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Social Security in the United Kingdom: A Model for Reform?

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Summary

Predictions of future financial problems in the U.S. Social Security program have helped fuel growing interest in converting all or part of the system into private accounts. The experiences of other countries have been cited by advocates of privatization as examples of how to change from a traditional “pay-as-you-go” social insurance system, in which workers receive retirement benefits that are defined by law and paid through the government, to one in which workers receive retirement benefits from their own accumulated savings. It has been suggested that the United Kingdom (U.K.) is especially relevant for the United States because it is a developed industrial democracy with a rapidly aging population. The U.K. system is divided into two tiers: the basic state pension which provides a small, flat-rate benefit to most workers and the State Earnings-Related Pension Scheme (SERPS) which provides a benefit based on employee earnings. Although this design is fairly common among developed nations, in the U.K., employers and employees have the option of leaving SERPS if they replace it with a private sector arrangement.

Supporters of the U.K. system maintain that it has improved the living standards of the elderly, lessened the role of government in private lives, increased saving and investment, reassured workers that retirement benefits will be available to them, and forestalled the large tax increases that would be needed to pay benefits under the old system. They contend that its structure could be particularly instructive for the U.S. because it is a gradual process that maintains basic protection while slowly shifting part of the responsibility for retirement income to the private sector. Rather than undergoing potentially wrenching transition problems, the process has built upon the existing public and private pension structure, facilitated by the provision of incentives for workers to switch to private arrangements.

Detractors say that the system has adverse social effects because it is disadvantageous for lower paid workers, part-time workers and women. They maintain that company pensions are not available to many workers and primarily benefit full-time, well paid employees. Furthermore, if the pension is based on the worker’s own contributions, they are forced to bear the risk of inadequate income in retirement due to poor investment performance or because the market dipped when they retired. Opponents also claim that these workers do not fare well with personal pensions because they carry high fixed administrative costs that continue in periods of unemployment when there is no opportunity to contribute more to the pension; have been poorly regulated leading to the “mis-selling” of pensions to workers who would have been better off staying in SERPS or an employer plan; and provide inadequate retirement income given insufficient contributions or investment returns.

Currently, the U.K. system is undergoing further reforms that aim to make private pension coverage accessible to a broader segment of the working population and improve benefits for lower paid workers who remain in the second tier of the public retirement system. Major changes include the introduction of “stakeholder” pension schemes and the new State Second Pension to replace SERPS.

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Social Security in the United Kingdom: A Model for Reform?

Introduction

Although the U.S. Social Security system's income currently exceeds outgo, it is generally recognized that the system will face financial problems in the next several decades due to the aging of the population and the retirement of the post-World War II baby boom generation. The ratio of workers to recipients is projected to fall from 3.4 to 1 today to 2.0 to 1 by 2050. The Social Security Board of Trustees projects that the system's expenditures will exceed its income in 2025 and do so until the Social Security trust funds are exhausted in 2038. On average over the next 75 years, expenditures are projected to exceed income by 14%.

This phenomenon is not unique. With few exceptions, life expectancies are increasing throughout the world, and the ratio of workers to retirees is shrinking. In response, other countries have undertaken various reforms. One approach has been to switch greater responsibility for providing retirement income from state sponsored systems to workers' own savings, a process commonly referred to as "privatization."

The experiences of these countries, especially Chile, have been cited as examples of how to change from a traditional social insurance system, in which workers receive retirement benefits that are defined by law and paid through the government, to one in which workers receive retirement benefits from their own accumulated savings. Critics, however, maintain that circumstances in many of these countries were very different from those prevailing in the U.S., such as being in earlier stages of economic development or, in the case of Chile, under the control of a military government that could replace a failing social security system as part of wholesale economic reform designed to roll back socialism. Given this criticism, it is logical to ask what other countries privatized in situations that are more similar to ours. The social security system in the United Kingdom (U.K.) is "partially" privatized in that workers can opt out of the part of the state provided pension program that is earnings-related. It has been suggested that the U.K. is especially relevant for the United States because it is similar to the U.S. culturally, economically, politically, and demographically. The U.K. and the U.S. have industrial economies, stable, democratically elected governments, aging populations, and in many respects, a common heritage.

As in the U.S., the U.K. population is aging. Although this is a worldwide phenomenon, it appears to be somewhat advanced in the U.K. For example, in 1990 the population age 65 and older was equal to 24% of the working age population — in the U.S. the figure was 19%. However, by 2030 it is projected the figures will be much closer, 39% and 35%, respectively. While the demographic trend is worrisome for U.K. policymakers, it is not as acute as for most other European countries, some of which are projected to have these ratios increase to almost 50% by 2030.

History of Social Security in the U.K.

Government support for the elderly in the U.K. began in 1908 with the Old Age Pensions Act. Benefits were paid by the government and were limited to poor people over age 70. A contributory program was introduced in 1925, with the Widows, Orphans and Old Age Contributory Pensions Act. Participation by workers was voluntary, except for manual laborers and others with earnings under a specified amount.

In 1942, economist Sir William Beveridge wrote a report that urged the government to provide a reliable retirement pension for all workers. Up to that time, social insurance programs for the elderly had been limited to those whose family income was below certain thresholds. This means testing carried such a stigma that some who qualified for benefits preferred destitution to the indignity of being labeled poor. Beveridge proposed a universal, non-means-tested program, supported by the contributions of virtually all workers, that would ensure a minimum level of income for every citizen. The Beveridge report led to passage of the National Insurance Act of 1946, which created the current compulsory social insurance program.

Responding to concerns that the “basic pension” under National Insurance provided inadequate income, in 1959 the government created a “second-tier” benefit, a supplemental earnings-related plan (called a “graduated pension”), effective in 1961. This program also was criticized for providing inadequate income, particularly since the amount of the additional pension was fixed at the time of retirement and declined in value thereafter due to inflation. It was also becoming clear that the workers most likely to have adequate retirement income were those who also had pensions provided by their employers (known as “occupational pensions”). In part to narrow the gap between workers with and without employer pensions, the 1975 Social Security Pensions Act replaced the graduated pension with a more generous supplemental earnings-related pension plan (the State Earnings-Related Pension Scheme (SERPS)), effective in 1978. Because SERPS was intended as a backup for workers without employer pensions, the Act gave workers and private companies the option of leaving SERPS if they had a defined benefit employer pension¹ that offered retirement benefits equal to or greater than those provided by SERPS.

