliminated. Secondly, extra tax would be collected from people who were higher-rate taxpayers during their working life and were likely to be lower- or basic-rate taxpayers during retirement. But this treatment results in an enormous public-policy risk. Since current tax reliefs are up-front it is very difficult to take them away. There would be a danger under basic pension plus that a future government would look at pension fund assets — perhaps as much as £1,000 billion forty years hence — and decide to collect tax on pensions in payment after all.

The proposal also dealt with the risk of inadequate fund performance by offering a guarantee that the flat-rate contribution would buy an annuity at least as valuable as the basic pension. In effect, the government would underwrite a real return of at least 4½ per cent a year on this part of the contribution. This basic pension guarantee would also ensure a retirement income — albeit a very low one — to people with long periods out of work because of unemployment or parenthood. Any guarantee of this kind creates ‘moral hazard’, encouraging people to make riskier investment decisions than they would otherwise, knowing that the government would bail them out. Basic pension plus would require fund managers to ignore the guarantee in making portfolio decisions, that is to invest prudently.

The Conservatives hoped that transactions charges could be limited under the basic-pension-plus scheme in two ways. First, since the scheme would be compulsory, there would be no need for promotional expenses to persuade people to take out the pension plans. Secondly, abolishing SERPS alone would have meant many people with relatively low earnings would have insufficient pension contributions to bear the transactions charges (see above). By adding the flat-rate £9-a-week contribution to cover the basic pension, total contributions should be sufficient to bear the charges, even for someone with very low earnings. However, the switch in the tax privilege to pensions in payment rather than contributions would exacerbate the charges’ problem, by reducing the value of contributions going into the fund.

Pension reform and New Labour

New Labour, desperate for power after 18 years in opposition, attacked the basic-pension-plus proposals savagely, particularly in the last week of a long (by British standards) six-week election campaign. Labour was worried that it would repeat the 1992 election, when the Conservatives snatched an unexpected victory. Labour’s tactics were scaremongering, aimed to frighten current pensioners rather than the generation covered by the new scheme (most of whom were anyway under 18 and so did not have a vote). Senior Conservatives, too, attacked the wisdom of presenting these complex proposals during an

election campaign. In the event, New Labour triumphed with a majority of 170, the largest ever, and the Conservatives were humiliated with their smallest share of the vote since 1832.

The new government has also been quick to exploit the issue of personal-pension mis-selling. The economic secretary to the Treasury, Helen Liddell, is in charge of the process. She is publishing a monthly analysis of the pace at which individual companies are reviewing potential mis-selling cases, the so-called 'naming and shaming' exercise. Fines averaging £230,000 were imposed on 12 firms between July 1997 and March 1998 for tardiness in dealing with priority mis-selling cases.⁴⁹ Furthermore, the Financial Services Authority launched in April 1998 a television advertising campaign, featuring an ostrich, to encourage further potential mis-selling victims to come forward.⁵⁰

At first sight, there seems little prospect of fundamental pension reform under New Labour. Not only did they attack the Conservatives' proposals, but also their manifesto promised to retain the basic pension and SERPS, which was one of their very few detailed commitments. And Gordon Brown, the chancellor of the exchequer (finance minister) promised in his first budget in July 1997 that there would be no change to the deductibility of pension contributions, along the lines of the basic-pension-plus proposal.

In practice, the New Labour government has proved far more radical across a range of policy areas, from student loans to granting independence to the central bank, the Bank of England (within a week of taking office). Tony Blair, the prime minister, and Gordon Brown are determined that welfare reform should be a central theme of their administration. Frank Field, a long-standing advocate of pension reform as chairman of the social security committee of the House of Commons, was appointed minister with special responsibility for long-term welfare reform under the secretary of state for social security, Harriet Harman. A pension-reform commission of the 'great and the good' has been set up, chaired by the former head of the National Association of Pension Funds (the umbrella organisation for employer pension plans). This commission will report its proposals to John Denham, pensions minister, in the autumn.

⁴⁹ Source: HM Treasury (1998).

⁵⁰ See Financial Services Authority (1998).

The commission's main role will be to flesh out Labour's commitment to 'stakeholder pensions', a notion currently as vague as its name suggests. Stakeholder pensions are in practice likely to look little different from personal pensions. Some ministers have suggested trades unions or mutual organisations should provide them. But most people in trades unions are already members of employer-provided plans.⁵¹ And the trend in the financial services industry has been towards demutualisation. A number of large, mutual building societies (savings and loans) have converted into publicly limited banks and mutual insurers have also become limited financial services companies. Other, smaller mutuals have been taken over by larger limited companies.

