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SOCIAL SECURITY PRIVATIZATION IN BRITAIN: KEY LESSONS FOR AMERICA'S REFORMERS

INTRODUCTION

Many young Americans are becoming increasingly anxious about the future of their Social Security benefits. Their fears are not misguided. Based on the latest official estimates,[1] Social Security benefit costs will exceed contributions within 15 years. Assuming the Social Security Trust Fund assets in government bonds are fully paid, the system will be unable to pay promised benefits by the year 2029. Clearly, it is a system badly in need of reform.

At the same time, workers in Britain, traditionally the closest ally of the United States, enjoy a veritable treasure trove of private pension funds. Britain's pension pool—already worth over £650 billion (over $1 trillion U.S. dollars)—is rapidly approaching the value of the country's annual economic output. In fact, it is larger than the pension funds of all other European countries combined.[2]

The reason? Instead of being locked into a rigid, financially troubled government-run system, millions of British workers can take advantage of a law that permits them to invest a portion of their payroll taxes in private retirement plans. Consequently, at a time in which young workers in the United States can expect only lower—even negative—returns on the taxes they pay into the current Social Security system,[3] workers in Britain enjoy solid returns from a substantially privatized pension system that allows them to invest a

1 *Communication from the Board of Trustees, Federal Old Age and Survivors Insurance and Disability Insurance Trust Fund* (Trustees' Report), House Doc. 105–72, 105th Cong., 1st Sess., April 24, 1997, pp. 28–29.

2 Peter Lilley, Secretary of State for Social Security, press statement, March 5, 1997, p. 1.

3 For a discussion of this issue, see Stuart M. Butler, "A Consumer's Checklist for Social Security Reform Plans," Heritage Foundation *F.Y.I.* No. 141, April 29, 1997; see also Daniel J. Mitchell, "Creating a Better Social Security System for America," Heritage Foundation *Backgrounder* No. 1109, April 23, 1997.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

portion of their payroll taxes in private stocks and equities. In Britain today, about three-quarters of all workers are enrolled in private pension plans.[4] In the United States, however, private-sector workers are not allowed to invest any portion of their 12.4 percent Social Security payroll tax in private stocks and equities or private retirement plans for their future retirement; all of their payroll taxes must go into the U.S. government's Social Security system with little guarantee that this "investment" will pay off down the retirement road.

Britain's Quiet Pension Revolution

The British social security reform effort tackled many of the problems that plague the U.S. Social Security system. Before Members of Parliament and other leaders could suggest solutions, however, they had to recognize that the government system had serious problems. Their solution was to enact a two-tiered system that offered security, flexibility, and a positive return on the investment of mandatory payroll tax money.

Under the British system of social security, a first tier pays a flat-rate basic pension, and a second tier pays pension benefits based on earnings while in the workforce.[5] All eligible employees are entitled to a safety-net Basic State Pension, but they also have a choice: remain in an American-style government pension program called the State Earnings Related Pension Scheme (SERPS) or divert a specified portion of their payroll taxes (known as "national insurance contributions") into a private company–based plan or personal pension plan. In this second tier, British employees must be enrolled either in SERPS or an approved private pension plan. (See Chart 1.) If they opt out ("contract out") of SERPS, they give up that portion of their government benefit when they retire, but they also can receive a bigger and better pension with higher returns on their private investments. Workers may contract back into SERPS, with certain restrictions, if they are unhappy with the private option.

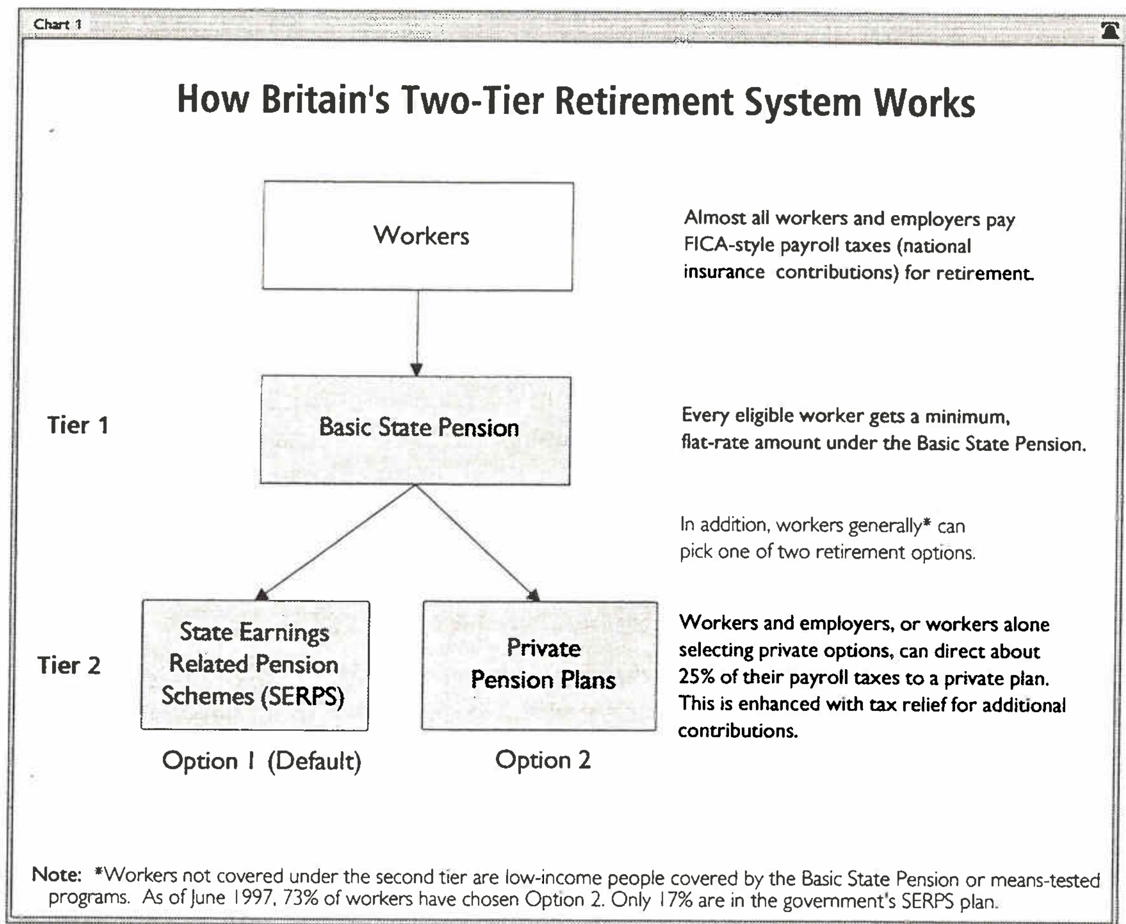
By restructuring their state pension system and allowing consumer choice and competition among private pension plans, the British have managed to amass huge retirement savings while controlling entitlement spending. According to Roderick Nye, director of the London-based Social Market Foundation, the Organization for Economic Cooperation and Development (OECD) "estimates that by 2030 the UK will have paid off its entire national debt; in France and Germany, where earnings-related pensions are paid out of contributions from those currently in work, the national debt will have doubled to exceed national income if current pension policies are maintained."[6] John Blundell, general director of London's Institute for Economic Affairs, reports that "Every European Union state except Britain has a huge overhang of debt, driven by the political bribe of offering something for nothing. We are probably no more virtuous as a people, but we have a far happier financial horizon."[7]

4 Andrew Dilnot, Richard Disney, Paul Johnson, and Edward Whitehouse, *Pensions Policy in the UK: An Economic Analysis* (London: Institute for Fiscal Studies, 1994), p. 9.

5 Personal communication from Sharon White, First Secretary of Economic Affairs, British Embassy, April 13, 1997. On the popularity of contracting out, see remarks of Iain Duncan-Smith, M.P., in *The Daily Mail,* April 13, 1994, p. 8.

6 Roderick Nye, "Pension Reform: Is Britain the Model?" *The Financial Times* (London), April 15, 1996, p. 16.

7 John Blundell, "The EMU Threat to Our Pensions," *The 1996 Annual Newsletter of the European Union of Women,* p. 4.



The U.S. Advisory Council Report[8]

In the United States, by contrast, members of the Social Security Advisory Council were tasked in 1994 with studying ways to ensure the long-term solvency of the Social Security system.[9] The council's report, released in January 1997, proposed several solutions, including a partial privatization of the 62-year-old U.S. system, routinely dubbed the deadly "third rail" of American politics because of its politically sacrosanct character. Even though the report's major proposals differed in crucial details, the Advisory Council urged unanimously that Social Security funds be invested in private stocks and equities to help ensure solvency and generate a higher rate of return on Americans' tax dollars.

One of the proposals endorsed by five of the 13 members of the Advisory Council contains elements that closely resemble the key components of the reformed British system. Under this proposal, 5 percent of the existing Social Security payroll tax would be used to foster the creation of private pension accounts.[10] Although the Advisory Council report outlines a broad proposal for reform, the British experience offers a more detailed guide that can help Congress expand private pension opportunities in the United States and avoid pitfalls on the path to Social Security reform.

8 For a brief discussion of the Social Security Advisory Council report, see Robert E. Moffit, "Reforming Social Security: Understanding the Council's Proposals," Heritage Foundation *F.Y.I.* No. 128, January 24, 1997.

9 Although there was some general agreement regarding needed changes, there was not a consensus on any long-term solution.