Soon afterward, projections of future costs grew rapidly leading to action by the government to curtail future SERPS benefits and provide workers not covered by an employer defined benefit plan the alternative of opting out of SERPS into an employer defined contribution plan² or an Appropriate Personal Pension³ (APP), effective in 1988.

¹In a defined benefit plan, a formula determines benefits (e.g., 1% of final pay per year of service) that the sponsor is obligated to honor (i.e., the investment risk is on the employer).

²In a defined contribution plan, a formula determines contributions (e.g., 10% of annual earnings), and the employee receives a benefit at retirement that depends on the accumulated value of the funds in his account (i.e., the employee bears the investment risk). In the U.S., a 401(k) plan is an example of a defined contribution plan.

³APPs are similar to Individual Retirement Accounts (IRAs) in the U.S.

During the 1990s, certain features of the system came under increasing criticism. Incentives were provided for employees to opt out of SERPS, but the private alternatives to SERPS proved impractical for many workers — employer plans were not available to many workers and personal pensions were disadvantageous for workers with low or unsteady earnings. In widely publicized “mis-selling” cases, many workers purchased personal pensions when it was not in their best interest to do so. In December 1998, the U.K. government outlined its proposal for a new pensions framework⁴ calling for the creation of “stakeholder” pension plans (flexible, fee-limited defined contribution plans) and the State Second Pension to replace SERPS. The proposal made no changes to the basic state pension. The U.K. government enacted legislation creating “stakeholder” pension schemes in November 1999 and the State Second Pension in July 2000. These latest reforms to the U.K. social security system are being phased in starting in April 2001.

The Current U.K. Social Security System and Recent Reforms

The U.K. social security system⁵ is a two-tiered, partially privatized system funded on a pay-as-you-go basis through payroll taxes (National Insurance (NI) contributions) levied on most workers and their employers. Workers with earnings above a specified threshold (the “lower earnings limit”) are automatically covered under the system. Contribution rates and “taxable” earnings differ for employees and employers, and reduced contribution rates apply if an employee contracts out of SERPS to reflect foregone future SERPS benefits.⁶ *Employees* pay NI contributions on a portion of weekly earnings (earnings between the “employee’s earnings threshold” and the “upper earnings limit”) at a rate of 10% if they remain in SERPS and 8.4% if they contract out of SERPS.⁷

Employers pay NI contributions on all weekly earnings above a specified threshold (the “employer’s earnings threshold”) at a rate of 12.2%. If an employee contracts out of SERPS, the employer pays a reduced rate on the first portion of taxable earnings (earnings above the “employer’s earnings threshold” up to the “upper earnings limit”) and the full rate (12.2%) on all additional weekly earnings. The amount of the reduction depends on the type of private pension the employee chooses

⁴U.K. Department of Social Security, *A New Contract for Welfare: Partnership in Pensions*, December 1998.

⁵In the U.K., “social security” refers to a broad range of programs and services. The U.K. social security system provides retirement, survivors, and disability benefits as well as sickness, maternity, unemployment, work injury, child, and welfare benefits, and health care services. In this report, the term “social security” refers only to the retirement portion of the program.

⁶Employees contracted out of SERPS do not receive a second-tier benefit from the government. Therefore, they and their employer pay a reduced rate of NI contributions. The reduction in NI contributions is known as the contracted-out “rebate.”

⁷Self-employed workers are eligible for first-tier benefits only. They pay a flat rate of £2 per week (\$3) plus 7% of a portion of net annual earnings.

in place of SERPS. The reduced rate is 9.2% if the employee participates in an employer-sponsored *defined benefit* plan and 11.6% for an employer-sponsored *defined contribution* plan. If the employee opts for a personal pension in place of SERPS, the employee and employer pay the full rate of contributions (10% for employee, 12.2% for employer) as if paying into SERPS and the government pays a “rebate” directly to the individual’s personal pension scheme.

The first benefit tier — the **basic state pension** — is mandatory and provides a small, flat-rate benefit based on *years* of contributions. A worker must pay NI contributions for at least 90% of his or her working life to receive full benefits. At the current pension eligibility age, a full career is 49 years for men (ages 16 to 65) and 44 years for women (ages 16 to 60).⁸ Workers receive credits toward the basic state pension for periods in education, training, unemployment, disability, caregiving, and child rearing. Because the basic state pension is indexed to prices, its value relative to average wages has declined over time.

The second benefit tier — **SERPS** — provides an additional earnings-based benefit to employees.⁹ Participation in SERPS is voluntary as employees have the option of “contracting out” of SERPS if they have an employer-sponsored, personal, or stakeholder pension (available starting in April 2001). Changes in the SERPS benefit formula included in the Social Security Act of 1986 resulted in lower benefits for workers who reach state pension age after April 5, 1999. In the absence of recent policy changes (see section on the State Second Pension below), SERPS benefits would decline gradually from 25% of the highest 20 years of earnings to 20% of lifetime average indexed earnings. In addition, SERPS benefits are based on the portion of employee earnings between the “lower” and “upper earnings limit.” The upper earnings limit is indexed to prices. If wage growth exceeds price growth in the future as projected, a smaller proportion of earnings would be credited under SERPS and the value of SERPS benefits as a proportion of earnings would decline for many workers.

Options for contracting out of SERPS were expanded at the same time that SERPS benefits were reduced for future retirees. Employers have had the option to contract out of the second tier of the public system since 1961 if they offer a qualified defined benefit plan. In 1988, contracting-out options were expanded to include employer-sponsored defined contribution plans and qualified personal pensions (known as Appropriate Personal Pensions) increasing the private sector’s role in the provision of retirement income (see **Figure 1**). Despite the increased options for contracting out of SERPS, choices remained limited for certain types of workers, especially low to moderate earners who lacked access to an employer-sponsored plan. More than one-third of employees do not have this option and persons with low or unsteady earnings do not fare well with personal pensions because high administrative

⁸Under the Pensions Act of 1995, the age at which women become eligible for benefits will increase gradually to 65 over the 2010 to 2020 period.