The latest thinking seems to be that the government will advocate something very similar to the original Fowler scheme in 1986: abolishing SERPS and replacing it with compulsory personal pensions.⁵² The transition costs of such a policy, given the residual nature of SERPS, would not be large. But the government is highly sensitive to the issue of transactions charges. A recent speech by the pensions minister promised that the review would look at ways of achieving economies of scale in private pension provision and 'new partnerships involving financial services organisations and a variety of affinity organisations [which] has caught people's interest'. The Office of Fair Trading (1997) has recently proposed a 'designated personal pension', which would be passively managed to reduce costs, would have a transparent charging structure with no fixed element and would have limited compulsory contributions from employers (when they offer an occupational plan).

VII. Conclusions

The pensions debate in Britain has tended to focus around the future role of SERPS. But even though benefits in this scheme continue to rise as it reaches maturity, the coverage among current workers has declined substantially. It is best described as a residual scheme,

⁵¹ Disney and Whitehouse (1990).

and is becoming more so. The key question in devising a replacement for SERPS is finding a cost-effective way of dealing with marginal labour-market groups: those with low earnings and interrupted employment patterns. It is unclear whether it is possible or desirable to privatise coverage for these groups, where contribution levels will be low and transactions charges are high.

Turning to the state scheme as a whole, including the basic pension, the major issue here is one of adequacy. With continued uprating in line with prices, it will be worth just 7 per cent of average earnings by 2030. Its value will be ‘nugatory’, in the words of Michael Portillo when he was chief secretary to the Treasury (public spending minister). Indeed, the problems of financing an ageing population from the exchequer perspective have now been eliminated, and contribution rates to finance state pensions are expected to decline by 3½ percentage points over the next 30 years. Already the results of this policy are apparent. After the pensioner income distribution narrowed in the 1960s and 1970s, it broadened substantially in the 1980s. ‘Two nations’ of pensioners are emerging yet again. This problem is likely to get worse.

But returning to earnings indexation of the basic pension would be extremely costly, raising the contribution rate required to finance pensions by 6 percentage points over the next 30 years. It would also be a very poorly targeted measure, with much of the gains going to the richest pensioners. A more means-tested approach — for example, increasing the income-support limits more quickly than prices — would be better targeted on poorer pensioners whose incomes have grown the slowest in recent years.

A little commented-on corollary of the restriction of SERPS entitlements is the reduction in all forms of mandatory pension coverage, since the minimum employer-provided pension (GMP) and minimum contribution to a personal pension (GMC) are linked to the value of SERPS. Along with the price-indexed basic pension, mandatory pension coverage will deliver very low replacement rates, and is significantly below the level financial-services experts would advise. Two-thirds of people contribute only the minimum rebate to their

⁵² Peston and Halligan (1998).

personal pension. The average contribution paid into their accounts by the government is £450 a year, compared with £950 a year for the one-third of people who contribute themselves in addition.⁵³ Consumer surveys show that just 26 per cent of workers consider their pension arrangements satisfactory.⁵⁴ A quarter of workers said they could not afford to make proper provisions and 17 per cent would like to increase their provision but were unable to do so.

But a New Labour government, despite signs of a more authoritarian streak than its Conservative predecessor, is unlikely to have the political will to cut peoples' current net incomes by forcing them to save more for retirement. With pensioners ever reliant in future on 'third pillar', voluntary savings, there is a risk that more will, through inertia or myopia, have an inadequate retirement income.

⁵³ Office of Fair Trading (1997) and Inland Revenue (1996*a*). See also Money Management (1997) on this issue.

⁵⁴ Mintel (1996).

Annex. Valuing pension entitlements

This annex gives detailed formulae for the calculation of the pension values illustrated in the paper.

SERPS

Those earning below the national-insurance lower earnings limit or paying the married-women's reduced rate of national-insurance contribution do not earn SERPS entitlements, unless covered by home-responsibilities' protection. Individuals who are contracted out will have their SERPS entitlement reduced by the amount of guaranteed minimum pension they are receiving or are assumed to be receiving (for example, in the case of personal pensions).

Earnings above the national-insurance upper earnings limit are ignored. The lower earnings limit by statute must be set approximately equal to the value of the basic state pension. The upper earnings limit may lie in the range 6½ to 7½ times the basic state pension. Typically, for revenue raising reasons, it has tended to remain near the top of the range. The current figures are £62 and £465 respectively.

