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The United Kingdom
Examining the Switch from Low Public Pensions to High-Cost Private Pensions

David Blake

10.1 Introduction

The United Kingdom is one of the few countries in Europe that is not facing a serious pensions crisis. The reasons for this are straightforward: Its state pensions (both in terms of the replacement ratio and as a proportion of average earnings) are among the lowest in Europe; it has a long-standing funded private pension sector; its population is aging less rapidly than elsewhere in Europe; and it governments have, since the beginning of the 1980s, taken measures to prevent the development of a pension crisis. These measures have involved making systematic cuts in unfunded state pension provisions and increasingly transferring the burden of providing pensions to the funded private sector. The United Kingdom is not entitled to be complacent, however, because there remain some serious and unresolved problems with private-sector provision.

This paper reviews the current system of pension provision in the United Kingdom, describes and analyzes defects in the Thatcher-Major governments' reforms that brought us to the present system, examines and assesses the reforms of the Blair government, and then identifies the problems that remain unresolved and how those problems might be addressed. The paper ends with an explanation of how the United Kingdom has been able to introduce changes relatively peacefully when attempts by continental European countries to reform their pension systems have frequently led to riots in the streets.

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I am very grateful for useful conversations with my discussant, Andrew A. Samwick.

10.2 The Current System of Pension Provision

A flat-rate, first-tier pension is provided by the state and is known as the Basic State Pension (BSP). Second-tier or supplementary pensions are provided by the state, employers, and private-sector financial institutions—the so-called three pillars of support in old age. The main choices are among (1) a state system that offers a pension that is low relative to average earnings but that is fully indexed to prices after retirement; (2) an occupational system that offers a relatively high level of pension (partially indexed to prices after retirement up to a maximum of 5 percent per annum), but that, as a result of poor transfer values between schemes on changing jobs,[1] is offered only to workers who spend most of their working lives with the same company; and (3) a personal pension system that offers fully portable (and partially indexed) pensions—although these are based on uncertain investment returns and are subject to very high setup and administration charges, often-inappropriate sales tactics, and very low paid-up values if contributions into the plans lapse prematurely.

Employees in the United Kingdom in receipt of earnings subject to National Insurance Contributions (NICs) will build up entitlement[2] both to the BSP[3] and, on "band earnings" between the Lower Earnings Limit and the Upper Earnings Limit,[4] to the pension provided by the State-Earnings-Related Pension Scheme (SERPS) and to its successor from April 2002, the (ultimately) flat-rate State Second Pension Scheme. These pensions are paid by the Department of Work and Pensions (as the Department of Social Security was renamed in June 2001) from State Pension Age, which is sixty-five for men and sixty for women.[5] The self-employed are also entitled to a BSP, but not to a SERPS pension. Employees with earnings in excess of the Lower Earnings Limit will automatically be members of SERPS, unless they belong to an employer's occupational pension scheme or to a personal pension scheme that has been contracted-out of SERPS. In such cases, both the individual and the employer who is contracting-out receive a rebate on their NICs (1.6 percent of earnings for the employee and 3.0 percent for the employer, unless it operates a COMPS [see

1. Blake and Orszag (1997) estimated portability losses of 25–29 percent for typical workers in the United Kingdom, changing jobs an average of six times in a typical career.

2. National Insurance Contributions also build up entitlement to health service, sickness, disability, and incapacity benefits and the job seeker's allowance.

3. Worth £67.50 per week for a single person in 2000–01, while national average earnings were £415 per week, suggesting a replacement ratio of about 16 percent.

4. The Lower Earnings Limit was £67 per week and the Upper Earnings Limit was £535 per week in 2000–01.

5. The State Pension Age for women is being progressively raised to sixty-five over the period 2010–20.

6. The non–contracted-out NIC rate in 2000–01 for employees was 10.0 percent of earnings between £76 per week and the Upper Earnings Limit, while for employers it was 12.2 percent on all earnings above £84 per week.

below], in which case the employer rebate is 0.6 percent[6]) and the individual gives up the right to receive a SERPS pension. However, there is no obligation on employers to operate their own pension schemes, nor, since 1988, has there been any contractual requirement for an employee to join the employer's scheme if it has one.

A wide range of private-sector pension schemes are open to individuals. One can join his or her employer's occupational pension scheme (if it has one), which can be any one of the following:

- Contracted-in salary-related scheme (CISRS)
- Contracted-in money purchase scheme (CIMPS)
- Contracted-out salary-related scheme (COSRS)
- Contracted-out money-purchase scheme (COMPS)
- Contracted-out mixed benefit scheme (COMBS)
- Contracted-out hybrid scheme (COHS)

A CISRS is a defined benefit (DB) scheme that has not been contracted-out of SERPS and thus provides a salary-related pension in addition to the SERPS pension. CIMPS provides a defined contribution (DC) supplement to the SERPS pension. COSRS must provide "requisite benefits" in order to contract out of SERPS—namely, a salary-related pension that is at least as good as the SERPS pension it replaced, whereas COMPS must have contributions no lower than the contracted-out rebate. COMBS can use a mixture of the requisite benefits and minimum contributions tests to contract out of SERPS; COHS can provide pensions using a combination of salary-related and money purchase elements. Individuals can also top off their schemes with Additional Voluntary Contributions or Free-Standing Additional Voluntary Contributions, up to limits permitted by the Inland Revenue.

As an alternative, individuals have the following personal pension choices that are independent of the employer's scheme:

- Personal pension scheme
- Group personal pension scheme (GPPS)
- Stakeholder pension scheme (SPS)

A PPS is divided into two components. The first is an Appropriate PPS, which is contracted out of SERPS and provides "protected rights" benefits that stand in place of SERPS benefits: They are also known as minimum contribution or rebate-only schemes because the only contributions permitted are the combined rebate on NICs with the employee's share of the rebate, grossed for basic rate tax relief (at 22 percent). The second is an additional scheme, also contracted out, that receives any additional contributions up to Inland Revenue limits. A Group PPS is a scheme that has been arranged by a small employer with only a few employees. It is essentially a collection of individual schemes, but with lower unit costs because

of the savings on up-front marketing and administration costs.[7] Stakeholder pension schemes (SPS) are low-cost personal pension schemes introduced in April 2001.

In 1996, the U.K. workforce totaled 28.5 million people, of whom 3.3 million were self-employed (*Economic Trends Annual Supplement* 1999, table 3.2). The pension arrangements of these people were as follows (Department of Social Security 1998b, table 1.0; and estimates by the Government Actuary's Department):

- 7.5 million employees in SERPS
- 1.2 million employees in 110,000 contracted-in occupational schemes
- 9.3 million employees in 40,000 contracted-out occupational schemes (85 percent of such schemes are salary-related, although 85 percent of new schemes begun in 1998 were money purchase or hybrid)
- 5.5 million employees in personal pension schemes
- 1.7 million employees without a pension scheme apart from the BSP
- 1.5 million self-employed in personal pension schemes
- 1.8 million self-employed without a pension scheme apart from the BSP

These figures indicate that 72 percent of supplementary pension scheme members in 1996 were in SERPS or an occupational scheme and 28 percent were in personal pension schemes.[8]

Table 10.1 shows the aggregate values of the entitlements[9] in the four key types of pension scheme in 1994. The total value of entitlements in the BSP and in occupational plans amounted to more than 100 percent of gross domestic product (GDP) each, whereas the value of SERPS and personal pension plans amounted to 30 percent and 21 percent of GDP, respectively. Table 10.2 shows the sources of retirement income in 1997–98. A single person had total retirement income averaging 43 percent of national average earnings. Nearly two-thirds of this came from state benefits and another one-fourth from occupational pensions. Personal pensions provided only about 5 percent of total retirement income for the average person.[10]

7. Private pension schemes in the United Kingdom benefit from an EET system of tax breaks: the contributions into schemes are *e*xempt from tax, the investment returns (with the exception, since 1997, of dividend income on U.K. equities) are *e*xempt from tax, and the pension is *t*axed (with the exception of a tax-free lump sum equal to 1.5 times the final salary in the case of a DB scheme, and 25 percent of the accumulated pension fund in the case of a DC scheme).