⁹SERPS is not available to self-employed workers, who must make private pension arrangements to supplement the basic state pension. Approximately half of the self-employed currently contribute to a personal pension.

charges can erode the value of an individual's account.¹⁰ To address second-tier coverage gaps, further changes are being made to the U.K. system. Reforms currently underway are designed to allow more individuals to replace SERPS with private arrangements and enhance benefits for lower paid workers and those with breaks in employment due to disability or periods caring for children or sick family members. Major changes include the creation of "stakeholder" pensions and reform of public second-tier benefits through the new State Second Pension.

Starting in April 2001, employees will have the option of contracting out of SERPS using new **stakeholder pensions** designed to benefit primarily moderate and higher earners who do not have access to an employer plan (as well as self-employed workers who are not eligible for SERPS). Stakeholder pensions are flexible, defined contribution plans with an asset-based administrative charge limit. Employers are required to provide employees access to a stakeholder pension scheme if they do not offer an occupational pension plan or a group personal pension. Self-employed workers may purchase them directly from providers. Employers are not required to make contributions, but they must collect and pay employee contributions. Employees may stop and restart contributions and transfer into and out of stakeholder schemes without penalty. Annual administrative charges are limited to 1% of the account's value. Stakeholder pensions are intended to be a good option for persons who change jobs frequently or work intermittently because they are not tied to a single employer. The ceiling on administrative charges is designed to benefit workers without an employer plan who find existing personal pensions too costly.

Starting as early as April 2002, SERPS will be replaced with the **State Second Pension** designed to improve second-tier benefits for lower paid workers (especially female, part-time workers who lack private pensions) and extend second-tier coverage to persons who leave the labor force for extended periods due to disability or family caregiving responsibilities (caring for children or sick family members). Under the State Second Pension, workers with annual earnings below a specified amount — the new "low earnings threshold" — will be credited with earnings equal to the "low earnings threshold" which will be indexed to average wage growth. In addition, qualified caregivers and disabled persons with little or no earnings for the year will be treated as if they had earnings equal to the "low earnings threshold" to protect their entitlement to benefits. Initially, the State Second Pension will provide an earnings-related benefit. After stakeholder pensions have become established, it will be converted to a flat-rate benefit providing an incentive for workers who earn more than the "low earnings threshold" to opt out of the State Second Pension in favor of private arrangements.

Table 1 summarizes key features of the U.K. social security system in 2000/2001 and recently enacted reforms.

¹⁰Personal pensions were sold to many workers who would have been better off remaining in SERPS or an employer plan. Many of these "mis-selling" cases involved older and lower paid workers. Given the effects of compounding, personal pensions are more advantageous for younger, higher paid workers who have longer periods to invest and can make regular contributions in amounts large enough to counteract high administrative fees.

Table 1. Key Features of the U.K. Social Security System, 2000/2001

Coverage	Two-tiered, partially privatized system funded by National Insurance (NI) contributions paid by most workers and their employers
	All workers with a minimum level of earnings are automatically covered under the system.
	Benefits are paid to men at age 65 and to women at age 60 (between 2010 and 2020, the retirement age for women will increase gradually to 65).
Contribution rates	
Employee rates	<i>Under SERPS</i> : 10% of earnings from £76.01 to £535 per week (\$109 to \$770)
	<i>Contracted out of SERPS</i> :* 8.4% of earnings from £76.01 to £535 per week (\$109 to \$770)
Employer rates	<i>Under SERPS</i> : 12.2% of earnings over £84 per week (\$121)
	<i>Contracted out of SERPS</i> :* — with an employer-sponsored defined benefit plan: 9.2% of earnings over £84 per week up to and including £535 per week (\$121 to \$770); 12.2% of all additional earnings — with an employer-sponsored defined contribution plan: 11.6% of earnings over £84 per week up to and including £535 per week (\$121 to \$770); 12.2% of all additional earnings — with an Appropriate Personal Pension: employees and employers pay NI contributions at the full rate (10% for employees, 12.2% for employers) and a rebate is paid directly to the individual's account by the government
Self-employed workers	Self-employed workers (none of whom are eligible for SERPS) pay a flat rate of £2 per week (\$3) plus 7% of net annual earnings between £4,385 and £27,820 (\$6,314 to \$40,061).
Benefit structure	
First tier: Basic state pension	Participation is mandatory.
	Provides a small, flat-rate benefit to employees and the self-employed based on the number of years of contributions (regardless of earnings).