To help them prepare their report, members of the Advisory Council had been briefed on the experiences of other countries, and several economists and scholars had suggested that Congress and the Clinton Administration use Chile's successful reforms of 1981 as a model for reform in the United States.[11] But even though the Chilean effort is impressive and valuable as a design, the political and economic conditions in Chile at the time of its reforms were very different from those in the United States today. Thus, Chile's usefulness as a relevant model for reform in the United States is limited.

In terms of culture, Britain is closer to the United States than is Chile. The British and American people have similar demographic and economic problems, a common language, and deep historical ties. Thanks to these similarities, Congress and the Administration can rely on the lessons learned from the successful British experiment to assure a solid and prosperous retirement for future generations of Americans.[12] But there is little time to waste. The longer policymakers delay in making the necessary changes, the more likely American taxpayers will have to make up for current unfunded liabilities within a shorter period of time.

BRITAIN'S BRIGHTER FINANCIAL FUTURE

The failure to tackle entitlement spending, especially public pensions, threatens several countries in Western Europe with the associated mountainous and unsustainable levels of public debt. In 1995 and 1996, for example, the governments of Italy, France, and Germany tried, but failed, to reform their state pension systems. The British are a bright exception.

Today, Britain ranks behind only the United States and Japan in the sheer size of its financial assets. Frank Field, cabinet minister for welfare reform in the Labor government and former chairman of the Social Security Committee of the House of Commons, recently observed that the "pension industry is one of Britain's most successful corporate sectors, alone accounting for much of the country's financial power. Unlike our European counterparts, who often hold pension assets in the book reserves of company accounts, Britain's fund assets are released into the world's capital and currency markets."[13]

In January 1996, then-Social Security secretary Peter Lilley explained how well Britain's position on pensions fared when compared with those of other developed countries:

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10 "The best of the three plans proposed in January by a commission that examined Social Security recommended a British-like plan with a safety net of basic benefits and an additional private savings account program." "Retirement: Unthinkable Thoughts," *The Florida Times Union* (Jacksonville), March 17, 1997, p. A–18. Carolyn Weaver, a member of the Social Security Advisory Council and director of Social Security and Pension Studies at the American Enterprise Institute, dubbed Britain's achievement a "quiet revolution." For her account of the Advisory Council's privatization option, see Carolyn L. Weaver, "Creating a New Kind of Social Security," *The American Enterprise,* January/February 1997.

11 Chile's experience with privatization inspired the more dramatic 1997 British reform proposals. The most notable work on the success of the Chilean system is that of Dr. José Piñera, labor minister of Chile from 1978 to 1980. See José Piñera, "Empowering Workers: The Privatization of Social Security in Chile," *Cato's Letters,* No. 10 (1996). See also Peter Passel, "How Chile Farms out Nest Eggs; Can Its Private Pension Plan Offer Lessons to the US?" *The New York Times,* March 21, 1997, p. C–27.

12 Heritage Foundation analysts long have argued that the British experience is a fruitful source of wisdom on Social Security reform. See, for example, Peter Young, "Britain Improves Social Security: A Model for the U.S.," Heritage Foundation *International Briefing,* December 2, 1985.

13 Frank Field, *Private Pensions for All: Squaring the Circle* (London: The Fabian Society, 1993), p. 15.

Table 1

1993 Pension Fund Assets as Share of Gross Government Debt

	General Government Gross Debt in Billions of U.S. Dollars	Pension Funds Assets in Billions of U.S. Dollars	Pension Funds Assets as a Share of Government Debt
U.K.	$428.08	$717.25	167.55%
Japan	1,910.74	1,800.00	93.71
U.S.	3,858.20	3,546.00	91.91
Germany	944.84	105.95	11.21
France	631.99	41.10	6.50
Italy	1,138.63	11.65	1.02

Sources: Koen Dr Ryck, *European Pension Funds: Their Impact on European Capital Markets and Competitiveness,* European Federation for Retirement Provision, 1996; Japanese Embassy.

> The OECD forecast each country's national debt assuming they continue with their present pensions systems and levels in taxes and charges. By 2030 in France and Germany, the national debt will have about doubled and will exceed national income. In Japan, which is ageing particularly fast, debt will reach three times national income. By contrast, Britain's second tier funded pensions place us in a unique position. The OECD forecasts that we will have paid off our entire national debt and started to build up assets.[14]

Britain's promotion of private pensions has been combined with a careful but decisive reduction in the growth of the state pension system. The present value of the country's "net public pension liabilities" is estimated at 5 percent of gross domestic product (GDP), which is noticeably below comparable figures for the United States and such other economic giants as Germany and Japan.[15] The lesson for the United States is clear: Carefully planned and executed policies governing entitlements can have a positive impact on the overall financial health of the country, particularly its public debt.

This partially privatized pension system has made substantial gains for British workers and retirees over the past decade. From 1986 to 1995, the gross rate of return for median private pension funds was 13.3 percent per annum.[16] Data supplied by 1,500 pension funds in 1996 for company-based retirement plans showed that 50 of Britain's largest occupational funds registered returns of 10.5 percent overall and 16.4 percent in British

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14 Quoted in letter to the author from Roderick Nye, director of the Social Market Foundation, July 10, 1997. According to Nye, these observations were "based on the OECD Economics Department Working Paper No. 156, *Ageing Populations, Pensions Systems and Government Budgets: How Do They Affect Saving?* Published in 1995."

15 "The outstanding feature of the UK pension system is that, under current policies, public expenditure on pension provision will remain modest, compared with other industrial economies. For example, [International Monetary Fund analysts] Chand and Jaeger (1996) estimate the present value of the difference between the UK's public pension expenditure and revenue up to 2050 is 5 percent of GDP with existing policies and contribution rates. This compares with a ratio of 26 percent for the US and above 100 percent in Japan, Germany and France." Alan Budd and Nigel Campbell, *The Roles of the Public and Private Sectors in the UK Pension System,* Her Majesty's Treasury, at *http://www.hm-treasury.gov.uk/pub/html/docs/misc/pensions.html.*

16 The annual increase in the retail price index during that same period was 4.6 percent. Personal communication from Peter Barnes, Department of Social Security, April 2, 1997.

Table 2

1993 Pension Funds Assets as Percentage of GDP

	GDP in Billions of U.S. Dollars	Pension Fund Assets in Billions of U.S. Dollars	Assets as a Share of GDP
U.K.	$903.12	$717.25	79.42%
U.S.	6,000.31	3,546.00	59.10
Japan	4,025.47	1,800.00	44.72
Germany	1,824.02	105.95	5.81
France	1,194.69	41.10	3.44
Italy	947.27	11.65	1.23

Sources: Koen Dr Ryck, *European Pension Funds: Their Impact on European Capital Markets and Competitiveness,* European Federation for Retirement Provision, 1996; Eurostat.

equities. A large sample of smaller firms registered returns of 11 percent overall and 17.1 percent in British equities.[17]

The Crucial Lessons

Britain's experiment in social security reform has accomplished several major goals. It has helped control entitlement spending; it has raised the standard of living for elderly persons; and it has given young people broad personal choice in deciding how best to invest their own money and control their own futures. The British experience, therefore, offers many valuable lessons for the U.S. Congress:

- **Offering the choice of enrolling in private pension plans is likely to be very popular.** Today, about 73 percent of British workers are in private plans; only 17 percent are left in SERPS.[18] Of the private pension holders in Britain today, 5.6 million have opted out since 1988 to open appropriate personal pension plans (the British version of tax-favored individual retirement accounts).[19]
- **Structural reform can mean a substantial increase in the standard of living of retirees.** From 1979 to 1993, the average incomes of British pensioners (before housing costs) rose by 60 percent—more than for any other segment of the British population. The largest increase in retirees' income during this period came from private pensions and investment income.
- **Social Security reform involves providing acceptable tradeoffs for younger workers.** Moving from a financially troubled pay-as-you-go system to a funded system that relies heavily on private stocks and equities involves a price for younger workers: They will have to pay not only for their own benefits, but for those of the older generation of retirees as well. The British experience shows that younger workers are prepared to accept that tradeoff. They believe they would be better off in a portable system of personal pension plans with solid rates of return on investment than in a system plagued by political

17 The WM Company, *1996 UK Pension Fund Industry Results,* 1997.
18 Budd and Campbell, *The Roles of the Public and Private Sectors in the UK Pension System.*
19 Personal communication from Sharon White, *op. cit.*

manipulation, politicians' broken promises, and incessant threats of higher taxes or reduced benefits.

- **Effective rules must be put in place to protect consumers and prevent fraud and abuse during any transition period.** Even the British experience has not been trouble-free. Without effective consumer protection, too many British workers moved from more generous employer-based plans, diverting a portion of their payroll taxes to less generous personal pension plans. The transition to personal pension plans initially was marred by instances of fraud and abuse, misrepresentation of private plan options, and inadequate disclosure of administrative costs and risks. To their credit, British officials recognized these problems and acted to correct them.