8. For more details of the U.K. pension system, see Blake (1995, 1997), Fenton, Ham, and Sabel (1995), Pensions Provision Group (1998), and Reardon (2000).

9. By entitlements I mean either the expected discounted value of accrued rights in DB schemes (whether funded or unfunded) or the value of accumulated financial assets in funded DC schemes.

10. This is partly because personal pension schemes have been around only since 1988.

Table 10.1 Aggregate Values of Pension Entitlements in 1994

Type of Scheme	£billions	Percent of GDP
Basic State Pension (BSP)	703	104
State Earnings-Related Pension Scheme (SERPS)	202	30
Occupational pensions	743	110
Personal pensions	140	21

Source: Blake and Orszag (1999, table 12).

Table 10.2 Sources of Retirement Income in 1997–98

	Single Person			Married Couples		
Source	£ per Week	Percent of Total	Percent of NAE	£ per Week	Percent of Total	Percent of NAE
State benefits[a]	95	64	27	133	44	38
Occupational pensions	33	22	10	90	30	26
Investment income[b]	14	9	4	48	16	14
Earnings[c]	7	5	2	33	11	9
Total	149	100	43	304	100	87

Source: Department of Social Security (2000, table 1).

Note: NAE = national average earnings.

[a]Includes Incapacity Benefit, Housing Benefit, Council Tax Benefit, etc.

[b]Includes income from personal pensions.

[c]Women in the 60–65 age range and men in the 65–70 age range.

10.3 The Thatcher-Major Reforms to the Pension System

The Thatcher Conservative government that came into power in 1979 became the first government in the Western world to confront head-on the potential crisis in state pension provision. The reforms were continued by the succeeding Major government. These governments introduced the following measures:

1. Linked the growth rate in state pensions to prices rather than national average earnings, thereby saving about 2 percent per annum (Social Security Act 1980).
2. Raised the state pension age from sixty to sixty-five for women over the course of a ten-year period beginning in 2010, thereby reducing the cost of state pensions by £3 billion per annum (Pensions Act 1995).
3. Reduced the benefits accruing under SERPS (which had been set up in only 1978) in a number of ways: (a) The pension was to be reduced (over a ten-year transitional period beginning in April 1999) from 25 percent of

average revalued band earnings over the best twenty years to 20 percent of average revalued band earnings over the full career (Social Security Act 1986); (b) the spouse's pension was cut from 100 percent of the member's pension to 50 percent from October 2001 (Social Security Act 1986); (c) the revaluation factor for band earnings was reduced by about 2 percent per annum (Pensions Act 1995). The combined effect of all these changes was to reduce the value of SERPS benefits by around two-thirds.

4. Provided a "special bonus" in the form of an extra 2 percent National Insurance rebate for all PPSs contracting out of SERPS between April 1988 and April 1993 (Social Security Act 1986); provided an incentive from April 1993 in the form of a 1 percent age-related National Insurance rebate to members of contracted-out PPSs who were aged thirty or older, to discourage them from recontracting back into SERPS (Social Security Act 1993).

5. Relaxed the restriction on PPSs that an annuity had to be purchased on the retirement date, by introducing an income drawdown facility enabling an income (of between 35 and 100 percent of a single life annuity) to be drawn from the pension fund (which otherwise remains invested in earning assets) and delaying the obligation to purchase an annuity until age seventy-five (Finance Act 1995).

6. Enabled members of occupational pension schemes to join personal pension schemes (Social Security Act 1986).

7. Simplified the arrangements for occupational schemes to contract out of SERPS by abolishing the requirement for occupational schemes to provide Guaranteed Minimum Pensions (GMPs): since April 1997, COSRSs had to demonstrate only that they offer requisite benefits that are broadly equivalent to those obtainable from SERPS (Pensions Act 1995).

8. Ended its commitment to pay for part of the inflation indexation of occupational schemes (Pensions Act 1995). Until April 1997, COSRSs had to index the GMP up to an inflation level of 3 percent per annum, and any additional pension above the GMP up to an inflation level of 5 percent per annum. Since the GMP replaced the SERPS pension, which was itself fully indexed to inflation, the government increased an individual's state pension to compensate for any inflation on the GMP above 3 percent per annum. However, the 1995 act abolished the GMP altogether and required COSRSs to index the whole of the pension that they pay up to a maximum of 5 percent per annum.

9. Improved the security of the assets in private-sector schemes through the creation of a compensation fund operated by the Pensions Compensation Board, a Minimum Funding Requirement, and a Statement of Investment Principles (Pensions Act 1995).

10.3.1 Defects in the Thatcher-Major Reforms

The main defects of the Thatcher-Major reforms were as follows:

1. The removal of the requirement that membership of an occupational pension scheme could be made a condition of employment. Membership was made voluntary and new employees had to take the active decision of joining their employer's scheme; fewer than 50 percent of them did so.

2. The lack of a requirement to ensure that transferring from an occupational to a personal pension scheme was in the best interests of the employee, leading directly to the personal pensions misselling scandal that erupted in December 1993. Between 1988 and 1993, 500,000 members of occupational pension schemes had transferred their assets to personal pension schemes following high-pressure sales tactics by agents of PPS providers. As many as 90 percent of those who transferred had been given inappropriate advice. Miners, teachers, nurses, and police officers were among the main targets of the sales agents. Many of these people remained working for the same employer, but they switched from a good occupational pension scheme offering an index-linked pension into a PPS toward which the employer did not contribute and that took 25 percent of the transfer value in commissions and administration charges. An example reported in the press concerned a miner who transferred to a PPS in 1989 and retired in 1994 aged sixty. He received a lump sum of £2,576 and a pension of £734 by his new scheme. Had he remained in his occupational scheme, he would have received a lump sum of £5,125 and a pension of £1,791. As a result of a public outcry, PPS providers have had to compensate those who had been given inappropriate advice to the tune of £11 billion.

3. A lack of restriction on the charges that could be imposed in personal pension plans, under the hope that market forces alone would ensure that PPSs were competitively provided.

4. Giving personal pension scheme members the right to recontract back into SERPS. This option has turned out to be extremely expensive for the government because of the back-loading of benefits in DB pension schemes such as SERPS: Benefits accrue more heavily in the later years than the earlier years.[11] Despite the financial incentives given to contract out of SERPS into PPSs, it turned out to be advantageous for men over the age of forty-two and women over the age of thirty-four to contract back into SERPS once the period of the special bonus had ended in 1993. To discourage this from happening, the government has been forced to offer additional age-related rebates to PPS members over age thirty since 1993. Far from saving the government money, the net cost of PPSs during the first ten years was estimated by the National Audit Office to be about £10 billion.

11. Although the back-loading effect is lower in average salary schemes (such as SERPS) than in final salary schemes (such as a typical occupational scheme).