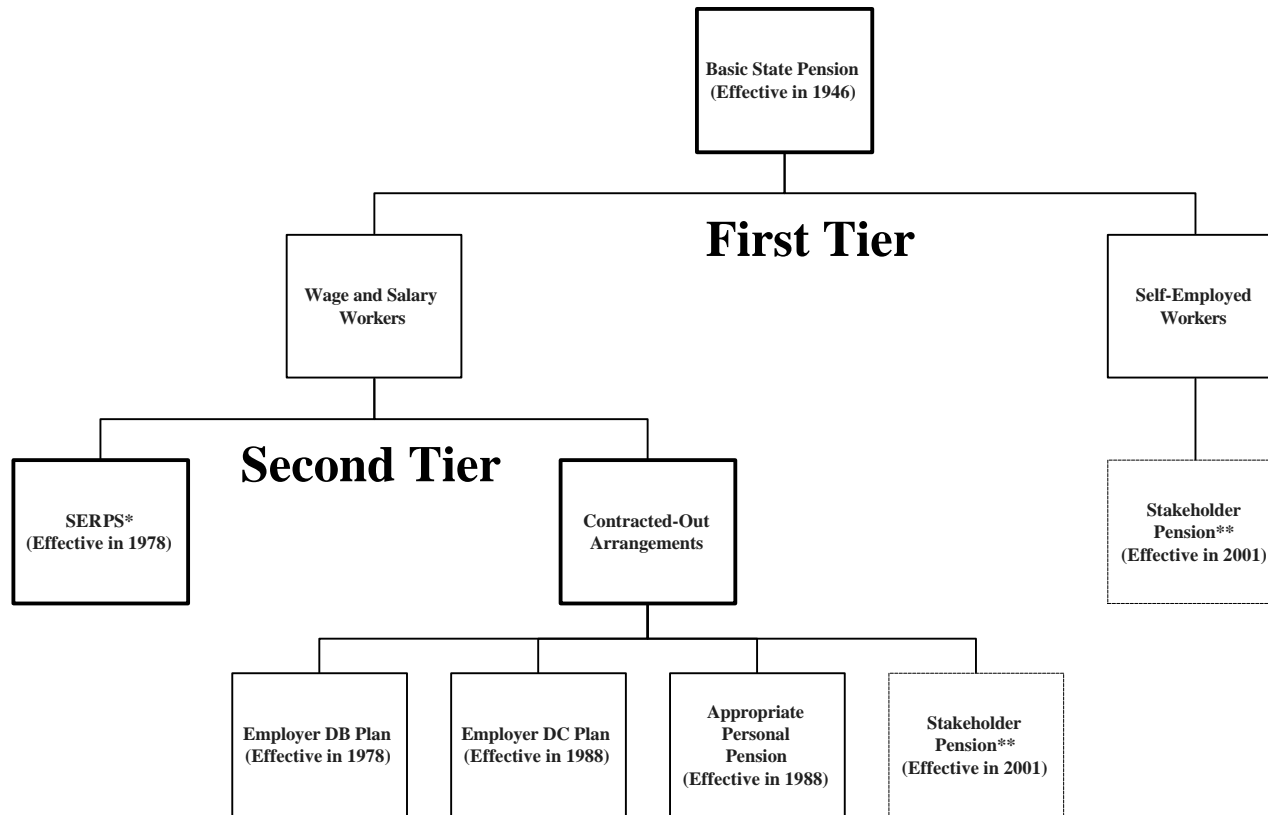
	To receive full benefits, a worker must pay NI contributions for at least 90% of his or her working life (currently, 49 years for men, 44 years for women).
	The basic state pension is £67.50 per week (\$97) for a single person, £107.90 per week (\$155) for a couple.
Second tier: SERPS	Provides an additional benefit to employees only (the self-employed are not eligible for SERPS).
	Participation is voluntary — employees may contract out of SERPS if they participate in an employer-sponsored defined benefit or defined contribution plan; an Appropriate Personal Pension; or a stakeholder pension (starting in April 2001). About one-fifth of employees are covered by SERPS.
	As of March 1999, the average SERPS benefit was £29.68 per week (\$43) for men, £16.85 per week (\$24) for women. The maximum SERPS benefit was £125.30 per week (\$180).
Recent reforms	
Stakeholder pensions	Effective in April 2001, stakeholder pensions may be used to contract out of SERPS.
	Stakeholder pensions are group provided, defined contribution plans designed to benefit primarily moderate and higher earners without access to an employer-sponsored plan (including self-employed workers who are not eligible for SERPS).
	Employers are required to provide access to a stakeholder pension scheme in the workplace if they do not offer an occupational scheme or a group personal pension. Employers are not required to make contributions, but they are required to collect and pay employees' contributions. Self-employed workers can purchase stakeholder pensions directly from providers including insurance companies, banks, and other financial institutions.
	Participants may stop and restart contributions and transfer into and out of stakeholder schemes without penalty.
	Annual administrative charges are limited to 1% of the account's value.
State Second Pension	Planned as a replacement for SERPS as early as April 2002.

	<p>The State Second Pension will provide an earnings-related benefit initially. After stakeholder pensions have become established, the State Second Pension will be converted to a flat-rate benefit.</p>
	<p>Designed to benefit primarily low earners and persons who leave the labor force for an extended period due to disability or family caregiving responsibilities.</p>

*Employees contracted out of SERPS do not receive a second-tier benefit from the government. Therefore, they and their employers pay a reduced rate of NI contributions.

Note: See the **Appendix** for a detailed description of the current U.K. social security system and recent reforms.

Figure 1. U.K. Social Security System



*As early as April 2002, the new State Second Pension will replace SERPS.

**Starting in April 2001, stakeholder pensions will be available to all persons including self-employed workers (who are not eligible for second-tier benefits) and non-earners.

KEY:

SERPS = State Earnings-Related Pension Scheme

DB = Defined Benefit

DC = Defined Contribution

Adopting the U.K. Approach to Social Security

Arguments For

Proponents of the U.K. system tout its beneficial effects at both the national and personal level. They argue that the reform of the national pension system in large measure rescued the U.K. from the financial straits currently facing other European countries because it has fostered both lower government spending on entitlements and increased national savings. Without such reforms, they say, forecasts showed that, to support the old system, payroll taxes would have had to double in the 21st century. They point out that the assets of employer pensions have grown from 36% of the U.K.'s Gross Domestic Product (GDP) in 1983 to 77% of GDP in 1994. They attribute recent forecasts of the U.K.'s eventual retirement of its National Debt to the savings fostered by the current design of the national pension system. This forecast of low debt also allows the U.K. to easily meet the requirements under the European Monetary Union agreement that participating countries must have a budget deficit of no more than 3% of GDP.

Proponents acknowledge that the U.K. system is a hybrid rather than a fully privatized system, but they maintain that this is one of its strengths making it an appropriate model for the U.S. system. The system is balanced, with the government still providing some benefits and continuing oversight and regulation to ensure that workers are protected from some of the dangers of marketplace risk. This continued government involvement and oversight makes the system amenable to change when necessary. For example, since contracting out was enacted, the government has ordered that private providers pay restitution to workers whom they misled into purchasing personal pensions. In addition, the government has required that employers provide protection against inflation both for annuitants and for accrued pension rights for workers who leave the firm. Another measure of balance is the diversification of risk between political and market forces provided by the mixture of public and private pensions. Recently, in response to criticism that the current mix of pension provision is inadequate, the U.K. government enacted legislation creating "stakeholder" pension schemes and the new State Second Pension to replace SERPS in an effort to improve retirement income for workers at all levels of income.

Proponents contend that the transition made to the current system should serve as an example to other countries and effectively invalidates the argument that switching to privatized systems causes inordinately difficult transition problems. Among the lessons they cite are the use of the existing framework (employer-provided pensions and private savings arrangements), the provision of incentives for workers to voluntarily contract out of the earnings-related state plan, and the continuing existence of a basic safety net to ensure a level of protection for all workers. They argue that intergenerational equity has been maintained by providing acceptable tradeoffs for younger workers to help bear the costs of continuing to maintain the benefits of current recipients while they move from a financially (and therefore politically) insecure public retirement system vulnerable to benefit cuts and/or contribution increases to a portable system of private pensions whose assets they believe to be more real and which they effectively own.