For SERPS purposes, earnings in each financial year since the scheme was introduced in 1978-79 are revalued in line with an index of economy wide average earnings. From this figure, the lower earnings limit in the year prior to retirement is deducted.⁵⁵ The total of revalued earnings net of the lower limit is then multiplied by an accrual factor, currently 1/80th or 1.25 per cent, to arrive at the additional pension entitlement.

The formula may be summarised

$$P_{SERPS} = \sum_{t=1978}^R (W_t \frac{Y_R}{Y_t} - LEL_{R-1}) X_{Rt} \text{ if } LEL_t \leq W_t, \quad W_t = UEL_t \text{ if } W_t > UEL_t$$

⁵⁵ The individual is assumed to be receiving the basic state pension (approximately equal to the lower earnings limit), so earnings up to the limit are 'replaced' at 100 per cent by the basic state pension. Earnings above the limit are replaced at a lower rate through SERPS.

where P is the value of the pension, R the year of reaching state pension age, W individual earnings, Y an index of average earnings, LEL and UEL the national insurance earnings limits and x the accrual factor.

For people retiring after 1998-99, the accrual factor is lower than the 1.25 per cent mentioned previously. First, the 1988 reforms reduced the target replacement rate from 25 to 20 per cent of earnings. Second, the accelerated accrual designed to give a full entitlement after 20 years ($20 \times 1.25 = 25$ per cent). This begins to unwind after 1998-99. The accrual rates given in Table A.1 show the effects of these reforms: SERPS, like many pay-as-you-go pension schemes, is considerably more generous to earlier cohorts, giving accrual rates more than three times larger than younger cohorts.⁵⁶

Table A1. **SERPS accrual rate by age**

<i>Accrual rate, per cent</i>	<i>1978-79 to 1987-88</i>		<i>1988-89 onwards</i>	
Before 1988-89	25/20	= 1.25	25/20	= 1.25
2000-01	25/21	= 1.19	25/21	= 1.19
2005-06	25/26	= 0.96	22.5/26	= 0.87
2010-11	25/31	= 0.81	20/31	= 0.65
2015-16	25/36	= 0.69	20/36	= 0.56
2020-21	25/41	= 0.61	20/41	= 0.49
2025-26	25/46	= 0.54	20/46	= 0.43
2027-28 onwards	25/49	= 0.51	20/49	= 0.41

Source: Government Actuary (1990).

Guaranteed minimum pension

The formula for the GMP is similar to the SERPS formula:

$$P_{GMP} = \sum_{t=1978}^R (W_t - LEL_t) x_{Rt} \cdot \frac{Y_R}{Y_t} \text{ if } LEL_t \leq W_t, \quad W_t = UEL_t \text{ if } W_t > UEL_t$$

where x' is the GMP accrual factor. The GMP will usually be less than SERPS for a number of reasons. First, the lower earnings limit is deducted before revaluation. Since this is now constant in real terms due to the price indexation policy, this reduces the pension below

SERPS. Second, the accrual factors for the GMP are lower for those retiring between 2000-01 and 2010-11 as the 20 per cent target replacement rate is introduced without phasing. The GMP is 'limited price indexed' up to a ceiling of 3 per cent, whereas SERPS is fully indexed.

The 1995 reforms

The 1995 reforms will alter the SERPS formula so that it is the same as the GMP, although the differences in accrual factors will remain. The effect is to reduce state pension entitlements for both those contracted in and for those contracted out, since they will no longer receive the difference between the GMP and SERPS. The amount of the loss is a fixed sum depending only on age of reaching state pensionable age; poorer pensioners will therefore lose disproportionately more. The contracting-out provisions were also altered. Schemes no longer have to provide the GMP, but to pass a minimum benefits test (that the accrual rate is at least 1/80th or 1.25 per cent of earnings above the lower earnings limit).

Personal pensions

The value of a defined-contribution pension at any one time is simple to determine by reference to the value of the pension fund, but is complicated in the case of personal pensions by the contracting out provisions. Defined-contribution schemes can contract out if a guaranteed minimum contribution (GMC) is made into the plan, which is set at the same level as the rebate of social security contributions. For personal pensions, national insurance is deducted from earnings at source, and at the end of the fiscal year the total value of the rebate is transferred directly to the personal-pension provider by the DSS.

The value of the eventual pension fund is the total of the contributions and the investment return they generate:

$$P_{PP} = \sum_{t=0}^R [(W_t - LEL_t) c_t (1+r)^{R-t}] \text{ if } LEL_t \leq W_t$$

⁵⁶ See Disney and Whitehouse (1993b) for an analysis of the rates of return to different generations in the state pension system.

where c is the contracted-out rebate (or GMC) plus associated income-tax relief, and r is the investment return.