10.4 The Blair Reforms to the Pension System

The New Labour Blair government came into power in 1997 with a radical agenda for reforming the welfare state. During this time, Frank Field, appointed the first Minister for Welfare Reform at the Department of Social Security (DSS) and charged with the objective of "thinking the unthinkable," proved to be too radical for the traditional Old Labour wing of the Labour Party and was soon replaced. The eventual DSS Green Paper proposals, "A New Contract for Welfare: Partnership in Pensions" (DSS 1998), turned out to be much less radical than initially anticipated, but nevertheless continued with the Thatcher government's agenda of attempting to reduce the cost to the state of public pension provision and of transferring the burden of provision to the private sector through the introduction of stakeholder pension schemes. Nevertheless, there was much greater emphasis on redistributing resources to poorer members of society than was the case with the Conservatives. Shortly after the publication of the Green Paper, the treasury issued a consultation document on the type of investment vehicles in which stakeholder pension contributions might be invested. I will examine these proposals in turn.

10.4.1 The Department of Social Security Proposals

The key objectives of the DSS Green Paper were to:

1. Reduce the complexity of the U.K. pension system by abolishing SERPS.
2. Introduce a minimum income guarantee in retirement linked to increases in national average earnings on the grounds that people who work all their lives should not have to rely on means-tested benefits in retirement; the first-tier BSP will remain indexed to prices, however, and over time will become a relatively unimportant component of most pensions.
3. Provide more state help for those who cannot save for retirement, such as the low-paid (those on less than half median earnings), the disabled and carers (those who look after children, the disabled, or the elderly on a voluntary basis), via the unfunded state system.
4. Encourage those who are able to save what they can for retirement, via affordable and secure second-pillar pensions that are:
   a. provided by the state for those on modest incomes (via a new unfunded state second pension), and
   b. provided by the private sector for middle- and high-income earners, with the option of new low-cost DC stakeholder pensions, which are likely to replace high-cost personal pensions. However, there will be no extra compulsion to save for retirement at the second pillar and no additional incentives over those already existing at the second pillar.

The Green Paper proposals formed the basis of the Welfare Reform and Pensions Act, which received the Royal Assent in November 1999. The act deals with following issues.

State Pensions

1. A Minimum Income Guarantee (MIG) of £75 per week was introduced for pensioners in April 1999; it is means tested and indexed to earnings. In April 2003, the MIG will rise to £100 per week. In the same month, a pension credit will be introduced with the aim of rewarding thrift by providing additional cash at the rate of 60 pence for every pound of savings income, earnings, or second pension. An individual's total income entitlement will equal the MIG plus 60 percent of the income received from any second pension, any savings, or any part-time work. The total income entitlement will be capped at £135 per week.

2. SERPS was replaced by a new State Second Pension Scheme (S2P) in April 2002. The S2P was initially earnings related, but from April 2007 becomes a flat-rate benefit even though contributions are earnings related—a feature intended to provide strong incentives for middle- and high-income earners to contract out. The S2P

a. Ensures that everyone with a complete work record receives combined pensions higher than the MIG;
b. Gives low-paid individuals earning less than £9,500 per annum twice the SERPS pension given at £9,500 per annum (implying that the accrual rate is 40 percent of £9,500 rather than the 20 percent under SERPS);
c. Gives a higher benefit than SERPS between £9,500 and £21,600 per annum (average earnings);
d. Leaves those earning more than £21,600 per annum unaffected (with an accrual rate of 20 percent);
e. Upgrades these thresholds in line with national average earnings; and
f. Provides credits for carers (including parents with children under age five) and the disabled.

Stakeholder Pensions

1. New stakeholder pension schemes (SPSs) were introduced in April 2001, but are principally intended for middle-income earners (£9,500–21,600) with no existing private pension provision. They can be used to contract out of S2P.

2. They are collective arrangements, provided by:

a. An employer,
b. A representative or a membership or affinity organization, or
c. A financial services company.

3. They are DC schemes, with the same restrictions as for personal pen-

sions—namely, that on the retirement date up to 25 percent of the accumulated fund may be taken as a tax-free lump sum; the remaining fund may be used to buy an annuity or to provide a pension income by way of a drawdown facility until age seventy-five,[12] when an annuity must be purchased with the remaining assets.

4. They have to meet minimum standards, known as "CAT" (charges-access-terms) marks concerning:
   a. The charging structure and level of charges (a maximum of 1 percent of fund value),
   b. Levels of contractual minimum contributions (£20), and
   c. Contribution flexibility and transferability (no penalties if contributions cease temporarily [for up to five years] or if the fund is transferred to another provider).
5. The main provisions of the 1995 Pensions Act apply to SPS, covering the annual report and accounts, the appointment of professional advisors, and the Statement of Investment Principles.
6. They are regulated principally by the Occupational Pensions Regulatory Authority, with the Pensions Ombudsman for redress and the selling of schemes and supervision of their investment managers by the Financial Services Authority.
7. Employers without an occupational scheme and with at least five staff members must offer access to one "nominated" SPS and must provide a payroll deduction facility.
8. There is a new integrated tax regime for all defined contribution pension plans. SPS, personal pension plans, and occupational DC plans will attract tax relief on contributions up to a maximum of 17.5 percent of earnings (below age thirty-six), rising to 40 percent (above age sixty-one). However, contributions up to £3,600 per annum can be made into any DC plan regardless of the size of net relevant earnings. Contributions in excess of £3,600 per annum may continue for up to five years after relevant earnings have ceased. Thereafter, contributions may not exceed £3,600 per annum. All contributions into DC plans will be made net of basic-rate tax, with providers recovering the tax from the Inland Revenue, and with higher-rate tax, if any, being recovered in the self-assessment tax return.

Occupational Pensions

1. Occupational schemes can contract out of the S2P.
2. Employers can again make membership of an occupational scheme a condition of employment, and employees are allowed to opt out only if they have signed a statement of rights being given up, certified that they have adequate alternative provision, and have taken advice that confirms that the alternative is at least as good as the S2P.

12. There are plans to raise this to age eighty.

3. The compensation scheme established by the 1995 Pensions Act was extended to cover 100 percent of the liabilities of pensioners and those within ten years of normal pension age.

Personal Pensions

1. PPS members may contract out of the S2P.
2. They receive protection in cases of the bankruptcy of the member.

10.4.2 HM Treasury Proposals

The treasury proposals were contained in "Helping to Deliver Stakeholder Pensions: Flexibility in Pension Investment" (HM Treasury 1999). They called for the introduction of more-flexible investment vehicles for managing pension contributions, not only those in the new stakeholder pension schemes, but also those in occupational and personal pension schemes. These investment vehicles were given the name Pooled Pension Investments (PPIs). The main PPIs are authorized unit trusts (open-ended mutual funds), investment trust companies (closed-ended mutual funds), and open-ended investment companies.

In comparison with the individual arrangements of existing personal pension schemes and the poor transferability of occupational pension schemes, PPIs offer:

- Lower charges, because collective investment vehicles have much lower overheads than individual investments, and
- Greater flexibility, because PPIs are easy to value and transfer between different stakeholder, personal, and occupational pension schemes. This flexibility allows employees to move jobs without having to change pension schemes, and thereby encourage greater labor market flexibility.

10.5 Assessment of the Blair Reforms

The Welfare Reform and Pensions Act, while containing some significant improvements on the existing system, does not fully meet the Green Paper's own objectives.

10.5.1 Reforms to State Pensions

Although the abolition of SERPS helped to simplify the United Kingdom's extremely complex pension system, the proposal to have a MIG (of £75 per week) that differed from the BSP (£67.50 per week) reintroduced substantial complexity at the starting point for state pension provision, especially when the difference between the two amounts (£7.50 per week) was initially so small. It would have been far simpler to set the MIG equal to the BSP and to link the latter to earnings. The government has explicitly

rejected this on the grounds of both cost[13] and the fact that it would benefit the high-paid as well as the low-paid, whereas the government's emphasis was on helping the low-paid. However, the problem with keeping the BSP linked to prices rather than to earnings is that it will continue to fall relentlessly as a proportion of national average earnings: It is currently only 16 percent of national average earnings and will fall to well below 10 percent by 2025. Although the government admits that this will save substantial sums of money, it implies that the government is effectively abandoning the first pillar of support in old age and obliging everyone to rely on the second and third pillars or on means-tested benefits. The Green Paper talked about building on the BSP, but this implies building on a sinking ship.