At another level, proponents laud the beneficial effects of the U.K. reforms on individuals. During the 1980s and 1990s, the income of pensioners in the U.K. grew proportionately faster than any other demographic group, and the percentage of pensioners living in poverty fell dramatically. During the period, the income of pensioners increased by two-thirds in real terms compared to a two-fifths increase in real average wages. Proponents say that younger workers and future generations have been spared the crushing burden of what would have been huge unfunded liabilities had the system not been reformed.

Proponents further contend that the standard of living for future retirees will be higher than if the old system had remained in force because of the higher rate of return inherent in private investments. They state that because SERPS is a pay-as-you-go system (as is Social Security in the United States), it can at most pay the average worker a rate of return equal to the rate of growth of average wages, whereas the rate of return on the equity of a funded occupational or personal pension plan historically has been considerably higher (from 1986 to 1995, the annual gross rate of return for median private pension funds in the U.K. was 13.3%). They argue that the enormous popularity of personal pensions illustrates this point. When workers in the U.K. were first allowed to opt out of SERPS using personal pensions in 1988, the Department of Social Security predicted that about half a million workers would do so initially. Demand turned out to be much greater than projected. By 1995, almost 6 million people had taken out a personal pension. Many American workers already have Individual Retirement Accounts (IRAs), which are very similar to U.K. personal pensions.¹¹ Given the familiarity Americans have with supplementary private retirement programs and the high rates of return the equity markets have provided to such plans over the past 20 years, proponents say it seems likely that a move to a semi-privatized system would be popular among U.S. workers.

Arguments Against

Critics of the U.K. system tend to focus on what they consider to be its adverse social effects including growing disparities in retirement income between low and high paid workers, full and part-time workers, male and female workers, and informed and uninformed workers. They are concerned that the features of the system tend to create a more unequal society, in which some people win and some people lose — and by increasing margins.

While conceding that pension income has risen *on average* during the past 2 decades, critics point out that the increase was not equally distributed. For example, between 1979 and 1997 the median income of the wealthiest pensioners increased 80% in real terms compared to 34% for the poorest pensioners. Critics contend that these disparities will only worsen as the new pension system matures.

Several reasons are cited for this forecast. First, due to the various deliberalizations mentioned earlier, the lowest paid workers, who probably will be totally reliant on National Insurance benefits, will have their standard of living steadily

¹¹The Investment Company Institute reports that one in three U.S. households owned Individual Retirement Accounts as of June 1999.

eroded. Second, the most reliable predictor of adequate income in retirement is eligibility for an employer pension. Demographically, employer-sponsored pension coverage is more concentrated on male, higher paid, full-time, full-career workers. Third, the adequacy of personal pensions depends heavily on the ability of the workers to make regular contributions over a lifetime with a particular premium on contributions at earlier ages in amounts large enough to minimize administrative costs which are fixed and continue through periods of unemployment. For lower paid workers, these administrative charges may be quite high, up to 30% of the total investment. It is said that it is possible for a worker with discontinuous employment to lose all of his or her contributions to administrative charges.¹²

Fourth, government regulators have confirmed that personal pensions have been marketed and sold to many people who lack investment expertise and would be better off financially had they stayed in their employer pensions or in SERPS. The “mis-selling” of personal pensions is said to have affected 1.5 million workers, mostly older and lower paid, who were persuaded by overzealous sales agents to switch to risky, inappropriate plans based on unduly optimistic estimates of rates of return. The government has ordered companies to reimburse these workers at an estimated cost of \$3.2 billion to date with total costs projected to reach \$20 billion.

Fifth, critics argue that many people choose to contract out essentially because the government bribed them to do so through rebates and tax incentives. As mentioned above, many workers were induced to opt out when it was not to their advantage, but critics contend that for many others, the incentives were a windfall and very costly to the taxpayer. Also, higher paid workers are said to be particularly advantaged because they receive more benefit, both in money amounts and in proportion to their earnings, from the preferential tax treatment given to pension contributions and income (i.e., the tax preferences are regressive).

Sixth, critics maintain that the current system is particularly disadvantageous for women because they tend to have lower earnings, shorter careers, and longer lifespans. Employer pensions are of most benefit to employees who have a lifelong record of full-time employment in a well paid occupation. Among married mothers who work, a large proportion do so in part-time labor. Only 12% of part-time workers were members of an employer pension in 1987. In addition, U.K. actuarial tables use gender-based life expectancy tables in computing annuities resulting in lower pension payments for women due to the longer period over which they are expected to receive benefits.

Critics are also uncomfortable with the displacement of risk from the government and the employer to the individual worker. Under defined contribution and personal pension plans the value of the pension depends on the cost of annuities at the time of retirement and the performance of the stock market during the period of investment. They point to the example of how a worker retiring and buying an annuity on October 23, 1987 would have received a pension 30% lower than if he had retired a week earlier.

¹²The new stakeholder pension scheme is designed to alleviate these problems.

Although much of their concern is directed at personal pensions, critics also warn that reliance on employer pensions presents problems as well. Much of their appeal is the provision of a predictable, practically inflation-proof benefit of which the employer bears the investment risk. These features exist largely because of government-imposed requirements, and employers are starting to complain about their onerousness. Although not widespread, there is evidence that there is a strong tendency for employers to choose a defined contribution design when given the opportunity (such as the creation of a new plan). Critics are concerned that, in the future, workers will be increasingly uncertain of their eventual benefits and bear more investment risk. They say it is unlikely that U.S. employers would be willing to accept such a degree of regulation and oversight.

Critics also complain about the features of some defined benefit employer plans that can lead to maldistribution of benefits. The design of employer pensions in the U.K. is generally free from legislative restrictions. Most defined benefit plans are based on final salary, which critics say give an incentive to managers to award themselves large salary increases in their last year of employment. Such plans also disadvantage workers whose earnings peak at mid-career, or who retire or leave the firm early. For workers who change employers, currently the terms of transfer do not ensure that a person with a given number of years of service in a defined benefit plan will carry that same number of years into a new plan. Older workers, for whom employer benefit costs are higher, may run the risk of involuntary employment termination.

As for the effects on the economy, critics say that claims of increased national savings ignore the substantial transition costs of providing incentives to contract out of SERPS. According to government estimates, the costs (in terms of foregone revenue) associated with the contracting out of SERPS into personal pensions were three times greater than the savings.¹³ Furthermore, critics are concerned that the growing discrepancies in retirement income and the erosion of the “floor of protection” provided by National Insurance may lead to increased welfare costs to the government in the long run.