- **It is important to focus on structural reform, not short-term budgetary savings.** Reforms should make significant structural changes in the Social Security system, but their implementation should be timed so that current beneficiaries and workers will not be harmed. The British success in carefully crafted pension reform has been reinforced by solid guarantees to workers and retirees. With rising pension incomes and strong returns on private investment, the British reforms have proven to be a good deal for ordinary people. Congress should structure Social Security reform so that, on balance, as many Americans as possible will be better off with reform than without it.[20]

- **Major structural reform can win bipartisan support.** One of the most remarkable lessons of the British experience is that structural reform is possible in a Western democracy long committed to social insurance. Outside the normal inter-party sniping typical in a democracy, there has been a remarkable degree of bipartisan support in recent years for Britain's opting-out system, and the new Labor government under Prime Minister Tony Blair is likely to consolidate and extend these reforms. The Labor Party has long supported private occupational pension plans and has published no plans to dismantle the privatized program now in place. "Labour is not going to change that," notes Paul Johnson of the London-based Institute for Fiscal Studies. "All it is committed to is continuing to raise the basic pension in line with prices."[21] Labor's leadership has been considering how, not whether, to expand private pension options for British workers and their families.[22]

- **Certain technical considerations must be addressed to make reform successful, and the British experience can provide solid guidance in these areas.** Specifically, policymakers will have to decide such issues as how to pay the inevitable transition costs, how to calibrate the degree of income transfer from younger workers to retirees, how to clarify the economic value of a basic government pension, and how to integrate part-time or low-income workers into a newly privatized system.

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20 Interview with Daniel Finkelstein, director, Conservative Research Department, British Conservative Party, London, March 6, 1997.

21 Paul Johnson, "Brown Is Just Starting, He'll Get Much Tougher," *The Evening Standard,* May 7, 1997, p. 18.

22 Jill Sherman, "Brown to Stay on Cautious Route," *The Times* (London), March 6, 1997, p. 9.

HOW THE BRITISH PENSION SYSTEM WORKS

Britain's state pension program represents a complex accretion of policies and programs enacted and implemented by Conservative and Labor governments since the end of World War II.[23] Today's system is grounded statutorily in the National Insurance Act of 1946, a major initiative of the postwar Labor government of Prime Minister Clement Attlee, which replaced Prime Minister Winston Churchill's Conservative government in 1945.[24]

Table 3

British National Insurance Contributions (Payroll Taxes), 1997-1998

Weekly Earnings in British Pounds	Tax Rate for Employees	Tax Rate for Employers
Below £62	0%	0%
62 to 109.99	10% of earnings above 62 pounds, +2% of 62 pounds	3
110 to 154.99	10% of earnings above 62 pounds, +2% of 62 pounds	5
155 to 209.99	10% of earnings above 62 pounds, +2% of 62 pounds	7
210 to 465	10% of earnings above 62 pounds, +2% of 62 pounds	10
Above 465	no additional taxes levied	10

Note: One pound = $1.60.
Source: British Embassy, Washington D.C., March 1997.

Under the National Insurance Act and subsequent legislation, all British workers with earnings above a "lower earnings limit" (LEL) and their employers contribute to a National Insurance Fund. These contributions are roughly equivalent to the payroll taxes used to finance Social Security and Medicare in the United States.[25] Combined employer and employee payments range from 15 percent to 22 percent of earnings, with the proportion of the employer contribution rising as a worker's income increases. Employees contribute if their earnings fall between a lower earnings limit of £62 ($99.20) per week and an upper earnings limit, or UEL, of £465 ($744) per week. An employee's contribution is 2 percent of earnings up to the LEL and 10 percent of earnings in excess of the LEL. Employers at this LEL pay 3 percent of all earnings. At the upper earnings limit, the employee contributes 2 percent of all earnings up to the LEL and 10 percent of all earnings up to £465 ($744) per week (the UEL). The employer, however, contributes 10 percent of all earnings for these high-income employees. The employee pays no additional payroll tax on earnings above the UEL, and the employer continues to pay 10 percent of the employee's earnings with no upper limit.

23 In 1909, prodded by Liberal Chancellor (later Prime Minister) David Lloyd George, the British government established a limited pension that provided a meager weekly sum for persons aged 70 years and older.

24 The postwar Labor initiative on government pensions was rooted in the work of Sir William Beveridge, a member of the Churchill Ministry whose 1942 report, *Social Insurance and Allied Services,* became the basis for the modern British state pension system.

25 These figures are for the fiscal year covering April 6, 1997, through April 5, 1998. The dollar equivalent is based on an exchange rate of $1.60 for the British pound, based on February 1997 data. The actual exchange rate on any given date is dependent on supply and demand for currencies in the foreign exchange markets.

The National Insurance Fund is managed by the Department of Social Security, which administers a variety of social programs as well as the state (national) pension system. The fund pays out pension benefits as well as unemployment benefits, and both depend on the employee's record of contributions.[26] Like the U.S. Social Security system, it is run on a pay-as-you-go basis: Current "contributions" (taxes) pay for current "expenditures" (benefits). The National Insurance Fund's accounts are held at the Bank of England, but it has no borrowing authority; by law, the fund must maintain a positive balance for the payment of pensions and other government benefits, and its money may be invested only in government and "local authority" municipal stocks.[27]

A Two-Tiered System

Over 10 million retirees are enrolled in Britain's pension system. This system has two distinct levels, or tiers: (1) the Basic State Pension and (2) the State Earnings Related Pension Scheme (SERPS) or private pension options. Workers may opt out of the second tier of the state pension system, but not the first.

Tier #1: The Basic State Pension. All British workers, subject to age and eligibility requirements, are entitled to the Basic State Pension, often referred to as the Old Age Pension. Today, the Basic State Pension pays single retirees £62.45 ($99.92) and couples £99.80 ($159.68) per week.

Beyond the Basic State Pension, the elderly also may be entitled to Income Support, a means-tested welfare program based on income and financed separately through general revenue. In addition, the elderly poor are eligible for the Council Tax Benefit, a form of assistance to offset property tax payments, and a housing subsidy called a Housing Benefit that is available to the poor on a sliding scale. Those officially designated as elderly poor, for example, are entitled to a subsidy equal to 100 percent of their housing costs. For older pensioners, the level of Income Support is likely to exceed the Basic State Pension, and the older the pensioner, the wider the disparity. Of the more than 10 million retirees in Britain, approximately 1.5 million receive some Income Support and another 2 million receive means-tested assistance with their housing costs.[28]

Traditionally, increases in the state pension were tied to wage increases. In the 1960s, the Basic State Pension was equivalent to 20 percent of average earnings. In the 1980s, however, in an effort to control soaring costs, the British government broke the link between pension and wage increases and substituted price increases as the basis for future pension increases. Such price increases, similar to adjustments in the Consumer Price Index in the U.S. Social Security system and Civil Service Retirement System, are generally slower than wage increases. Thus, even though the purchasing power of the Basic State Pension has not changed, it is now the equivalent of 14 percent of average earnings.[29] Because of the changes made in 1989, however, British retirees—unlike retirees in the United States—no longer are penalized by the "earnings rule," which

26 Disability benefits in Britain are paid out of general revenues.

27 *Social Security Department Report: The Government's Expenditure Plans 1997–1999*, presented to Parliament by the Secretary of State for Social Security and Chief Secretary to the Treasury by Command of Her Majesty, March 1966, p. 8.

28 Paul Johnson, *The Reform of Pensions in the UK*, manuscript, Institute for Fiscal Studies, 1996, p. [2].

29 Steve Bee, Prudential Corporation, Presentation to the Committee on Social Security, House of Commons, February 1997, p. 3.

reduces the state pension if a worker chooses to work past the age of retirement.[30]

Tier #2: The State Earnings Related Pension Scheme or Private Pension Options. Workers may enroll in SERPS, often referred to as the "additional" state pension, or invest part of their payroll tax in an approved pension plan. It is mandatory that employees enroll in one of these options.

Established by the Labor government in 1978, the SERPS component of the state pension system was designed to give retirees more generous benefits related to the real value of employees' earnings. Because of the disparity in future retirement prospects between British workers with occupational pensions and those without, SERPS was, in effect, an attempt to level the playing field for British retirees who were not enrolled in private occupational pension plans.

Only British workers employed by a company and with earnings above the LEL are eligible for retirement benefits under SERPS. Self-employed workers and the unemployed are not. Like the Basic State Pension, SERPS is financed by payroll taxes on a pay-as-you-go basis.[31] It was designed to provide for a pension based on 25 percent of the average of the best 20 years of earnings (later amended to 20 percent) in addition to the basic flat-rate pension funded out of the National Insurance Fund.

How British Workers May Opt Out of SERPS

British workers may contract out of SERPS (but not the Basic State Pension) and enroll in an approved occupational pension plan or certain types of personal pension plans.[32] According to the Department of Social Security, "The Government's view is that where people are able to provide for themselves they should be encouraged to do so."[33] Two private options are available for workers who opt out of SERPS: an occupational pension plan based on employment and a personal pension plan similar to an individual retirement account.

Occupational plans. In consultation with employers, workers may substitute an occupational pension plan for the second tier of coverage, with a portion of their payroll taxes (national insurance contributions) used as a rebate to offset the cost of a private "occupational pension scheme." The value of this tax rebate of payroll taxes (national insurance contributions) varies over the years and is determined periodically by the secretary of state for social security based on the recommendation of the British Government Actuary. Today, employers receive a rebate of 3 percentage points on their payroll taxes, and employees receive a rebate of 1.6 percentage points of earnings for money paid into an employer-sponsored pension plan.

30 David Blake, *Pension Schemes and Pension Funds in the United Kingdom* (Oxford: Clarendon Press, 1995), p. 66.

31 In practice, SERPS payments are funded not only from payroll taxes, but also from general revenues.

32 Under the National Insurance Act of 1959, which took effect in 1961, private employers and employees were able to contract out of the State Graduated Retirement Pension Scheme, the "additional" state pension program that existed before SERPS was established in 1978. "About 4.5 million employees had been contracted out. These, nearly twice the number expected, included most public service and nationalized industry workers, and about a quarter of the employees who were members of private occupational schemes." Blake, *Pension Schemes and Pension Funds*, p. 15.