If the government is genuinely concerned about security at the minimum level for all, it should consider funding the first pillar appropriately by establishing an explicit fund (like the Social Security Trust Fund in the United States) into which it places the NICs of those who are in work, while the government itself funds the contributions of the low-paid, carers and the disabled.[14] The contribution rate could be actuarially set to deliver the MIG for all when they retire. It could be a hypothecated part of NICs. In other words, the contributions would accrue "interest" equal to the growth rate in national average earnings. The state could explicitly issue national average earnings–indexed bonds, which the social security trust fund would buy. This is the only honest way of both preserving the value of and honoring the promises under the first pillar. The second and third pillars could then be formally integrated with the first pillar; that is, the second pillar could be used to deliver the tranche of pension between the MIG and the Inland Revenue limits, while the third pillar is used for voluntary arrangements above the Inland Revenue limits. If the first pillar remains unfunded, there is nothing to prevent future generations' reneging on an agreement that they are expected to keep but into which they did not voluntarily enter.

The fact that membership of pension schemes at the second pillar remains voluntary is highly worrying for reasons of myopia and moral hazard; compulsory contributions are seen as one way of dealing with these problems. Myopia arises because individuals do not recognize the need to make adequate provision for retirement when they are young, but regret

13. An additional £3 billion per year (*Daily Telegraph,* 31 July 1999).

14. In fact, the Conservative government in the United Kingdom announced in March 1997 plans to privatize the entire state pension system from the turn of the century and to end its unfunded nature. All individuals in work would receive rebates on their NICs, which would be invested in personalized pension accounts. The initial costs in terms of additional taxation were estimated to be £160 million in the first year, rising to a peak of £7 billion per year in 2040. However, the long-term savings to the taxpayer from the end of state pension provision were estimated to be £40 billion per year (all in 1997 prices). The proposals were put on hold as a result of the Conservative government's defeat in the May 1997 General Election (see *Basic Pension Plus,* Conservative Central Office, 5 March 1997).

this misjudgment when they are old, by which time it is too late to do anything about it. Moral hazard arises when individuals deliberately avoid saving for retirement when they are young because they calculate that the state will feel obliged not to let them live in dire poverty in retirement. Inevitably, this will lead to substantial means testing in retirement.

In short, although the Welfare Reform and Pensions Act has some good points, it fails three of Frank Field's tests for a good state pension system: It is not mandatory, it is not funded, and it remains means-tested (Field 1996a,b)

10.5.2 Reforms to Private Pensions

The government's proposal to have a maximum charge of 1 percent of fund value on SPSs will have two dramatic effects on private-sector pension provision, especially on PPSs.

The first is that it will help to force economies of scale in DC pension provision. This is because stakeholder pensions will be a retail product with wholesale charges. To deliver this product effectively providers will need to exploit massive economies of scale. The current charges for personal pension schemes, which average 1.4 percent and rise to as much as 2.2 percent of fund value for twenty-five-year policies (*Money Management,* October 1998); are much higher than the 1 percent CAT-marked limit on SPS. There may be a range of providers of SPS to begin with, but the only way for a provider to survive in the long run will be if it operates at low unit cost on a large scale. This will inevitably lead to mergers among providers and a final equilibrium with a small number of very large providers.

Existing personal pension providers and distribution channels face these challenges:

- Appropriate PPSs face massive competition from SPSs for future NIC rebates.
- SPSs could be better than PPSs for middle-income groups, leaving PPSs as a choice only for those on high incomes who require and are willing to pay for a bespoke product.
- New, affinity-based SPSs gateway organizations will link up with pension providers (e.g., Amalgamated Engineering and Electrical Union, which has 720,000 members, and Friends Provident).
- The treasury's proposed PPIs (see section 10.4.2) provide a low-cost alternative investment vehicle to the high-cost managed funds of most PPSs.
- Individual Savings Accounts (ISAs), introduced by the treasury in April 1999 to encourage greater personal-sector saving, also provide an important alternative to PPSs. Contributions into ISAs of up to £5,000 per annum are permitted, and the investment returns are free from income and capital gains tax. Although not intended as pension

saving vehicles (e.g., they do not attract tax relief on contributions, unlike standard pension saving products), ISAs can be used in retirement income planning because they enjoy the big advantage that they can be cashed in tax-free at any time, thereby avoiding the need to purchase a pension annuity on the retirement date.

The second benefit is that it will effectively force stakeholder pension funds to be managed passively, because active management would result in a charge higher than 1 percent. As demonstrated below, active fund managers have not demonstrated that they can systematically deliver the superior investment performance that justifies their higher charges. Furthermore, passively managed mutual funds (which are similar investment vehicles to PPIs) in the United States, such as Vanguard, have charges below 0.3 percent.

10.6 Unresolved Issues in Pension Scheme Design

Led by the United States, there has been an enormous growth in DC pension provision throughout the world: It seems that private pension provision in the future will be dominated by DC. The United Kingdom has had more than a decade of experience with DC provision, and much of this has been less than satisfactory. Various U.K. governments have attempted to deal with some of the problems that have been identified, but many issues have not been resolved. It is worthwhile explaining the key problems that the United Kingdom has experienced with its DC provision.

10.6.1 The Accumulation Phase of Defined Contribution Pension Schemes

The investment phase of DC schemes has experienced the following problems in the United Kingdom.

High and Confusing Charges

The charge structures of most existing personal pension scheme providers are high, complex, disguised, and front-loaded. Table 10.3 shows that the average personal pension scheme with a twenty-five-year investment horizon takes 19 percent of the fund value in charges, while the worst scheme takes nearly 30 percent.[15] On the one hand, such charge structures have the effect of confusing consumers to such an extent that they are unable to assess whether the schemes in which they are being invited to participate—for a significant period of time, and with a substantial commitment of resources—offer value for money. On the other hand, they give little incentive to the provider to offer value for money on a long-term basis. An examination of *Money Management's* annual *Personal Pensions*

15. More details on charges in personal pension schemes are contained in Blake and Board (2000).

Table 10.3 Charges and Reductions in Yield in Personal Pension Plans (%)

	5 Years	10 Years	15 Years	20 Years	25 Years
Charges as a percentage of fund value					
Best overall[a]	3.1	4.1	7.2	8.5	9.8
Best commission-loaded fund	4.0	4.1	7.4	8.9	10.6
Industry average	11.6	13.0	14.8	17.7	19.0
Worst fund	19.2	22.0	24.6	28.2	27.8
Reduction in yield					
Best overall[a]	1.26	0.79	0.90	0.76	0.68
Best commission-loaded fund	1.63	0.79	0.92	0.80	0.73
Industry average	4.91	2.65	1.93	1.68	1.39
Worst fund	8.47	4.76	3.43	2.88	2.16

Source: Money Management (October 1998).

Note: Regular-premium personal pension plan (£200/month).

[a]Lower of best commission-loaded and best commission-free.

publications (Walford 2000) also reveals that providers change their charge structures on a regular basis. This makes it very difficult to compare schemes over time and raises the question as to whether particular charge structures and changes to them are used to conceal the impact of costs, and thereby confuse consumers even more.