¹³Liu, Lillian. Retirement Income Security in the United Kingdom. *Social Security Bulletin*, v. 62, n. 1, 1999.

Appendix: Detailed Description of the U.K. Social Security System

The U.K. social security system is a two-tiered, semi-privatized public pension system with a fairly complex contribution and benefit structure. The system is funded through payroll taxes (National Insurance (NI) contributions) levied on workers and employers. NI contribution rates and the amount of earnings on which contributions are paid differ for workers and employers. Reduced NI contribution rates apply for persons who contract out of the earnings-related part of the system in favor of private arrangements. The first benefit tier — the **basic state pension** — is mandatory and provides a small, flat-rate benefit to most workers. The second benefit tier — the **State Earnings-Related Pension Scheme (SERPS)** — provides an additional benefit based on earnings to employees (self-employed workers are not eligible for SERPS). Participation in SERPS is voluntary. Employees may opt out of the second tier of the system if they participate in an employer-sponsored plan, a qualified personal pension or, as of April 2001, a stakeholder pension (see **Figure 1**).

During the past decade, the U.K. system has drawn criticism from some policymakers concerning the limitations associated with existing contracting-out options, particularly given the reduction in SERPS benefits for future retirees. Many workers do not have access to employer-sponsored plans and personal pensions are impractical for those with low earnings or unsteady work patterns. Some policymakers expressed concern that, without further adjustments to the public retirement system, the income gap between the wealthiest and the poorest pensioners would continue to widen. Currently, the U.K. government is phasing in a series of new reforms — including the introduction of “**stakeholder**” pensions and the new **State Second Pension** — that aim to make private pensions accessible to a broader segment of the working population and improve second-tier benefits for those who remain in the state system, especially lower paid workers.

Financing

The basic state pension and SERPS are financed on a pay-as-you-go basis from NI contributions paid by workers and employers. The programs are assessed periodically to determine if NI contribution rates are sufficient to maintain program solvency. General revenues may be used if funding shortfalls occur. Employees who remain in SERPS pay 10% of weekly earnings between £76 and £535 (\$109 to \$770). Employees pay a reduced rate of 8.4% if they contract out of SERPS. Because employees who contract out of SERPS do not receive a second-tier benefit from the government, they pay lower NI contributions to reflect the state’s reduced liability. The reduction in NI contributions is known as the contracted-out “rebate.”

Employers pay 12.2% of all weekly earnings over £84 (\$121) for employees who remain in SERPS. If an employee contracts out of SERPS, the employer pays a reduced rate on the first portion of “taxable” weekly earnings (earnings between £84 and £535 (\$121 to \$770)) and the full rate of 12.2% on all additional weekly earnings. A reduced rate of 9.2% applies if the employee participates in an employer *defined benefit* plan and 11.6% if the employee participates in an employer *defined contribution* plan. If the employee has an Appropriate Personal Pension in place of

SERPS, the employee and employer pay NI contributions at the full rate as if they were paying into SERPS (10% for employee, 12.2% for employer) and the government makes a payment directly to the individual's personal pension scheme to reflect the contracted-out rebate.

Table A-1. Employee and Employer National Insurance Contribution Rates in the United Kingdom, 2000/2001

	SERPS	Contracted out of SERPS
Employee rates		
Earnings from £76.01 to £535 per week Employee's earnings threshold: £76 per week <i>Upper earnings limit: £535 per week</i>	10%	8.4%
Employer rates		
Earnings over £84 per week Employer's earnings threshold: £84 per week	12.2%	<i>with an employer defined benefit plan:</i> C 9.2% of earnings above the "employer's earnings threshold" up to and including the "upper earnings limit;" 12.2% of additional earnings <i>with an employer defined contribution plan:</i> C 11.6% of earnings above the "employer's earnings threshold" up to and including the "upper earnings limit;" 12.2% of additional earnings

Note: If an employee contracts out of SERPS using an Appropriate Personal Pension, the employee and employer pay NI contributions at the full rate (10% for employees, 12.2% for employers) and a payment is made directly to the individual's account by the government to reflect the "rebate" on NI contributions. The amount of the rebate, which ranges from 3.8% to 9.0%, is based on the worker's age with higher rebates paid to older workers.

Self-employed workers, who are not eligible for SERPS, pay a flat rate of £2 per week (\$3) plus 7% of net annual earnings between £4,385 and £27,820 (\$6,314 to \$40,061). The self-employed are not required to contribute to a second pension. Approximately half currently contribute to a personal pension.

First Benefit Tier — Basic State Pension

Workers with earnings above a certain level must pay NI contributions to earn entitlement to the basic state pension which provides a small, flat-rate public pension based on years of contributions (regardless of earnings). The basic state pension is available to both employees and the self-employed. Benefits are paid to men at age 65 and to women at age 60 (between 2010 and 2020, the retirement age for women will increase gradually to 65). To qualify for the full basic state pension, a worker must pay NI contributions for at least 90% of his or her working life (currently, 49 years for men, 44 years for women). Individuals may receive credits for periods in education, training, unemployment, disability, caregiving and child rearing. Reduced benefits (a percentage of the full basic pension based on the number of qualifying years) are payable, however, workers must have enough qualifying years to receive at least 25% of the full basic pension (below that amount no benefit is payable). There is no option for early retirement with reduced benefits. Benefits are increased for each year a worker defers retirement beyond the state pension age.

Basic state pensions have been indexed since 1950. During the 1950s and 1960s, pensions were indexed on an *ad hoc* basis. Between 1975 and 1981, pensions were automatically adjusted by the growth in either prices or earnings, whichever was greater. Since that time, they have been indexed automatically to price growth resulting in a decline in pension values relative to average earnings. In 1978, the maximum basic state pension replaced about 25% of the average wage. In 1998, it replaced 16% of the average wage. If earnings continue to rise faster than prices as projected, the value of the maximum basic state pension as a percentage of average wages is projected to fall to 10% by 2030 and 7.5% by 2050.¹⁴

The basic state pension provides only a minimal level of benefits: £67.50 per week (\$97) for a single person and £107.90 per week (\$155) for a couple.¹⁵ There are an estimated 11 million recipients. Spending for the basic state pension is an estimated £33.8 billion (\$49 billion).