The value of the rebate over time is shown in Table A.2.

Table A.2. Contracted-out rebate 1988-89 to 1996-97

	<i>Basic rebate</i>	<i>Incentive rebate</i>
1988-89	5.8	-
1989-90 to 1991-92	5.8	2
1992-93 to 1995-96	4.8	1 (over age 30)
1996-97 onwards	2.3-9.0	-

Note: from 1996-97 the rebate is age-related, as shown in Section V above.

References

- Beveridge, W. (1942), *Social Insurance and Allied Services*, HMSO, London.
- Confederation of British Industry (1994), *A View from the Top: Senior Executives' Attitudes to Pensions Provision*, William M. Mercer Ltd for CBI, London.
- Creedy, J. and Disney, R.F. (1988), 'The new pension scheme in Britain', *Fiscal Studies*, vol. 9, no. 2, pp. 57-71.
- Curry, C. (1996), 'PENSIM: a dynamic simulation model of pensioners' incomes', Government Economic Service, Working Paper no. 129.
- Department of Social Security (1992), *Retirement and Retirement Plans*, HMSO, London.
- Department of Social Security (1993), *The Growth of Social Security*, HMSO, London.
- Department of Social Security (1994), *Survey of Employers' Pension Provision*, HMSO, London.
- Department of Social Security (1996), *Pensions Act and Associated Regulations: Compliance Cost Assessment*, HMSO, London.
- Department of Social Security (1997a), *Social Security Statistics 1997*, HMSO, London.
- Department of Social Security (1997b), 'Guaranteed secure pensions for all, says Peter Lilley', DSS press notice, no. 97/044, London.
- Dilnot, A. W and Disney, R. F. (1989), 'Pension schemes after the 1989 Budget', *Fiscal Studies*, vol. 10, no. 3, pp. 34-49.
- Dilnot, A. W., Disney, R. F., Johnson, P. G. and Whitehouse, E. R. (1994), *Pensions Policy in the UK: An Economic Analysis*, Institute for Fiscal Studies, London.
- Dilnot, A. W., Kay, J. A. and Morris, C. N. (1984), *The Reform of Social Security*, Oxford University Press, Oxford.
- Dilnot, A. W. and Johnson, P. G. (1993a), *The Taxation of Private Pensions*, Institute for Fiscal Studies, London.
- Dilnot, A. W. and Johnson, P. G. (1993b), 'Tax expenditures: the case of occupational pensions', *Fiscal Studies*, vol. 13, no. 1, pp. 42-56.
- Disney, R. F. (1995), 'Occupational pension schemes: prospects and reforms in the UK', *Fiscal Studies*, vol. 16, no. 3, pp. 19-39.
- Disney, R. F., Meghir, C.H.D. and Whitehouse, E. R. (1994), 'Retirement behaviour in Britain', *Fiscal Studies*, vol. 15 no. 1, pp. 24-43.
- Disney, R. F. and Stears, G. (1996), 'Why is there a decline in defined benefit pension plan membership in Britain?', Institute for Fiscal Studies, Working Paper no. 96/4.
- Disney, R. F. and Whitehouse, E. R. (1990a), 'Do wage differentials compensate occupational pension entitlements? A preliminary look at the evidence', Institute for Fiscal Studies, Working Paper no. 90/10.