Furthermore, in order for consumers to compare products, it is important that they are aware of the full set of charges they face. It is frequently the case that some charges are disguised or hidden. One illustration of this concerns the treatment of paid-up policies (or PUPs; see Slade 1999, who reports a survey by AXA Sun Life). When policy holders move to a new pension scheme, they have the choice of taking a transfer value with them or leaving their assets in the original scheme, which is then converted into a PUP; the assets cannot be liquidated prior to retirement. Only 15 percent of policy holders take transfer values, whereas the rest leave PUPs. The regulator requires, however, that pension schemes disclose only transfer values and full maturity values. There is no obligation to disclose PUP maturity values, and, although schemes may do so if they wish, few actually do.

There is clearly a trade-off between high transfer values and high full maturity values: Schemes with front-loaded charges will quote low transfer values and high maturity values relative to schemes with level charges. Different providers compete on the basis of the transfer and full maturity values that they quote. However, PUP maturity values, which, in principle, should be related to transfer values, can turn out to be poor value for money. For example, the AXA Sun Life survey reports the case of one provider that quotes the highest transfer value among twelve leading providers, but ranks twelfth for its PUP maturity value quote. It appears that some schemes quote high transfer values to attract business, knowing that only 15 percent of those policy holders not going to full term are likely to

take transfers, whereas the remaining 85 percent end up with low PUP maturity values.

Another example of hidden charges comes from a survey of fund management fees by Towers Perrin (1998): Some fund managers did not report their full sets of charges. The three key charges are for asset management, broking (i.e., transaction execution), and custody. There are also charges for reporting, accounting, and performance measurement. Some fund managers report the asset management fee (as some proportion of the value of the net assets under management) only *after* deducting the broking and custody fees. Some fund managers justify this on the grounds that both the portfolio transactions and the safekeeping are conducted by a third party independent of the fund manager, typically the global custodian. Other fund managers operate full "clean fees"; that is, they report full charges, including third party fees that are merely passed through to the client. Yet other fund managers add commissions to third party fees before passing them through. In some cases, however, the broker or custodian is related to the fund manager (e.g., is part of the same investment banking or insurance group). In such cases, it is more difficult to allocate charges appropriately.

The lack of transparency can also lead to incentive problems. Brokerage fees are related to turnover, which provides an incentive to churn (i.e., overtrade) the portfolio; this is especially so if the transactions are executed by an in-house broker and the brokerage fee is hidden from the client. Some fund managers, in contrast, use discount brokers to reduce the costs to the clients. Some clients impose turnover limits to reduce costs. However, the most effective means of keeping charges down is complete fee transparency, full disclosure for each fund management function, and benchmark-related performance measurement (where the impact of hidden fees is exposed through poor performance).

Low Persistency with Voluntary Arrangements

A regular-premium pension scheme involves a substantial commitment of time and resources by both the scheme's sponsor and its members if the desired objectives are to be achieved. Any significant front-loading of charges in schemes means that members suffer substantial detriment if their contributions lapse prematurely (as the discussion of PUP maturity values, above, indicates). As the Personal Investment Authority (the predecessor to the Financial Services Authority) argues, "if investors buy policies on the basis of good advice, they would not normally be expected to cancel premiums to their policies unless forced to do so by unexpected changes in their personal circumstances. This means that persistency is a powerful indicator of the quality of the selling process" (1998, 3).

The Personal Investment Authority shows that persistency rates after just four years of membership are between 57 and 68 percent (table 10.4). The persistency rate is higher for schemes arranged by independent finan-

Table 10.4 Persistency Rates for Regular-Premium Personal Pension Plans (%)

	Company Representatives				Independent Financial Advisors			
	After 1 Year	After 2 Years	After 3 Years	After 4 Years	After 1 Year	After 2 Years	After 3 Years	After 4 Years
1993	84.1	72.3	63.6	56.7	91.5	83.3	76.6	70.5
1994	83.7	72.8	64.4		91.3	82.1	74.5	
1995	85.5	75.0			90.8	81.6		
1996	86.6				90.2			

Source: Personal Investment Authority (1998, table 1).

cial advisors than by company representatives, suggesting that the clients of the former are generally more satisfied with their policies than those of the latter. Although only four years of data are available, the evidence suggests that very few personal pension scheme members (only about 16 percent) are likely to maintain their memberships in the scheme long enough to build up an adequate pension.

The Personal Investment Authority regards these persistency rates as "disturbing" (1998, 10) and offers a number of explanations: Members were missold pensions that were either unsuitable or too expensive; regular premium policies might be unsuitable for those with irregular earnings or uncertain long-term employment; a change of employment may lead to a member's joining an occupational scheme and abandoning his or her personal one; adverse general economic conditions could worsen persistency rates. The Personal Investment Authority also offers suggestions as to why the IFAs are more successful than company representatives. First, IFAs tend to advise clients who have higher incomes, and who are more likely to continue contributing; second, policies chosen by an IFA are likely to be from a wider range of policies than those offered by representatives of any single company, leading to a greater likelihood of the policy's closely matching the particular needs of the client.

Making membership in second-pillar pension schemes mandatory rather than voluntary would do much to deal with the problem of low persistency.

Below-Average Investment Performance

Investment performance as well as the costs of delivering that performance is critical in DC schemes. Research by Blake, Lehmann, and Timmermann (1999, 2000), Blake and Timmermann (1998), and Lunde, Timmermann, and Blake (1999) has shown the following.[16] On average, U.K. pension funds have underperformed the market in key asset classes (table

16. Similar results hold in the United States (see, e.g., Lakonishok, Shleifer, and Vishny 1992).

Table 10.5 **Performance of U.K. Managed Funds in Comparison with the Market, 1986–94**

	Average Portfolio Weight	Average Market Return	Average Pension Fund Return	Average Outperformance	Percentage Outperformers
U.K. equities	53.70	13.30	12.97	−0.33	44.80
International equities	19.50	11.11	11.23	0.12	39.80
U.K. bonds	7.60	10.35	10.76	0.41	77.30
International bonds	2.20	8.64	10.03	1.39	68.80
U.K. index bonds	2.70	8.22	8.12	−0.10	51.70
Cash and other investments	4.50	9.90	9.01	−0.89	59.50
U.K. property	8.90	9.00	9.52	0.52	39.10
Total	100.00	12.18	11.73	−0.45	42.80

Sources: Blake, Lehmann, and Timmermann (1999, 2000).

Notes: All numbers are percentages. International property is excluded because no market index was available.

10.5), and there has been a wide dispersion of performance by individual fund managers (table 10.6), with little evidence of funds' being able to generate superior (i.e., above average) performance consistently over extended periods. Poorly performing funds are eventually wound-up or merged into more successful funds, but it can take many years for this to happen, during which time policy holders experience consistently poor returns.

On top of this, the research found that fund managers have not been especially successful at active fund management. In particular, it found that 99.47 percent of the total return generated by U.K. fund managers can be explained by the strategic asset allocation—that is, by the long-run asset allocation specified by pension-scheme sponsors on the advice of their actuaries, following an asset-liability modeling exercise. This is the passive component of pension fund performance. The active components are security selection and market timing. The average pension fund was unsuccessful at market timing, generating a negative contribution to the total return of –1.64 percent. The average pension fund was, however, more successful in security selection, making a positive contribution to the total return of 2.68 percent. The overall contribution from active fund management, however, was just over 1 percent of the total return (or about 13 basis points per annum), which is *less than active fund managers' annual fees* (which range from 20 basis points for a £500 million fund to 75 basis points for a £10 million fund; *Pensions Management,* September 1998).