Second Benefit Tier — State Earnings-Related Pension Scheme (SERPS)

Under National Insurance, an additional earnings-related benefit (SERPS) is payable when a worker reaches the state pension eligibility age. As originally designed, SERPS provided a benefit equal to 1.25% per year of coverage (up to a maximum of 20 years) times the average indexed amount of the 20 highest years of earnings between the “lower” and “upper earnings limit.” Therefore, SERPS

¹⁴Liu, Lillian. Retirement Income Security in the United Kingdom. *Social Security Bulletin*, v. 62, n. 1, 1999.

¹⁵The Minimum Income Guarantee (MIG), a means-tested benefit for the elderly, provides slightly higher benefits. On a weekly basis, the MIG provides £78.45 (\$113) for single persons ages 60-74 (£121.95 (\$176) for couples); £80.85 (\$116) for single persons ages 75-79 (£125.35 (\$181) for couples); and £86.05 (\$124) for single persons age 80 and older (£131.05 (\$189) for couples).

provided a maximum replacement of 25% ($1.25\% \times 20 \text{ years} = 25\%$) of the best 20 years of average indexed earnings. Combined with the basic state pension, a full-career worker with average earnings received a replacement rate of about 40% (combined benefits replaced about 40% of a worker's earnings in the year before retirement).

SERPS benefit formula changes, included in the Social Security Act of 1986 as a means to reduce future public pension costs, resulted in lower benefits for workers who reach pensionable age after April 5, 1999. In the absence of policy changes described below, SERPS benefits would decline gradually from 25% of the highest 20 years of average indexed earnings to 20% of lifetime average indexed earnings.¹⁶ Furthermore, benefits are based on a worker's earnings between the "lower" and "upper earnings limit." The upper earnings limit is indexed to prices. If wages grow faster than prices as projected, a smaller proportion of earnings would be credited under SERPS and the value of SERPS benefits as a proportion of earnings would decline over time.

As of March 1999, the average SERPS benefit was £29.68 per week (\$43) for men, £16.85 per week (\$24) for women. The maximum SERPS benefit was £125.30 per week (\$180). Currently, SERPS spending is an estimated £4.7 billion (\$6.8 billion).

As early as April 2002,¹⁷ SERPS will be replaced with the State Second Pension. The State Second Pension is designed to benefit primarily lower paid workers (by providing a higher benefit than SERPS)¹⁸ and persons whose careers are interrupted by periods of disability or caring for children or sick family members (by providing earnings credits during non-work periods to protect their entitlement to benefits). Under the State Second Pension, workers with earnings between the annual "lower earnings limit" (the level of earnings at which individuals are automatically covered under the system) and a new, higher "low earnings threshold" will be treated as if they had earnings equal to the low earnings threshold.¹⁹ Similarly, caregivers and disabled persons with little or no earnings for the year will be treated as if they had earnings equal to the low earnings threshold if they meet certain requirements.²⁰

¹⁶The revised benefit formula provides for 1% per year of coverage (instead of 1.25% per year) up to 20 years. In addition, benefits would be based on earnings for all working years since 1978 (the year SERPS benefits were introduced) instead of the highest 20 years of earnings.

¹⁷In July 2000, the Child Support, Pensions and Social Security Act of 2000 established the State Second Pension as a replacement for SERPS. The earliest implementation date for the State Second Pension is April 2002. The actual implementation date depends on the readiness of operational systems needed to administer the program.

¹⁸Because SERPS benefits are based on earnings, career low earners do not build up substantial second-tier benefits.

¹⁹The "low earnings threshold" is £9,500 (\$13,680) in 1999/2000 terms. In the future, it will be indexed to average wage growth.

²⁰Caregivers may qualify for the earnings credit if they receive a *Child Benefit* for a child (continued...)

The State Second Pension will be implemented in two stages. In the first stage, it will provide a benefit based on earnings. Different accrual rates (40%, 10%, and 20%) will apply to three bands of earnings such that persons who have annual earnings between the “lower earnings limit” and an “upper threshold” of £21,600 (\$31,104) will receive a benefit higher than they would have received under SERPS with the largest proportional increases going to the lowest earners. Persons with earnings of £21,600 and higher will receive a benefit equal to what they would have received under SERPS.

In the second stage, which is to be implemented after stakeholder pensions have become established (an estimated 5 years), the State Second Pension will be converted to a flat-rate benefit based on the “low earnings threshold” for persons who have a significant number of working years left. At that point, everyone who remains in the State Second Pension will be treated as if they had earnings equal to the “low earnings threshold” regardless of actual earnings. The conversion to a flat-rate benefit is designed to encourage moderate and higher earners to make private second-tier arrangements such as an employer plan if available or a stakeholder pension.

The government estimates that 18 million people will benefit from the State Second Pension including 14 million low and moderate earners, 2 million caregivers, and 2 million disabled persons. The majority of low earners expected to benefit are female, part-time workers who do not have private pension arrangements.²¹

“Contracting Out” of SERPS

Currently, workers may opt out of SERPS through membership in their employer’s pension plan or an Appropriate Personal Pension.²² Starting in April 2001, employees will have the option to contract out of SERPS using newly established stakeholder pensions. Most workers who contract out of SERPS join an employer-sponsored defined benefit pension plan in which case their contributions and their employer’s contributions to the social security system are reduced by the equivalent of the estimated amortized cost of the pension. Originally, the plan had to offer a guaranteed minimum pension roughly equivalent to what SERPS would have provided, but this requirement was replaced by more general requirements on the

²⁰(...continued)

under age 6 in their care; are entitled to *Invalid Care Allowance*; or receive *Home Responsibilities Protection* (a person is treated as being precluded from regular employment by responsibilities at home if they are caring for a sick or disabled person). Disabled persons who are entitled to *Incapacity Benefit* or *Severe Disablement Allowance* may qualify for the earnings credit if they have paid NI contributions for at least one-tenth of their working lives since 1978 (when SERPS benefits were introduced) by the time they reach the state pension eligibility age.

²¹U.K. Department of Social Security. *The Changing Welfare State: Pensioner Incomes*. March 2000.