33 *Social Security Department Report*, p. 41.

Beyond the tax rebate, employers may contribute an amount above the basic contribution required to contract out of the government pension system and receive tax relief. An employee may contribute up to 15 percent of his regular earnings to such a plan tax-free.[34] The tax-free limit for employer and employee contributions combined is 17.5 percent of employee earnings. Today, the average contribution rate for such occupational plans (or schemes in British parlance)[35] is 5 percent of earnings by the employee and 10 percent by the employer. These contributions receive tax relief at the highest marginal rate of income tax for both the employee and the employer. Additionally, the investment returns are free of both income and capital gains taxes.

Occupational plans must be approved by the government, but they are managed privately. They may be defined benefit plans based on years of service and final salary or defined contribution plans based on contributions to a fund and a return on investment. All, however, must provide—in the judgment of the British government—benefits at least as good as those available under SERPS.

When private companies contract out of SERPS, usually in consultation with employees or their representatives, their managers and workers give up their state pension benefits under the program. In contracting out, however, the company must provide a "guaranteed minimum pension" for each worker that is roughly equal to the benefits he would have had under SERPS. If private companies and their workers wish to buy back into SERPS at a future date, they may do so. This requires that the private-sector trustees pay a special "state scheme premium" to the Department of Social Security, after which the department restores the SERPS benefits to the employees.[36]

Most private company plans set up after consultations with employees or trade union representatives are defined benefit plans in which workers' pensions are calculated on the basis of years of work and a final salary amount based on an average of earnings over a certain period of years before retirement. Employers also may offer an extra ("top-up") pension plan above the standard occupational plan, but neither the contribution nor the investment income from such an additional plan receives any tax advantage. Today, industry-wide and company-wide occupational pension plans that combine tax advantages with an employer's contribution typically provide the best pensions for British workers and make British retirees among the most financially comfortable in the world.[37]

Occupational pension plans existed long before the modern state pension system. In Britain, they can be traced as far back as 1375.[38] By the 1960s, approximately half of all British workers were covered by such plans,[39] which are governed by a rich body of law.

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34 There are higher tax-free contributions ranging from 20 percent to 27 percent for older workers from 51 to 74 years of age. Blake, *Pension Schemes and Pension Funds,* pp. 87–88.

35 In the British context, the word "scheme" does not connote anything sinister, as it would in American usage; it merely refers to a program or plan. SERPS is called a "contracted in" scheme.

36 Under the Pensions Act of 1995, effective in 1997, there will be new statutory standards governing the administration of occupational pensions, including pension payments and exchanging pensions for lump sums, and a new statutory standard for private pension plans. For an updated discussion of the process of "contracting out," see *Pensions Act 1995: Contracting Out Made Simple* (London: National Association of Pension Funds, 1997).

37 Blake, *Pension Schemes and Pension Funds,* p. 156.

38 Personal communication from Professor David Simpson, economic adviser to Standard Life Assurance Company of the United Kingdom, February 28, 1997. The schemes were devised by medieval guilds: "The first recorded occupational pension scheme was that of the Guild of St. James of Garlekhithe of London in 1375." Blake, *Pension Schemes and Pension Funds,* p. 27.

Under the Pensions Act of 1995, the British government requires indexation of occupational pension payments, with benefits increased according to inflation or up to a maximum of 5 percent annually, whichever is the lesser amount.[40] The government also imposes a minimum funding requirement to guarantee coverage of the value of the benefits and a system to compensate employees if the sponsoring employer becomes insolvent or employees lose pension funds because of illegal actions on the part of employers.

Men and women enrolled in such plans must be treated equally. In addition, they have a legal right to transfer their pension rights either from one company plan to another or to a personal pension plan. Occupational plans may invest no more than 5 percent of their assets in the employer's company, are to be actuarially re-evaluated every three years, and must permit persons to pay tax-free "additional voluntary contributions" into their pension funds. These funds are managed, subject to trust law, by a board of trustees that may invest the funds or appoint a fund manager to make the investments. To receive favorable tax treatment, these plans must receive contributions from employers; must meet certain benefit levels; must be set up as irrevocable trusts separate from employers; and must spell out clearly the rights and obligations of workers, trustees, and employers.[41] For example, British employers today may not force employees to join company-based pension plans.

As noted, these private pension plans must satisfy a legal "requisite benefits test" by providing benefits roughly equal to those provided by SERPS. Plans also are certified by the Pension Schemes Office, an agency of the Inland Revenue (Britain's equivalent of the U.S. Internal Revenue Service). In the case of an employer-sponsored "money purchase scheme" (a defined contribution plan), the total contribution must be at least at the level of the contracted-out rebate, currently set at 4.6 percent of earnings. Typically, the employer will fund a pension on a matching basis with the employee, and a typical scheme will have a 5 percent employee and a 5 percent employer contribution. Today, 62 percent of all British pensioners and 70 percent of pensioner couples have an occupational pension. During the 1979 to 1994 period, the incomes from such pension plans rose by 60 percent.[42]

Personal pension plans. The second option available to British workers, both employees and the self-employed, is to contract out of SERPS and enroll in an appropriate personal pension (APP) plan. These "money purchase" plans are sponsored by various organizations, including banks and building societies (mortgage companies), insurance companies, unit and investment trusts (mutual funds), and mutual associations or "friendly societies." Under current law, if a worker is already enrolled in an occupational plan and getting a rebate, he may not enroll in an APP also.

Workers who want to participate in an APP must continue to pay the national insurance contributions, but the Department of Social Security then pays a tax rebate from these payroll taxes (currently 4.6 percent of earnings) into an APP of the worker's choice.[43]

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39 Johnson, *The Reform of Pensions in the UK,* p. [2].

40 Association of Consulting Actuaries, *The Changing Face of UK Occupational Pensions in Smaller Companies,* September 1996, p. 24.

41 *State, Occupational and Personal Pension Arrangements in The United Kingdom* (London: National Association of Pension Funds, 1997), pp. 8–9.

42 *Reshaping Our Social Security System,* Conservative Government Talking Points, March 1997, p. 22.

43 *National Insurance Fund Long Term Financial Estimates: Report by the Government Actuary on the Third Quinquennial Review Under Section 137 of the Social Security Act of 1975,* ordered by the House of Commons to be printed January 31, 1995, p. 30.

This rebate is the minimum permissible level of contribution to such a personal pension plan, although workers may make additional contributions as well.

From 1988 to 1992, to encourage contracting out to private pension plans, the government offered workers not only the standard rebate, but also an additional 2 percent "incentive tax rebate." In 1993 and 1994, the government reduced the standard tax rebate from 5.8 percent to 4.8 percent of earnings and replaced the generous additional 2 percent incentive rebate with a 1 percent incentive rebate for persons over 30. In 1994, for example, this enabled these workers to receive a total annual tax rebate of 5.8 percent of earnings. Today, the standard tax rebate is 4.6 percent. This combination of tax rebates, incentive rebates, and tax relief for contributions to personal pension plans has made these plans especially attractive to younger British workers.

Moreover, workers who contract out of SERPS to open up their own APPs do not give up their SERPS benefits from previous working years; their future pension is simply recalculated on the basis of their earnings during the period of SERPS membership.[44] At the same time, to qualify for government approval and tax relief, a personal pension plan must (1) be government-certified; (2) meet minimum contribution standards; (3) use accumulated funds to purchase an annuity at a specified retirement age; and (4) provide an annuity for widows, widowers, and children.[45] Annuities may be purchased from approved insurance companies or friendly societies of the worker's choice.

Personal pension plans have some strong advantages:

- **Popularity and portability.** As noted previously, personal pension plans—fully portable and characterized by a variety of investment options in stocks and equities—appeal strongly to young working people (both male and female), the self-employed, and workers not enrolled in occupational pension plans. Studies show that, on the basis of the tax rebates alone, younger workers, especially those in their 20s and 30s, can expect a pension that is twice that provided by SERPS.[46]

  Based on 1994–1995 estimates, the Department of Social Security reports that personal pension plans have appealed generally to workers with modest incomes, that 60 percent of persons enrolled in these plans were under 30 years of age, and that 37 percent were women.[47] It is estimated that about a quarter of all British workers now have personal pension plans.[48]

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44 Blake, *Pension Schemes and Pension Funds,* p. 211.

45 Until 1996, a person enrolled in an appropriate personal pension could start using it between the ages of 50 and 75 but had to do so by purchasing an annuity. With the Pensions Act of 1995, new arrangements were set up for these pensions so that persons could "draw down" income from their fund and defer purchase of an annuity up to age 75. By allowing people to defer annuity purchases, current law enables them to get the best returns on their investment and avoid having to retire when annuity rates may be at historic lows.

46 Johnson, *The Reform of Pensions in the UK,* p. [12]. See also Richard Disney and Edward Whitehouse, *The Personal Pensions Stampede* (London: Institute for Fiscal Studies, 1992).

47 Department of Social Security, *Personal Pension Statistics: 1994/95* (London: Crown Copyright, 1996), pp. 4–6.

48 "Personal pensions are much more attractive than other options for younger workers. SERPS is less generous to them, and contributions to a personal pension are more valuable because there is a longer time to retirement for investment returns to compound." Dilnot et al., *Pensions Policy in the UK,* p. 28.