Virtually the same or better returns could have been generated if pension funds had invested passively in index funds. In addition, fund man-

Table 10.6 **Fractiles of Total Returns by Asset Class for U.K. Managed Funds, 1986–94**

	U.K. Equities	International Equities	U.K. Bonds	International Bonds	U.K. Index Bonds	Cash and Other Investments	U.K. Property	Total
Minimum	8.59	4.42	6.59	−0.64	5.59	2.67	3.05	7.22
5%	11.43	8.59	9.44	2.18	7.20	5.46	5.07	10.60
10%	11.85	9.03	9.95	7.56	7.81	7.60	6.58	10.96
25%	12.44	9.64	10.43	8.30	7.91	8.97	8.03	11.47
50%	13.13	10.65	10.79	11.37	8.22	10.25	8.75	12.06
75%	13.93	11.76	11.22	13.37	8.45	11.72	9.99	12.59
90%	14.81	12.52	11.70	14.55	8.80	14.20	10.84	13.13
95%	15.46	13.14	12.05	18.15	8.89	16.13	11.36	13.39
Maximum	17.39	14.68	17.23	26.34	10.07	19.73	13.53	15.03
Maximum − minimum	8.80	10.26	10.64	26.98	4.48	17.06	10.48	7.81

Sources: Blake, Lehmann, and Timmermann (2000, table 1).

Notes: The table shows the fractiles of the cross-sectional distribution of returns on individual asset classes as well as on the total portfolio. Amounts are average annualized percentages.

agement costs would have been lower and the dispersion in returns across fund managers would have been reduced. Alternatively, if fund managers believe that, despite all the evidence, they can generate superior investment performance, they should be willing to accept performance-related investment management fees that reward good ex post performance and penalize poor ex post performance.

Given the major weaknesses in the existing design of DC pension schemes in the United Kingdom, the above outcomes at the accumulation stage of high charges and fund management fees, low persistency of contribution payments, and poor and widely dispersed investment performance should come as no surprise.

10.6.2 Distribution Phase of Defined Contribution Pension Schemes

Stakeholder pensions are CAT-marked in an attempt to avoid the problems experienced with personal pensions. However, the CAT-marking applies only to the accumulation phase, the phase that the scheme member does not directly experience. Little or nothing has been said about the distribution phase, when the member discovers whether he or she will receive a good pension. The distribution phase for U.K. DC schemes involves the purchase of a life annuity. The provision of annuities involve the following risks.

Adverse Selection and Longevity Risk

This is the risk that the individuals most likely to purchase annuities on a voluntary basis are those who believe that they are likely to live longer than the average for the population of the same age. Individuals may have a good idea, on the basis of both their own personal medical and family histories, whether they are likely to experience lighter or heavier mortality than others in the population of similar age. Life insurance companies do not have access to this information with the same degree of reliability.

The insurance company is unable to differentiate between prospective purchasers who will experience heavier mortality (and so make a profit for the life insurance office) and those who will experience lighter mortality (and hence make a loss for the life insurance office); however, it realizes that those most likely to purchase annuities will come from the latter group rather than the former.

To hedge this risk, the life insurance office will base its annuity rates on the "select group" that is most likely to purchase annuities. Annuities will therefore be poor value for the money for members of the first group.

Underestimating Increases in Longevity

Longevity tends to increase over time and there can be severe financial consequences if insurance companies underestimate increases in longevity. Longevity forecast errors of up to 20 percent over intervals as short as ten years are not uncommon (MacDonald 1996).

Inflation Risk

This risk, faced by those purchasing level annuities, is that unanticipated high inflation rapidly reduces the real value of the pension.

Interest Rate Risk

Annuity rates vary substantially over time. They are related to the yields on government bonds of the same expected term; and because long-term yields vary by up to 100 percent, annuity rates will vary by the same order of magnitude (Credit Suisse First Boston 1999).

Reinvestment Risk

The risk faced by annuity providers that there are insufficient long-maturing matching assets (especially government bonds) available to make the annuity payments, with the consequence that the proceeds from maturing assets may have to be reinvested on less favorable terms or in less suitable assets.

Inefficient Allocation of Risks in Annuities Markets

These risks are currently allocated in the following way: The *state* assumes interest-rate and inflation risk after the annuity is purchased (because annuity providers purchase fixed-income and index-linked bonds from the government to generate the cash flows needed to meet their level and indexed annuity obligations). The *annuity provider* assumes mortality risk after the annuity is purchased (because it will incur losses if annuitants live longer than expected). The *annuitant* assumes interest rate risk before the annuity is purchased, and if he or she chooses to buy a level annuity, inflation risk after the annuity is purchased (because the annuitant can retire at a trough in interest rates and there could be unexpectedly high inflation after he or she takes out a level annuity).

Annuity providers add loadings of 10–14 percent (Finkelstein and Poterba 1999) to cover their costs and risks. Even loadings of this size, however, may be inadequate to cover the costs of failing to forecast mortality improvements accurately. Anecdotal evidence suggests that annuity providers in the United Kingdom have underestimated the life expectancy of their current annuity pool by about two years. Furthermore, since 1999, there has been a substantial shortage of new long-maturing government bonds (both fixed interest and index linked), and this has had the effect of introducing reinvestment risk into the U.K. annuity market for the first time in its history (Bishop 1999). From the annuitants' viewpoint, the falling annuity yields during the 1990s have shown that the interest rate risk they bear is substantial.

This allocation of risks is not efficient. Annuity providers could do more to promote products that help annuitants hedge interest rate risk (e.g., phased annuities, protected annuity funds in which the interest rate risk is

hedged using derivatives, or investment-linked annuities). Similarly, the state could do more to help annuity providers hedge longevity risk. One way would be to make supplementary pensions mandatory, thereby bringing the longevity experience of annuitants closer to that of the whole population. Another would be to issue new types of bonds, known as Survivor Bonds (Blake and Burrows 2001). These are life annuity bonds whose coupon payments decline in direct proportion to the rate at which a cohort of sixty-five-year-olds on the issue date of the bond dies out, and with the coupons remaining in payment until this cohort had fully completed its life cycle. This would enable annuity providers to hedge both aggregate mortality risks and improvements in mortality, but leave specific mortality risks a commercial choice of the provider (e.g., the provider could target groups with lighter than average mortality [such as nonsmokers] and charge an additional premium, but that would be a commercial decision).

10.7 The Political Economy of Pension Reform

How has it been possible for U.K. governments to reduce the size of state pension provision without significant political protest, when similar attempts to do so on the Continent have led to street protests and strikes (e.g., in Italy in November 1994 and France in November 1995)?

Consider the SERPS pension. When it was first introduced in 1978, it offered a pension of 25 percent of the best twenty years' band earnings revalued to the retirement date by increases in NAE, with a 100 percent spouse's pension. Within a quarter-century, the value of these benefits had been reduced by two thirds before the scheme was abandoned altogether. How has this been achieved so peaceably? There are three main explanations. First, SERPS had been established only a few years before changes began to be made to it, so very few people were drawing the pension and little loyalty to the scheme had accumulated. Second, SERPS was an incredibly complex pension system that very few pension professionals have fully understand, let alone members of the general public. Although there was comment in the media at the time of these changes to SERPS, very little of it seemed to have permeated the consciousness of the mass of the population and the extent of the changes was little understood. Third, the changes were introduced with a lag of fifteen to twenty years, so it was easy for everyone to forget about them.

Even when changes were introduced immediately, such as the switch in the uprating of the state pension from earnings to prices, the immediate difference was relatively small and most people failed to realize how, over time, small differences can compound into large amounts.[17]

17. Had the indexation of the BSP been preserved to the growth rate in national average earnings since 1980, the BSP would have been £95 per week in 1999 rather than £66.75 (*Daily Telegraph,* 31 July 1999).