²²Employers are permitted to contract out employees who are members of an employer pension plan that meet the qualifying criteria. In effect, the option of contracting out is the employees’ as they decide whether to join or remain in such plans. If they do not, they must participate in SERPS or an Appropriate Personal Pension.

structure of the plan effective April 1997. Since 1988, workers have had the option of choosing an employer-sponsored defined contribution plan or an Appropriate Personal Pension. In either case, the contribution rate must at least equal the contracting-out rebate or the amount that would produce the minimum pension requirements. Employees can make additional voluntary contributions to increase the value of the pension. For the first 5 years, the government encouraged workers without an employer pension to opt out of SERPS into an APP by providing rebates on part of their National Insurance contributions plus a 2% bonus and the option to reenter SERPS. From 1993/1994 through 1996/1997, the 2% bonus was reduced to 1% for those age 30 and over. Initially, the government estimated that about 500,000 people would contract out of SERPS in favor of personal pensions with the number eventually expected to reach 2 million. By 1995, almost 6 million workers had opted for personal pensions (5.4 million having left SERPS and the remainder having left occupational pension plans).²³

The tax system provides another incentive to contract out of SERPS. Worker and employer contributions to both employer and private pensions are tax deductible, and no tax is payable on income or capital gains of the pension funds. Pension benefits are fully taxable although the tax code provides additional tax breaks for retirees.

The government requires that, except for civil service and military pensions, employer pensions must be fully funded for workers to be allowed to contract out of SERPS. All but 5% of the investments of the pension fund must be outside the company and can revert to the company only in limited circumstances. Unlike employer-sponsored defined benefit plans in the U.S., they must preserve the value of the benefits of employees who leave the firm before retirement by indexing the final salary by the rate of inflation, up to 5% per year. In addition, unlike in the U.S., the government requires that employer defined benefit pensions provide beneficiaries annual increases in benefits indexed to inflation, up to 5% per year. (In the U.S., there is no government requirement that employer-provided pensions must index benefits to inflation. Most plans do not adjust benefits after retirement, and those that do usually do so at a rate well below that of inflation.)

Currently, there are two types of personal pensions. An “Appropriate Personal Pension” is a personal pension taken out in place of SERPS. An “ordinary” personal pension is an individually-arranged personal pension usually taken out by the self-employed (who are not covered under SERPS) or as an addition to SERPS or an employer pension. With either type of personal pension, a worker may withdraw up to 25% of assets as a tax-free lump sum upon retirement. Otherwise, the assets must be used to purchase an annuity from a life insurance company which pays the retiree an agreed upon income for the rest of his or her life. Flat payment annuities or annuities indexed to inflation are available. The part of the personal pension that replaces SERPS, however, must be indexed to inflation, up to 5% per year. Because some workers retire at a time when annuities are very expensive, rules allow them to defer their purchase until age 75.

²³Congressional Budget Office. *Social Security Privatization: Experiences Abroad*. January 1999.

Starting in April 2001, stakeholder pensions will be available as an alternative to SERPS.²⁴ Stakeholder pensions are fee-capped, defined contribution plans designed to benefit primarily moderate and higher earners who do not have access to an employer-sponsored plan and for whom existing personal pensions are not a good value (including the self-employed who are not covered by SERPS). Designed as a low cost, portable private pension option, stakeholder pensions are intended to benefit persons who change jobs frequently or work intermittently. They will be sold in the workplace by insurance companies, banks and other financial institutions. Self-employed workers will be able to purchase them directly from providers.²⁵

By October 2001, employers with five or more employees are required to offer persons with at least 3 months' service access to a stakeholder pension scheme if an occupational scheme or a group personal pension is not offered (employees are not required to join the stakeholder scheme).²⁶ Employers are not required to make contributions, but they must process employee contributions through the payroll system.²⁷ Employees may change payroll deductions every 6 months. Minimum contributions may be set no higher than £20 (\$29). Contributions of up to £3,600 per year (\$5,184) are allowed regardless of earnings with higher contribution amounts subject to existing personal pension age and earnings-related limits (ranging from 17.5% of annual earnings for persons age 35 and under to 40% of annual earnings for persons age 61 and older).²⁸ Employees may stop and restart contributions and transfer into and out of stakeholder schemes without penalty. Under stakeholder

²⁴In November 1999, stakeholder pension schemes were established by the Welfare Reform and Pensions Act of 1999. Both occupational and personal pension schemes may acquire "stakeholder" status if they meet certain requirements and are registered as a stakeholder scheme with the Occupational Pensions Regulatory Authority (OPRA).

²⁵Stakeholder pensions will be available to non-earners as well (including children) subject to an annual contribution limit of £3,600 (\$5,184). Employees in occupational schemes may contribute to a stakeholder pension at the same time if their annual earnings do not exceed £30,000 (\$43,200). The government estimates that about 90% of employees contributing to an occupational scheme will qualify for stakeholder pensions.

²⁶Employers are exempt if they provide an occupational scheme which all staff are eligible to join within 1 year of employment (excluding new employees within 5 years of retirement and those under age 18); provide a group personal pension for all staff to which they contribute at least 3% of employee earnings; or all staff have earnings below a specified amount (the "lower earnings limit").

²⁷Employees may make contributions directly to the scheme.

²⁸Under new pension rules, the £3,600 non-earnings-related contribution limit also applies to personal pensions. Previously, contributions to personal pensions were linked entirely to earnings (contribution limits were specified as a percentage of income based on the age of the worker). As a result, persons without income (nonworking spouses, caregivers, etc.) were precluded from contributing to a personal pension. Similarly, workers who had been contributing to a personal pension were not allowed to continue making contributions during temporary periods out of the labor force. Under the new guidelines, individuals may contribute up to £3,600 per year (\$5,184) to a personal pension regardless of earnings. Higher contribution amounts are allowed subject to existing age and earnings-related limits. For personal and stakeholder pensions, earnings-related contributions may continue for up to 5 years after earnings have ceased.

pension schemes, annual charges are based on a percentage of fund assets up to a ceiling of 1%. It is said that given the ceiling on charges, investment options will likely be limited. If more than one investment fund is offered, the stakeholder scheme must designate a default investment fund.

Additional Information on Stakeholder Pensions and the State Second Pension is Available at the Following U.K. Web Sites:

U.K. Department of Social Security:	[http://www.dss.gov.uk]
Inland Revenue:	[http://www.inlandrevenue.gov.uk]
Occupational Pensions Regulatory Authority:	[http://www.opra.gov.uk]