Contracting out of the state pension system to enroll in a personal pension plan is not good for everyone, however. For older workers, the Department of Social Security warns that opting out of SERPS in favor of personal pension plans normally is not wise: "At present, when people come within 15 to 20 years of retirement, they will nearly always do better in SERPS than in an appropriate personal pension scheme...because the rebate of national insurance contributions is paid at a flat rate and does not take into account the age of the person contracting out."[49]

Table 4

Tax Relief for Contributions to Britain's Personal Pension Plans Rises With Enrollee's Age

Enrollee's Age	Tax Free Contribution Limits: Maximum Percentage of Pensionable Earnings
35 and under	17.5%
Age 36 - 45	20
Age 46 - 50	25
Age 51 - 55	30
Age 56 - 60	35
Age 61 and Over	40

Note: "Pensionable Earnings" = income on which benefits and contributions are calculated.
Source: National Association of Pension Funds Ltd., March 1997.

The attraction of personal pensions is not difficult to explain. Under current law, the amount a person may contribute each year to his personal pension tax-free depends on his age. A person 35 or younger can deposit up to 17.5 percent of his annual "pensionable" earnings tax-free; the older a person is, as Table 4 shows, the more he can contribute with tax advantages on a progressive scale. Employers also may contribute to personal pensions and receive a tax break. This option has become increasingly popular: As of 1993, 75 percent of all new private pension plans were personal pension schemes.[50]

- **Flexibility.** A worker does not have to contract out of SERPS to open a personal pension. A worker can remain in SERPS ("contract in"), forego the payroll tax rebate, and still take out a tax-free personal pension plan, subject to certain limitations, to supplement his retirement earnings. Persons enrolled in occupational pensions also can use personal pension plans as a way to receive "transfer payments" from a private plan from previous employment.[51] Under current law, income from a personal pension can be paid to a worker at any time from age 50 to age 75, at which time a worker must purchase an annuity. These rules give workers flexibility in retirement and an opportunity to increase the returns on their investments. Pensions normally are taxable, but there are

49 *Social Security Department Report,* p. 45.
50 Blake, *Pension Schemes and Pension Funds,* p. 159.
51 *Ibid.,* p. 162.

exceptions. Up to 25 percent of the money in a worker's personal pension fund can be taken as a tax-free lump sum upon retirement, and that lump sum can be left tax-free to his spouse and children upon his death.

Although the Department of Social Security is responsible for the regulation of occupational pensions, the Personal Investment Authority, a special agency that reports to the British Treasury, exercises regulatory responsibility for personal pensions.[52]

BRITAIN'S TAX POLICY TOWARD PENSIONS

Pensions in Britain are taxable, but the government encourages workers and employers—particularly in plans that are contracted out of the state pension system—to make contributions to private pension plans with significant tax relief. A worker can receive tax relief for personal contributions to an occupational pension plan of up to 15 percent of earnings, and both capital gains and investment income from the plan are tax-free. Likewise, a worker who contributes to an APP receives full tax relief on his contributions of 17.5 percent of earnings, or more, depending on age, and any investment income and capital gains are also exempt from income and capital gains taxes. Again, subject to certain limits, lump-sum pension benefits paid on retirement or death are tax-free.

The British government encourages personal savings in other ways as well. A worker can make additional voluntary contributions to an employer's occupational pension plan, or "free standing" additional voluntary contributions outside of an employer's plan, and receive tax relief for such contributions, subject to certain rules, as long as they do not exceed 15 percent of annual earnings.[53] People can open up Personal Equity Plans (PEPs) and deposit up to £6,000 ($9,600) per year, with the interest and capital gains on these investments tax-free, subject to certain restrictions. Britons also can deposit up to £3,000 ($4,800) in a Tax Exempt Special Savings Account (TESSA) in the first year, and more limited amounts over a period of two to five years, and receive tax-free interest. Not surprisingly, the British savings rate is roughly twice that of the United States.

The new Labor government, according to its election platform, will continue to support tax policies that encourage savings and investment. In 1995, Labor leader Tony Blair declared that there could be "more private funding" of pensions while the government would continue "to provide a minimum guarantee for all."[54] This year, Frank Field, the new cabinet minister for welfare reform, called for expanded private pensions based on compulsory contributions for employers and employees and a phasing out of a component of the existing state pension program.[55] Field has said that

> Labour should agree to the winding up of SERPS (the second tier of the state pension system) so that every taxpayer will be paying into a funded pension scheme. These new individually owned schemes should run alongside a state pay-as-you-go scheme, the bill for which, thanks to Mr. Lilley [then

52 The Personal Investment Authority currently regulates about 4,000 firms providing personal pensions. David Simpson, *Regulating Pensions: Too Many Rules, Too Little Competition* (London: Institute of Economic Affairs, 1996), p. 30.

53 Employers are prohibited from contributing to these instruments.

54 "Britain in the USA," *The British Media Review*, September 28, 1995.

55 "Britain: Tomorrow's Pensioners," *The Economist*, March 8, 1997, p. 64.

Conservative cabinet minister for social security], is reasonable for taxpayers.[56]

According to its party platform, Labor "will introduce a new individual savings account and extend the principle of TESSAs and PEPs to promote long term saving. We will review corporate and capital gains tax regimes to see how the tax system can promote greater long term investment."[57]

HOW THE BRITISH IMPROVED THEIR PENSION SYSTEM

Pension reform, a staple of British politics since World War II, in recent years has been driven by growing demographic and fiscal pressures.[58] Today, just as in the United States, the ratio of people working to the number of people retiring is declining. This deterioration is not as serious as it is in other West European countries,[59] but British officials also realize that it will accelerate when today's baby boomers are well into retirement. Therefore, they are drafting comprehensive proposals to cope with this eventuality now.

Today, spending on the elderly (estimated at over £40 billion, or $64 billion, in 1996–1997) is the largest item in the British social security budget.[60] The level would have been even higher, however, and the resultant financial pressures on the British taxpayers more severe if Parliament had not acted to improve and open up the system, thereby ensuring, as David Willetts, M.P., has observed, "that we avoid the more melodramatic scenarios of a crisis in public finance for older people."[61]

The key steps in Britain's social security reform have included:

1. **Improving** the living standards of the elderly;
2. **Expanding** personal choice;
3. **Slowing** the growth of the state pension system;
4. **Curtailing** future tax increases;
5. **Establishing** equity; and
6. **Protecting** consumers.

Improving the Living Standards of the Elderly

State pension benefits provided about 60 percent of pensioners' income in the early 1980s, but this level had fallen to about 50 percent in the early 1990s.[62] In the meantime, generous private pension options more than filled the gap. Today, largely as a result of government policy, almost 90 percent of British pensioners have private incomes over and above the Basic State Pension.[63]

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56 Frank Field, "Working for Pensions That People Trust," *The Daily Telegraph,* March 6, 1997.

57 *New Labour: Because Britain Deserves Better* (London: Labor Party, 1997), p. 13.

58 Interview with Bernard Jenkin, M.P., Westminster, March 5, 1997.

59 "We in the UK can expect to see the smallest deterioration in our support ratio. We got old first." Peter Lilley, *Winning the Welfare Debate* (London: Social Market Foundation, 1995), p. 36.

60 *Reshaping Our Social Security System, op. cit.*

61 David Willetts, *The Age of Entitlement* (London: Social Market Foundation, 1993), p. 11.

62 Christopher Downs and Rosalind Stevens-Strohmann, *Risk, Insurance and Welfare: The Changing Balance Between Public and Private Protection* (London: Association of British Insurers, 1995).

Table 5

Average Income of British Pensioners by Source: 1979-1993

Income Source	Average Pensioners Income in Pounds per Week* 1979	1993	Change in Income
Earnings	£13.10	£9.50	-27%
Benefit Income	69.20	90.50	31
Investment Income	12.30	27.40	123
Occupational Pensions	18.20	42.30	133
Other Income	0.70	0.50	-24
Total Gross Income	113.40	170.20	50
Total Net Income	98.20	148.50	51
Total Net Income After Housing	84.20	131.90	57

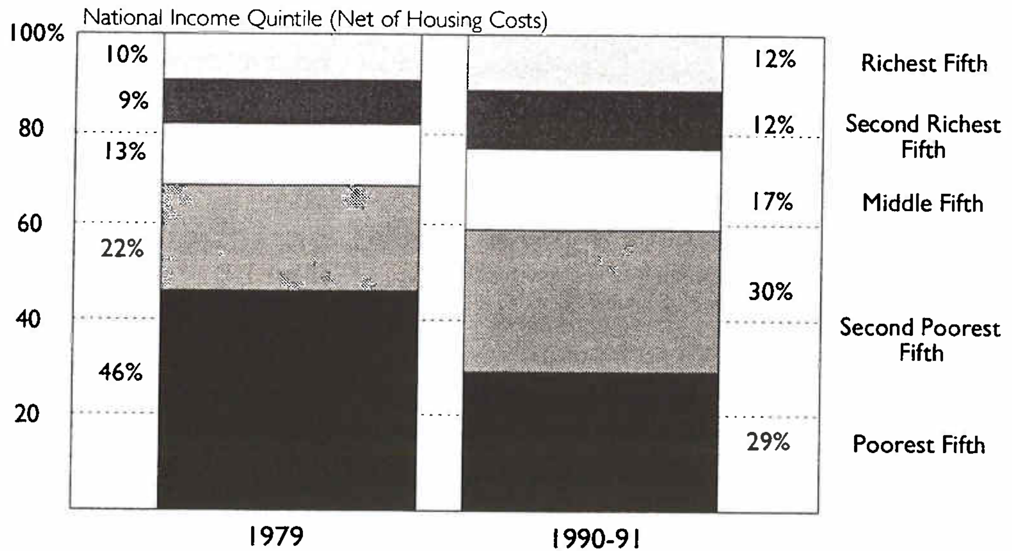
Note: *Income in July 1993 prices; estimates are derived from the 1979 and 1993 Family Expenditure Surveys.
Source: The Department of Social Security, United Kingdom, March 1996