A final explanation lies in the fact that state pension provision is much less important for most people in the United Kingdom than on the Continent, and those for whom it is important (namely, the low-paid) have little political influence.

The situation on the Continent is rather different. State pensions there provide much higher replacement ratios than in the United Kingdom, and social solidarity appears to be a more important objective than it is in the United Kingdom. As a consequence, it is much more difficult to alter pension arrangements on the Continent, even if the political will to do so is strong—which it clearly is not.

10.8 Conclusion

Over the last twenty years, governments have had two major impacts on pension provision in the United Kingdom. First, they have reduced the cost of providing state pensions by reducing the level of benefits from the state schemes. Second, they have encouraged greater and more effective private-sector provision, although the Conservative and Labour governments have done this in quite different ways. The Thatcher-Major governments made private supplementary pension arrangements voluntary and used tax incentives to encourage consumers to join personal pension schemes; but they left it to the market to determine the structure and efficiency of these schemes. The result was schemes that exhibited very high front-loaded charges, because retail customers tend not to be skilled at assessing the cost-effectiveness of retail financial products (Office of Fair Trading 1997, 1999). In contrast, the Blair government, recognizing the market failure arising from poorly informed consumers, imposed restrictions on the structure of stakeholder pension schemes that helped to force economies of scale and hence lower charges.

Charges, however, constitute only one of the issues that must be resolved with DC pension schemes if such schemes are to provide effective long-term alternatives to state pensions. Other issues include persistency and investment performance during the accumulation phase, and longevity, inflation, and interest-rate and reinvestment risks during the distribution phase. With DB schemes, poor portability has been a perennial problem that neither the Conservative nor the Labour governments have tackled effectively.

The other countries of Europe would be wise to examine closely the situation in the United Kingdom, less for the way in which reforms to state provision were made (because there is no equivalent political will in Europe to match such reforms) than for the sometimes painful lessons that were learned in terms of private-sector provision.

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Comment

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The system of public pensions in the United Kingdom is in many ways unique and, in particular, uniquely complicated to an outside observer. The author is to be commended for a clear and detailed discussion of what the U.K. system represents and how it has gotten to that point over the last twenty-five years. The main fact about the U.K. system is that it currently faces a substantially smaller financial problem than in other European countries. Less-rapid aging and a smaller pay-as-you-go (PAYGO) system bode well for the United Kingdom.

This fact tempts us to consider the United Kingdom to be a model for other European systems that now face financial crises. This would be misleading, since the United Kingdom is not in its current position because it emerged from a past financial crisis of the sort the Europe now faces. Instead, it achieved its enviable position directly, without the transition that other European countries must soon undertake. The distinction between the United Kingdom's being a model, rather than just an example, is critical in a discussion of the pension crisis now facing Europe. The general conclusion of my remarks is twofold. First, the system in the United Kingdom does not give us much guidance about the transition out of the pension crisis faced by countries with mature PAYGO systems. Second, the pension system in the United Kingdom is nonetheless quite informative about some of the pitfalls that may besiege other European countries once they have found their own ways to more funded systems.

It is not quite right to say that the United Kingdom is ahead of other European countries. Instead, it benefits from what can be described as a historical accident or a deliberate policy choice. In the postwar period, the United Kingdom adopted Beveridge's plan for public income support, in

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which there was a basic fixed-rate pension set at a subsistence level. Prior to the implementation of the State Earnings-Related Pension Scheme (SERPS) in 1978, the United Kingdom had no comprehensive system of publicly funded earnings-related pensions.

As a result of this delay, SERPS has three defining characteristics that distinguish it from systems in other developed countries. First, SERPS was not very big, because it had to replace earnings only above the basic state pension and below an upper earnings limit. Second, it was easily scaled back in subsequent legislation during the mid-1980s. There were no vested interests in this system, because it had no large startup generation of pensioners to receive an enormous windfall. In the United States and other countries that currently have mature PAYGO public systems, there is always a generation dependent on Social Security for its current income, so that meaningful reform is politically unlikely (if not impossible) in the absence of a financial crisis. Third, by the time SERPS was established, there was a very well-developed employer-provided pension sector, and the public system was therefore designed to allow contracting out by suitable occupational and (later) personal pension schemes.

Public pension systems are intended to provide valuable services to their participants. Apart from issues of benefit levels, which will be discussed next, there are three economic reasons that countries establish public pension systems. The first is the standard problem of moral hazard. Societies implicitly, if not explicitly, provide a guarantee against poverty in old age. This insurance may give households an incentive to consume too much and to save too little while working. The second is the pooling of longevity risk. The possibility of slipping into poverty increases with longevity in the absence of an annuity, even if the moral hazard problem has been addressed in expected value. Because private annuity markets have always been incomplete, public systems have primarily paid benefits as indexed annuities. Making the "purchase" of the annuity mandatory for all beneficiaries overcomes the adverse selection problem that exists in private markets. Third, the goal of relieving poverty is close to uniform across all members of the population. The cost savings due to economies of scale in operating a single plan with centralized administration are enormous compared to the costs of a decentralized system operated by smaller private entities.

How well does the U.K. system address the goal of providing poverty relief among the elderly? This is the primary goal of the Basic State Pension (BSP), the first tier of the system. The BSP is a flat pension of £67.50 per week for a single person, an amount reported to be equal to about 17 percent of national average earnings. The first tier has much to recommend it. It is mandatory, centralized, and uniform, so it generates very little in the way of administrative or selection costs. It is also not very generous. This has the benefit of not distorting private saving decisions

too much. However, the BSP seems quite low as a level of income to avoid poverty. A retiree receiving only the BSP would be eligible for additional poverty relief programs. Although these other programs may be run in a more discretionary manner than the BSP, their costs should still be included in an assessment of the overall public system to provide retirement income support.

Additionally, if the BSP does not provide poverty relief, then a case can be made for expanding it. In many countries, for example, the first tier of benefits is set at the level of the minimum wage. If the fiscal costs of expanding the BSP are deemed to be too high for an unfunded system, then the increase can be phased in gradually, thereby allowing for some prefunding of these new liabilities.

Importantly, most workers and beneficiaries are not covered by the BSP alone. Public policy goals typically extend to providing comfortable, more than just subsistence, levels of income in retirement. Having a comfortable retirement for most people requires earnings replacement. Furthermore, there is far more heterogeneity in a condition of comfort than in one of being "not impoverished." In particular, it is evident that there is considerable variation across households in their preferences to substitute consumption over time, leisure over time, and consumption for leisure during all periods of time. There is also variation in life-cycle earning experiences. This heterogeneity makes the need to implement a centrally managed, uniform system less imperative. Accommodating this heterogeneity makes the second-tier or earnings-related benefits far more complicated.