- Disney, R.F. and Whitehouse, E. R. (1990*b*), 'Union membership and occupational pension coverage in Britain: a disaggregated analysis', Institute for Fiscal Studies, Working Paper no. 90/16.
- Disney, R.F. and Whitehouse, E. R. (1991), 'How should pensions in the UK be indexed?' *Fiscal Studies*, vol. 12, no. 3, pp. 47-61.
- Disney, R.F. and Whitehouse, E. R. (1992*a*), 'Personal pensions and the review of the contracting out terms', *Fiscal Studies*, vol. 13, no. 1, pp. 38-53.
- Disney, R.F. and Whitehouse, E. R. (1992*b*), *The Personal Pensions Stampede*, Institute for Fiscal Studies, London.
- Disney, R.F. and Whitehouse, E. R. (1993*a*), 'Contracting out, indexation and life-cycle redistribution in the UK state pension scheme', *Oxford Bulletin of Economics and Statistics*, vol. 55, pp. 25-41.
- Disney, R.F. and Whitehouse, E. R. (1993*b*), 'Will younger cohorts obtain a worse return on their pension contribution?' in Creedy, J. and Casson, M. (eds), *Economic Inequality and Industrial Structure: Essays in Honour of P.E. Hart*, pp. 85-103, Edward Elgar, Aldershot.
- Disney, R.F. and Whitehouse, E. R. (1994), 'Choice of private pension and pension benefits in Britain', Institute for Fiscal Studies Working Paper no. 94/2.
- Disney, R.F. and Whitehouse, E. R. (1996), 'What are pension plan entitlements worth in Britain?' *Economica*, vol. 63, pp. 213-238.
- Financial Services Authority (1998), "'Don't bury your head in the sand" warns FSA film about pensions mis-selling', FSA press notice, no. 98/18, London.
- Government Actuary (1981), *Occupational Pension Schemes in 1979: Sixth Survey*, HMSO, London.
- Government Actuary (1986), *Occupational Pension Schemes in 1983: Seventh Survey*, HMSO, London.
- Government Actuary (1991), *Occupational Pension Schemes in 1987: Eighth Survey*, HMSO, London.
- Government Actuary (1992), 'Review of the terms for contracting out: a consultative note', mimeo., GAD, London.
- Government Actuary (1994*a*), *Pensions Bill 1994: Report by the Government Actuary on the Financial Provisions of the Bill on the National Insurance Fund*, Cm 2714, HMSO, London.
- Government Actuary (1994*b*), *Occupational Pension Schemes in 1991: Ninth Survey*, HMSO, London.
- Gustman, A. and Steinmeier, T. (1992), 'The stampede towards defined contribution plans: fact or fiction?', *Industrial Relations*, vol. 31, pp. 361-9.

- Hemming, R. and Kay, J.A. (1981), 'Contracting out of the state earnings-related pension scheme', *Fiscal Studies*, vol. 2, no. 3, pp. 20-28.
- Hemming, R. and Kay, J.A. (1982), 'The costs of the state earnings-related pension scheme', *Economic Journal*, vol. 92, no. 3, pp. 300-319.
- Inland Revenue (1996a), *Inland Revenue Statistics 1996*, Government Statistical Service, London.
- Inland Revenue (1996b), *Tax Treatment of Provision for Retirement: An Overview*, HMSO, London.
- Johnson, P. G. and Stears, G. (1995), 'Pensioner income inequality', *Fiscal Studies*, vol. 16, no. 4, pp. 69-93.
- Lawson, N. (1992), *The View from No. 11: The Memoirs of a Tory Radical*, Bantam Press, London.
- Lex (1998), 'UK pensions: buyer beware', *Financial Times*, 18 April.
- Meghir, C.H.D. and Whitehouse, E. R. (1996), 'Labour market transitions and retirement of men in the UK', *Journal of Econometrics*, vol. 79, pp. 327-354.
- Mintel (1996), *Retirement Planning*, London.
- Money Management (1996), 'Unique survey: personal pension plans', pp. 61-92, *Financial Times Magazines*, London.
- Money Management (1997), 'Rebate only pensions: money down the drain?', pp. 46-53, *Financial Times Magazines*, London.
- National Audit Office (1991), *The Elderly: Information Requirements for Supporting the Elderly and the Implications of Personal Pensions for the National Insurance Fund*, HMSO, London.
- Office of Fair Trading (1997), *Report of the Director General's Inquiry into Pensions*, London.
- Peacock, A. (1992), 'The credibility of economic advice to government', *Economic Journal*, vol. 102, no. 414.
- Pension Law Review Committee (1993), *Pension Law Reform*, HMSO, London.
- Personal Investment Authority (1997a), *Simplifying the Pensions Review: Further Guidance*, London.
- Personal Investment Authority (1997b), *Simplifying the Pensions Review: Statement of Policy*, London.
- Peston, R. and Halligan, L. (1998), 'Ministers set to back compulsory second pensions', *Financial Times*, 16 January.
- Riley, B. (1998), 'The flightless pensions: does financial reform go far enough?', *Financial Times*, 18 April.

- Securities and Investments Board (1996), 'The SIB announces plans to speed up the pension mis-selling review', SIB press notice, no. 051/96, London.
- Securities and Investments Board (1997), *Simplifying the Pensions Review: Amending Guidance*, London.
- Whitehouse, E. R. (1990), 'The abolition of the pensions earnings rule', *Fiscal Studies*, vol. 11, no. 3, pp. 55-70.
- Whitehouse, E. R. (1995), 'Fonds de pension et mesures d'incitation fiscale', *Risques*.
- Whitehouse, E. R. and Wolf, M. (1997), 'State retirement plans', *Financial Times*, March.
- World Bank (1994), *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth*, Oxford University Press.