Between 1979 and 1995, the income of British pensioners increased in real terms by 60 percent—the largest increase among any group in Britain.[64] Not surprisingly, as a proportion of the population, the percentage of pensioners who are among the poorest citizens shrank dramatically.[65] From 1982 to 1992, home ownership among British pensioners jumped from 47 percent to 60 percent.[66] On the basis of a comparative analysis conducted in 1993 by actuaries on behalf of the Department of Social Security, British pensioners, given the combination of state and tax-favored private pension options, generally were better off than their counterparts in Germany, the leading economic power in Europe.[67] From 1979 to 1993, as noted in Table 5, the biggest jumps in the income of British pensioners came from occupational pensions (133 percent) and investment income (123 percent). Thus, the available evidence "suggests that the income position of UK pensioners to the rest of society has been gradually improving"[68] and that this improvement is largely attributable to growth in the "private provision" of pensions.[69]

Expanding Personal Choice

Parliament's single most important reform in the Social Security Act of 1986 was to expand the private tier of the British pension system, further encouraging British citizens to provide for their own retirement by enrolling in government-certified appropriate personal pension plans.

63 *Reshaping Our Social Security System,* p. 3.
64 *Ibid.,* p. 22.
65 *Ibid.*
66 Paul Johnson, Richard Disney, and Gary Stearns, *Pensions 2000 and Beyond,* Vol. 2 (London: Institute for Fiscal Studies, 1996), p. 53.
67 Alistair B. Cooke, *The Campaign Guide 1994* (London: Conservative Central Office, 1994), p. 27.
68 Downs and Stevens-Strohmann, *Risk, Insurance and Welfare,* p. 63.
69 *Ibid.,* p. 61.



Note: Figures are for income level after housing costs are taken out.
Sources: Andrew Dilnot et al., *Pensions Policy in the UK*, Institute for Fiscal Studies, 1994; Department of Social Security, 1993.

As noted, APPs have been extraordinarily popular, especially with younger British workers.[70] Before this option was introduced, workers had to join an occupational pension plan in order to secure a retirement income higher than that provided by the state pension system. As of 1992, most of the participants in occupational pension plans had been males with consistent work histories.[71] With new personal pension options, younger workers, especially women, could contract out of SERPS into a personal plan and receive a substantial tax rebate, an initial incentive rebate of 2 percent, and tax relief for contributions. The number of persons with personal pensions jumped dramatically from approximately 1.9 million in 1988 to 5.5 million in 1993,[72] thereby reducing the long-term liabilities of the British state pension system.

Slowing the Growth of the State Pension System

During the high inflation periods of the 1970s, state pension increases had been indexed to wage increases, which normally outpaced price increases and thus generated tremendous costs. In 1981—in the middle of a recession—Parliament broke the link between wage increases and pension increases by deciding to index pension increases to prices, which were rising faster than earnings. In addition to ensuring that government pensions at least would keep up with general inflation, substituting price indexation for wage

70 "The success of the personal pensions has surprised the government. In 1988, the government estimated that at most 1.75 million people would leave SERPS and take out personal pensions. By the end of 1990, more than 4.5 million people had taken out personal pensions." Blake, *Pension Schemes and Pension Funds,* p. 253.

71 For a description of the demographics of Britain's occupational pensions, see *ibid.,* pp. 99–110.

72 *Reshaping Our Social Security System,* p. 24.

indexation has had a profound and continuing impact on controlling costs. Since 1980, this change alone has saved British taxpayers nearly £9 billion ($14.4 billion).

The future savings from this adjustment, according to Paul Johnson, will prove to be even more dramatic:

> Starting from where we are the Government Actuary (1995) estimates that spending on the basic pension will reach £47 billion [$75.2 billion] in 2030 and remain about constant thereafter. With earnings indexation from the present spending would rise to £80 billion [$128 billion] in 2030 and £107 billion [$171.2 billion] in 2050. With price indexation National Insurance Contribution rates would need to be barely changed by 2030, but with earnings indexation they might have to rise by nearly ten percentage points.[73]

Curtailing Future Tax Increases

In a move to ease the future burden on British taxpayers, Parliament enacted the Social Security Amendments of 1986, which took effect in 1988 and lowered the SERPS replacement rate from 25 percent to 20 percent of the best 20 years of earnings. Although this reduction in the base calculation for the state pension was structurally significant, the impact was lessened because it did not affect any British worker retiring before the year 2000. Nonetheless, from the standpoint of future costs, the 1986 changes were significant. As Paul Johnson reports, "The Government Actuary estimated that the reforms to SERPS would cut future spending such that by 2033 the National Insurance Contribution rate could be three percentage points lower than it would otherwise have been."[74]

Establishing Equity

Under the original British state pension system, the official age of retirement was 65 for males and 60 for females. The Pensions Act of 1995, however, equalized the age of retirement at 65 for both men and women.[75] Women became eligible for a state pension at age 60 in 1940, a time in which most women were married and dependent, and when few had any independent opportunity to become eligible under British law for a government pension.[76] Today, however, British women account for almost half the workforce, and—just as in the United States—changing conditions in the workplace, growing equality in the private sector, and the fact that women live longer than men have encouraged a change in the law.[77]

This simple change will ease demographic pressures on the pension system, reduce costs, and discourage both age and sex discrimination. Like other British reforms, the age equalization provisions are to be implemented gradually, with age of retirement increases in six-month increments to be phased in between 2010 and 2020. The government estimates that this change alone will save taxpayers £15 billion ($24 billion) by 2025.[78]

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73 Johnson, *The Reform of Pensions in the UK,* p. [5].

74 *Ibid.*

75 Another factor in the enactment of the equalization of age provision was a 1990 judgment by the European Court of Justice, a judicial body of the European Union, that males and females should be treated equally with respect to their pensions.

76 Under the state pension system, a married woman is eligible for 60 percent of her husband's basic retirement pension. A 1978 change in British law, the Home Responsibilities Act, reduced the number of years for persons (especially women) whose work opportunities were limited because of the need to care for dependents at home.

77 British women draw pensions, on average, nine years longer than men do.

Protecting Consumers

The Pensions Act of 1995 also strengthened previous legislation and established a more comprehensive system of consumer protection for persons enrolled in occupational schemes, including:

- More rigorous **disclosure** of funds and assets;
- Greater **accountability** of fund managers to employees;
- A requirement that **professional advisers** report to plan trustees rather than to employers;
- A new **solvency** requirement for pension plans; and
- A **compensation** system to cover losses from fraud.[79]

The Pensions Compensation Board, a panel appointed by the secretary of state for social security, finances the compensation fund with a small levy on pension plans.[80] Oversight and enforcement of these rules is vested in the Occupational Pensions Regulatory Authority (OPRA), a government agency accountable to Parliament. OPRA can investigate problems in occupational pension plans, maintain a register of personal and occupational plans, secure information from pension plans, appoint or suspend trustees in troubled plans, institute proceedings, and impose civil monetary penalties for breaches of pension law.[81] Disputes between occupational pension fund trustees and employers and trustees of other pension plans can be settled by the pensions ombudsman, an independent agent created by Parliament in 1990, giving both employers and private pension plans an alternative to costly litigation.[82]

In the 1980s and early 1990s, there was insufficient protection of British consumers against fraud in private plans. Much of the impetus for recent regulatory reform was occasioned by the 1992 Maxwell Affair in which officers of a prominent publishing firm had misappropriated employees' pension funds.[83] There also was misrepresentation ("mis-selling") of personal pension plans. Too many British workers made bad investment decisions as a result of bad advice from unscrupulous salesmen.

The problem was not so acute for workers who opted out of SERPS and opened up a personal pension plan.[84] The major difficulties centered on those who switched from occupational pension plans, in which employers were making a substantial contribution to their employees' plans, to personal pension options without such employer contributions. Too many workers made these decisions without a full explanation of the financial consequences of moving from a company plan to a personal defined contribution plan.

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78 *Reshaping Our Social Security System,* p. 27.

79 Today, the new compensation system will cover losses up to 90 percent in cases of fraud or bankruptcy. The Compensation Board is required to satisfy itself that there are "reasonable grounds" to believe there has been a "reduction in the scheme's assets due to an offense involving dishonesty." According to Barnes, "This is a less stringent test than that adopted in criminal cases. Action by the Board should not prejudice any separate criminal proceedings." Personal communication from Peter Barnes, *op. cit.*

80 For 1997 to 1998, the levy is £0.23 (roughly 37 cents) per plan member.

81 Personal communication from Peter Barnes, *op. cit.*

82 *Ibid.*

83 For an excellent summary of the Maxwell scandal, see Blake, *Pension Schemes and Pension Funds,* pp. 261–279.

THE FUTURE OF PENSION REFORM IN BRITAIN

The largely successful pension reforms of the 1980s have established the groundwork for the next stage of pension reform: more expansive private options for the next generation of British workers. Members of Parliament—whether Labor or Conservative, and despite partisan differences—are committed to more extensive pension reform.