The U.K. system permits real choice in the way participants obtain their earnings-related benefits. The mechanism is "contracting out" of the state system (SERPS) on the condition that a privately provided substitute is available. Contracting out was initially simple, permitting a rebate only to occupational pension plans with defined benefits (DBs) comparable to SERPS benefits. It is now more complicated, in order to accommodate and promote innovation in the private pension sector. A pension can be eligible for a rebate if it provides similar benefits under a DB plan or uses the rebate to contribute to a defined contribution (DC) plan. Given the role played by contracting out, it would be nice to see more detailed information on both the time-series and cross-sectional aspects of contracting out. It is surprising that there not been more research on the economic effects of contracting out, particularly with respect to saving.[1]

The debate over social security reform in other European countries and the United States has included plans that look like a contracting-out rebate. In those plans, a new investment-based account is established for each person, into which a small contribution is made, perhaps 2 percent of payroll per year. In the future, the private account will replace some of

1. For an early example, see Samwick (1989).

the benefits that would otherwise be payable from the PAYGO system. If calibrated correctly, the amount of benefits replaced from the investment-based account can be enough to alleviate the entire fiscal burden that is generating the financial crisis today.[2]

If this investment account contribution is diverted from the existing PAYGO tax, then an equal-sized source of revenue must be found if current beneficiaries of the unfunded system are to be paid. Here is where the distinctive features of the U.K. system are important. In the United Kingdom, the contracting-out rebate was not "opting out" of paying the unfunded liability to past generations. It was entirely prospective—there were no such past generations. It was not a transition device to solve the problems currently confronting the rest of Europe or the United States, and it cannot be used as such in the absence of another revenue source. It is precisely the difficulty of finding this other revenue source in the political process—whether it is higher taxes or lower benefits in the pension system or elsewhere in the government budget—that keeps meaningful reform from being implemented.

Establishing provisions to allow contracting out was a sensible thing to do when starting a new system. Initially, these provisions could help keep costs low because they allowed existing occupational pension schemes to deliver the benefits that would otherwise have been required of the public systems. Over time, the system of contracting out has become more complicated in its implementation and underlying economics. In fact, the United Kingdom is sometimes used as an example of the heavy administrative costs that would occur if other countries allowed for private-sector implementation of the second tier of the pension system. The United Kingdom represents one possible system that mixes public and private components. Many of the same features exist in the United States in the part of the retirement system that is implemented through banks and employers but subsidized by the tax code—for example, Roth and traditional Individual Retirement Accounts, DB pension plans, DC and 401(k) plans, and Keogh plans for the self-employed. The amount of choice allowed in the U.K. system should be thought of as an upper bound on what would reasonably be expected in the rest of Europe. In other countries, there will be a greater emphasis on keeping costs low because administrative costs are in addition to the fiscal transition cost.

There is much to learn from the U.K. experience in that regard. Problems are generally the result of trying to manage a system with elements of both choice and insurance. Based on the early history of the U.K. experiment, several problems and some solutions can be offered. First, based on the numbers in the paper, 3.5 out of 28.5 million workers have only the

2. See Samwick (1999) for a complete discussion of the "Two Percent Plan" originally put forth in Feldstein and Samwick (1998).

BSP (before the new system). This suggests that one-eighth of the workforce is left out of the earnings-related system. Combined with the low level of the BSP, incomplete coverage is a recipe for elderly poverty.

Second, workers could initially contract in and out of SERPS several times over their working lives. Because SERPS was a DB plan, and DB plans tend to be back-loaded, the optimal strategy was for workers to contract back into SERPS late in their working lives.[3] One way this problem was addressed was to scale back the generosity of the public system, so the costs of this type of behavior are lessened. Another was to make the contracting-out rebate an increasing function of the worker's age to prevent this from occurring. Perhaps a better way should be established to prevent these sorts of switches through a longer-term commitment to being contracted out, or through a greater reliance on DC methods in the state system.

Third, establishing new administrative structures is costly, especially if they are organized as private financial market institutions in which turnover and aggressive selling tend to generate high initial costs. On the administrative side, private accounts generate additional transaction costs of processing payments into and out of the system. These costs can be minimized by relying on existing systems, such as the payroll and income tax systems, to process payments, perhaps with the assistance of a financial clearinghouse.[4] On the investment side, there have been dubious sales practices and worker confusion in the contracted-out market in the United Kingdom. Much of this has been due to new problems associated with widespread private management of DC schemes. Other parts of the problem relate to the aggressive selling of actively managed mutual funds, which, as the paper quite clearly shows, are seldom worth the extra management fees. When financial markets are used to achieve social objectives, and the government is therefore a residual claimant on the financial performance of the investments, then more regulation is optimal than may normally be the case. Limiting the range of investment options (particularly to passively managed funds) and imposing capitalization requirements on financial intermediaries are some of the ways in which this could occur. A default plan (like the treasury's proposed Pooled Pension Investments, or PPIs) may be useful when allowing choice in social insurance.[5]

One problem that the United Kingdom avoided was the issue of whether the financial investments should be managed in a central fund or in indi-

3. A pension plan is back-loaded when a disproportionate share of the benefit entitlement accrues in the later, rather than in the earlier, years of coverage.

4. See Goldberg and Graetz (2000) for a detailed discussion of such a system.

5. A formal plan along these lines is discussed in greater detail in Samwick (1999). A default plan has three important features. First, it sets the low-fee, low-service standard. Second, it provides an easy way to set a guarantee that is independent of individual investment choices. Third, it allows small accounts to incubate for several years before being transferred to a private financial institution.

vidual accounts. Because the private plans came first, the government was never in a position to own private securities directly. Not all countries are in a position to allow government-administered central funds as part of their transitions to more funded systems. For example, to close the funding gap in the United States will eventually require assets of about 60 percent of gross domestic product. Today, such a fund would be nearly $6 trillion (see Samwick 1999).

In summary, the current position in the United Kingdom is the result of favorable demographic and historical conditions. Delaying the introduction of earnings-related pensions, and then rescinding them shortly after implementing them, has helped keep the U.K. system out of dire fiscal straits. This is the feature of the public pension system that distinguishes the United Kingdom from the rest of Europe and the United States. Eventually, however, all countries will have to design institutions that blend insurance and choice in a way that provides poverty relief, earnings replacement, and income security for retirees. It is in this respect that the evolution of public pensions in the United Kingdom can provide guidance for other countries.

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Discussion Summary

David Blake agreed with the discussant that it was easy to get rid of the SERPS scheme because it had only just begun. Blake noted that the history of the United Kingdom in terms of social welfare protection is based on the Beveridge principle: maintaining the minimum safety net and giving the public responsibility for providing above that minimum safety net. The basic state pension does provide an extremely low pension in retirement, and it is not intended to provide a comfortable standard of living during retirement. Individuals without other resources would be able to receive additional welfare benefits, such as housing benefits or municipal tax relief.

Laurence J. Kotlikoff said that the speaker has done a great service in making clear the workings of the British pension system. In the view of Kotlikoff, the British pension reform (of introducing personal pension plans with their high charges) has generated an unmitigated disaster, with many people ending up with much lower pensions than if they had remained in their occupational plans and turning to the government for redress. As an alternative, he referred to a joint proposal for the United States by Kotlikoff, Sachs, and sixty-five other economists to put a portion of payroll tax contributions into private accounts with a matching contribution provided by the government on a progressive basis. These accounts are invested passively in a global index fund to provide an inflation-indexed pension. This proposal would lead to a collective low-cost pension system in which everyone gets the same return. *Axel Börsch-Supan,* responding to the Kotlikoff proposal, expressed his doubts that an index fund that carries about 64 percent of GDP can be passively managed.

David A. Wise asked about the difference between the United Kingdom and the United States concerning the institutional structure of personal pension plans. There is no evidence of high charges or fraud in the United States as are described in the paper for the United Kingdom. *David Blake* explained this difference between the countries by pointing out the different degrees of financial literacy among consumers. However, he regarded it unfair to speak of fraud. Instead, the problems in the United Kingdom are very high effective charges, which are disguised in the marketing literature. He said that British consumers lack the financial sophistication to make long-term decisions of this kind.

Axel Börsch-Supan noted that the contracting-out rebate is essentially a subsidy that leads to a significant fiscal burden. According to *David Blake,* the fiscal burden comes from the fact that the government must keep increasing national insurance rebate to discourage people from contracting back into SERPS.