The New Labor Government's Reform Agenda

During the 1980s, Labor opposed the Conservative government's reforms in state pension system benefits, particularly those affecting SERPS, and criticized its regulation of personal pensions as inept. Although the new government has not unveiled a comprehensive reform agenda yet, the Labor Party is committed in principle to preserving the Basic State Pension as the foundation of the retirement system; it also opposes a means test for the basic pension and favors a sustainable second level of funded pensions, compatible with the demographic changes facing the country and based on a "high level of contributions."[85] Labor is not committed, however, to restoring SERPS to its original form.[86]

Most important, the new government has voiced no opposition to workers' contracting out of the state pension system and receiving a tax rebate on their national insurance contributions for doing so.

Broadly, Labor envisions a new system of funded pensions for people without occupational pensions based on competition among pension providers. According to Labor Party literature, funded pensions "are capable over time of producing the best returns each individual can achieve from their hard earned savings. They have the potential to give people a real sense of ownership—an identifiable stake in their own pension—which will generate the contribution needed for retirement security."[87] Labor has given the name "stakeholder pensions" to the second tier of pensions. Although formally committed to occupational pensions, it wants to make pension arrangements more understandable while promoting a variety of pension plans outside the standard financial services industry, including multi-employer plans and plans sponsored by employer and employee organizations, local Chambers of Commerce, and friendly societies.[88]

Labor is expected to retain personal pensions but also to regulate them more closely: "We want to make sure that the six million people who are currently in so-called appropriate personal pensions do not see so much of their hard-earned savings being eaten up in excessive costs and charges."[89] Pension policies also should promote long-term savings:

84 According to Paul Johnson of the Institute for Fiscal Studies, two major studies of the problem showed that (1) more than 90 percent of workers opting out of the SERPS program to set up personal pensions were making rational economic decisions; and (2) they would "be at least as well off" with a personal pension plan as they would remaining in the government program. The difficulty took place in switching among private-sector plans: "The real problem of ill informed choices leading to undesirable outcomes has been among members of occupational schemes leaving their schemes in order to join personal pensions. The trouble is that in doing so they have lost their employer's contributions to the scheme. Only in rather special circumstances will this sacrifice be worthwhile." Johnson, *The Reform of Pensions in the UK,* p. [15].

85 "Security in Retirement," in *Road to the Manifesto* (London: Labor Party, 1996), p. 3.

86 Whatever the final shape of its future pension reform, Labor clearly is not going backward: "We have already suggested that SERPS could not easily or sustainably be rebuilt in its present form. New funded pension schemes could produce better returns for the same contribution level for many people." *Ibid.,* p. 6.

87 *Ibid.,* p. 3.

88 *Ibid.,* p. 5.

"That is why we are developing plans for Individual Savings Accounts that would enable people to save for the medium and the long term."[90] Labor also is encouraging pension plans to offer life insurance to their members at competitive rates and promises to develop a "Citizenship Pension" for persons with low wages and uneven work experience.[91]

Conservative Pre-Election Proposals

In March 1997, just before the general election, Secretary of State for Social Security Peter Lilley outlined the Conservatives' comprehensive plan for further restructuring the British state pension system.[92] According to reporters at the *Financial Times,* "The move would represent the most radical reform of the welfare state since world war two."[93] Significantly, noted Woodrow Wyatt of *The Times,* Labor's new minister of state for welfare reform was impressed with the basic idea: "Frank Field immediately recognized the virtues of Peter Lilley's plan for a gradual move into compulsory and properly funded private pension schemes."[94]

The Conservative proposal, targeting new workers in 2001, contains three elements:

- **A new privatized basic pension to replace the government earnings-related pension.** Every young person entering the workforce would be guaranteed a Basic State Pension. This pension would be funded out of the existing national insurance contributions (payroll tax), just as the current system is today, but would be run as a private plan, not as a government program. In value, it would be at least equal to the current Basic State Pension and indexed to prices, as the basic pension is today. The current SERPS component of the British pension system would be phased out.
- **A tax rebate.** Every young person entering the workforce would receive rebates. The size of the first—a rebate from national insurance contributions—would be determined by the calculations of the Government Actuary, an agency of the Department of Social Security, and indexed to inflation. Under the government's calculations, an initial rebate of £9 ($14.40) per week would be required to establish a basic pension. In addition, young people entering the workforce would receive a tax rebate of 5 percent of their wages, which would go into the new privatized pension system. These rebates could be put into an occupational pension plan or a personal pension plan.
- **A portable personal pension.** All young people would have privately managed pension funds that they, not the state or their employers, would own. Under the projections of the Government Actuary, the initial rebate of £9 per week would

89 *Ibid.,* p. 4.

90 *Ibid.,* p. 5.

91 *Ibid.*

92 Much of the inspiration for the Conservative proposal comes from the work of the Adam Smith Institute, a prominent free-market British think tank. For a thorough discussion of the privatization of Social Security programs, see Eamonn Butler and Madsen Pirie, *The Fortune Account: The Successor to Social Welfare* (London: Adam Smith Institute, 1995). See also Eamonn Butler and Matthew Young, *A Fund for Life: Pension and Welfare Reform in Practice* (London: Adam Smith Institute, 1996).

93 Robert Preston, James Blitz, and William Lewis, "Tories Plan to Privatize Pension Provision," *Financial Times* (London), March 6, 1997, p. 1.

94 Woodrow Wyatt, "Is Blair's Tory Party Up to It?" *The Times* (London), May 13, 1997.

be enough for the average wage earner to build up a fund worth £130,000 ($208,000) upon retirement, which would finance a tax-free pension of £175 ($280) per week at today's prices.[95] In any case, regardless of the performance of these plans, the government would underwrite them so that persons would be guaranteed payments equal to the current Basic State Pension.[96] According to *The Times,* the expanded provision of personal pensions

> will allow people to own the whole of their pensions, instead of trusting some future government to abide by its predecessors' promises. Everyone will have a visible stake in the economy—and their pensions should rise in line with economic growth instead of merely with inflation. Unless the economy collapses or pension funds are run by crooks, most people will be much better off in retirement. And the government's guarantee limits the risk.[97]

The Conservatives' proposed change in pension policy would bolster private investment, reduce the burdens of the government's own pension system, and stimulate economic growth. In adopting a universal compulsory savings proposal, Conservatives moved closer to Labor.[98]

Although criticizing the specific Conservative reform, Labor also is working on a set of reforms that would expand personal pensions.[99] There is interest within the Labor Party in enabling trade unions to sponsor and manage private pensions plans.

The British system has had its share of problems, and there are ample opportunities to make that system work better. Nevertheless, despite their partisan differences, officials have arrived at a broad consensus on pension policy. Says Dr. Ann Robinson, director general of the National Association of Pension Funds, "There seems to be general agreement that funded pensions are superior to pay as you go and that the benefit of such pensions should be more widely available, particularly to those individuals with lower incomes and less regular work records."[100]

Reality defines this new consensus. Today, British workers have a real choice: They can put all their payroll tax into a government-run pension, or they can use a portion of their payroll tax to earn higher returns on their private investments. Overwhelmingly, they have chosen the second course. Thus, Labor recognizes the popularity of existing private options and the recent legislation governing them. Reports Paul Johnson:

> While there remains disquiet on the left of the party, the leadership appears broadly content with the shape of the pensions legislation as it now stands. Such cross party agreement is of course important for the health of a policy on something as long term as pension provision.[101]

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95 Lilley press statement, p. 2.

96 Preston et al., "Tories Plan to Privatize Pension Provision," p. 28.

97 "The Pension Plan" (editorial), *The Times* (London), March 6, 1997, p. 19.

98 "Up until yesterday the Government rejected the idea of universalizing compulsory pension savings, saying that voters would see it as a tax increase. That argument is now truly dead and buried." Field, "Working for Pensions That People Trust," *op. cit.*

99 Philip Webster and Jill Sherman, "Tory Aim Is One Hundred Seventy Five Pound Tax Free Pension," *The Times* (London), March 6, 1997, p. 1.

100 Ann Robinson, "Labour Faces an Age Old Problem," *The Parliamentary Monitor,* May 1997, p. 7.

Social Security: Similar Problems Require Similar Solutions

The 1997 Social Security Advisory Council report is a starting point for the emerging debate in the United States over what is needed to assure the long-term solvency of Social Security. But this not simply a quantitative issue. Congress also must focus on assuring both the quality of the retirement available to older Americans and an adequate income for the aged and for disabled American workers and dependent survivors of deceased workers. Although benefits for current pensioners and those near retirement age should be protected, today's demographic, economic, and political realities demand a full and fair debate on the kind and quality of pension options workers should carry into the next millennium.[102]

Like the British state pension program, Social Security is a system of pay-as-you-go financing in which current benefits are paid from current payroll taxes. Designed in the 1930s and amended over the years, the system has served its purpose but now is showing signs of financial weakness that require a basic review of its structure and method of financing. The British experience offers Congress strong lessons and strategies for success.

The Demographic Time Bomb

The basic problem confronting Social Security is not disputed by anyone: The simple demographic reality is that the ratio of workers to retirees will have fallen from a ratio of 20:1 in 1950 (and 3:1 in 1990) to a ratio of 2:1 by about 2025 or 2030.

Congress should note that the British system also has undergone fiscal and demographic strains. As David Blake of the University of London's Pensions Institute has written, "It had been clear for several years that the financial structure of the national insurance scheme was unsound."[103] Although Britain's demographic pressures are not as heavy as those in other European countries, they have been a major factor in British entitlement reform and have served to drive the debate about overhauling the state pension system and expanding private pension options. Peter Lilley observes,

> When the Welfare State began there were five working people contributing to support one pensioner. By the year 2030, for every five working people there will be three pensioners. The only way to ensure decent pensions without burdening future taxpayers is through saving and investing to pay for pensions.[104]

For the United States, the rapid aging of the population has a relentless logic of its own, overrunning easy solutions and political quick fixes. In 1990, 21 percent of the U.S. population was 55 years old or older. By 2010, when the baby-boom generation begins to retire, that portion of the population will have grown to 25 percent. By 2030, it will have jumped to 30 percent. This problem is manageable, however, and strategies to cope with it

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101 Johnson, *The Reform of Pensions in the UK,* p. [9].

102 The authors believe that the current focus for revision should be the Old Age Pension scheme. Even though the disability program has some serious problems, these programs should be considered separately; the present disability and survivor benefits and financing mechanisms should not be a part of this review.

103 Blake, *Pension Schemes and Pension Funds,* p. 13.

104 Lilley press statement, p. 1.

can be hammered out over the next few years with time to spare. In effect, this is what the British have started to do, thus making their experience directly relevant to the solution of the difficulties in the United States. But political will is essential.

The High Costs of Congressional Inaction

For Americans, it is important to note that political paralysis carries with it an unacceptably high price. Specifically, if Congress and the Administration fail to reform Social Security, the country will face four overriding and continuing problems:

Problem #1: Heavy future tax increases on younger working families or lower benefits for retirees. Taxes are not keeping up with Social Security benefits, and current contribution rates will not—and cannot—sustain promised benefit levels. Based on the latest official estimates, benefit costs will exceed contributions within 15 years. By the year 2029, assuming that Social Security Trust Fund assets in government bonds are fully paid, the system will be unable to pay promised benefits. These estimates are from the middle range of the official trustees' reports, yet the situation could be worse. Based on recent experience, the time frames are likely to be shortened. As noted in Table 6, the trend in official projections of the depletion of the Social Security Trust Fund shows the year of exhaustion now progressively closer since 1983—the last time Congress addressed Social Security financing.

Likewise, the growing tax burden to sustain the entire British social security system,[105] including state pensions, was a driving factor in the enactment of reforms in the 1980s. Britain's state pension program has struggled, however, with ever-higher costs since 1946. By the early 1950s, the national insurance contributions were not enough to cover program costs; and by 1965, the costs of the state pension system were twice what British officials had predicted originally.[106]

The popular backlash during the 1970s against Labor's economic policies—policies that contributed simultaneously to high unemployment and high inflation—propelled the Conservatives, led by Margaret Thatcher, into power in 1979. The Conservatives started fashioning a social policy consistent with their pro-growth economic objectives, including changes in the state pension system and reductions in the tax burden on future generations.[107] Parliament's major initiative in this area, the Social Security Act of 1986, allowed expanded contracting out of the state pension scheme and effected a crucial change in the formula for government pension increases. The result: Britain now "stands almost alone in having no serious increase in future tax burdens predicted as a result of an aging population," in the words of Paul Johnson. "To some extent this reflects a rather less dramatic aging profile than that seen in most countries. But the most important aspect has been the determined way in which the government has bitten the bullet in recognizing possible future problems early on and tackling them in a radical and effective manner."[108]

105 According to former secretary Lilley, 1997 British government spending on all social security benefits, including pensions, amounts to £93 billion, or approximately $149 billion in today's U.S. dollars. This costs every working person in Britain £15 ($24) per day. *Reshaping Our Social Security System,* p. 1.

106 *Ibid.,* p. 3.

107 Daniel Finkelstein, "The System of Social Security in Great Britain," manuscript, September 28, 1995, p. 11.

108 Johnson, *The Reform of Pensions in the UK,* p. [7].

Table 6

U.S. Social Security Trust Fund Depletion: Current Estimates Have the System Going Bankrupt in 32 Years

Year of Estimate	Projected Maximum Trust Fund Balance (Billions of Current Dollars)	Year Trust Fund Projected to Be Depleted	Present Value of Tax Income Plus Current Fund Minus Obligations (Billions of Dollars)
1983	$20.75	2063	$148.3
1984	18.393	2059	37.4
1985	11.955	2049	-268.8
1986	12.739	2051	-342.6
1987	12.411	2051	-377.6
1988	11.838	2048	-664
1989	11930	2046	-849.5
1990	9.233	2045	-1,242.7
1991	8.02	2041	-1,185.1
1992	5.535	2036	-1,772.6
1993	4.923	2036	-1,863.7
1994	2.976	2029	-2,841.9
1995	3.275	2030	-2,832.7
1996	2.829	2029	-3,094.2
1997	2.834	2029	

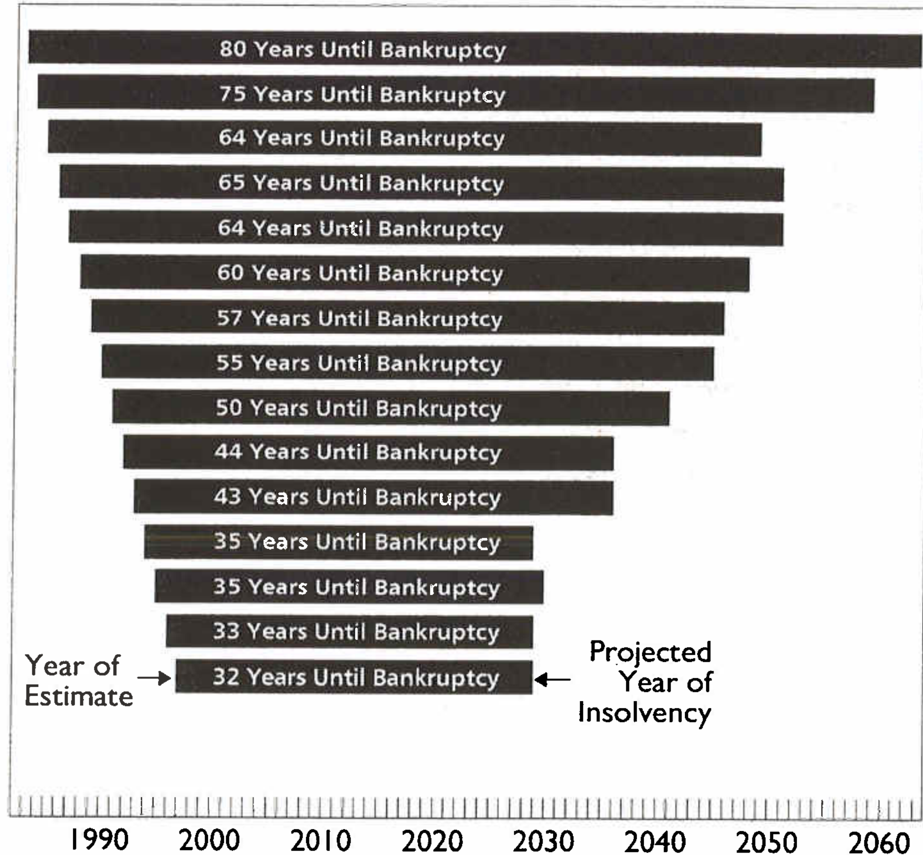
Note: Data compiled by Sylvester J. Schieber, Vice President, Watson Wyatt Worldwide, and a member of the Social Security Advisory Council, reprinted with permission.
Sources: 1983 to 1997 Annual Reports of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Social Security Administration, and the Office of the Actuary, Social Security Administration.

Not surprisingly, fiscal conservatism also guides the new Labor government in its approach to the pensions issue:

> Labour believes that pensions policy can only be secure and sustainable if it takes place within a framework of sound public finances. We are not proposing measures here which place any demands on the public purse that are not already envisaged in the published Public Expenditure Plan; but there is ample scope for making better use of taxpayers' resources already committed.[109]

As noted, the Conservatives have proposed a sweeping privatization of pensions that, if enacted, would save British taxpayers an estimated £40 billion ($64 billion) per year by 2040.[110] Thus far, Labor does not appear ready to reverse course and support big

109 *Road to the Manifesto,* p. 2.
110 Lilley press statement, p. 3.



Note: Data compiled by Sylvester J. Schieber, Vice President, Watson Wyatt Worldwide, and a member of the Social Security Advisory Council, reprinted with permission.

Sources: 1983 to 1997 Annual Reports of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Social Security Administration, and the Office of the Actuary, Social Security Administration.

taxes on British citizens to shore up the old state pension system.[111] It remains to be seen exactly how the Labor government will continue the momentum toward private pension expansion.

Problem #2: A decreasing rate of return for working families. American workers face a decreasing rate of return on contributions paid by workers as Social Security matures. The average American worker retiring at age 65 in 1950 received a real annual rate of return of about 20 percent on all taxes paid under the Federal Insurance Contributions

111 According to Roderick Nye, director of the Social Market Foundation, "Many of us fear dismantling chunks of the social safety net that we may one day rely on ourselves. But there is a growing disinclination to fund new entitlements or more claimants through increased taxes." Nye, "Why Lilley May Deserve a Statue," *The Independent,* February 2, 1996.

Act (FICA), while workers retiring at age 65 in 2005 and beyond will receive a real annual rate of return of less than 2 percent.[112]

The situation is different for British workers, who can take a portion of their "payroll taxes" and opt out of SERPS. Well-established British private pension options already increase the rate of return on workers' investments. Annual *real* returns were nearly 9 percent during the 1980s,[113] and the trend is improving in the 1990s. Dr. Oonagh McDonald, fellow at the Center for Financial Services at the University of Leeds and a former Labor member of Parliament, notes that, between 1984 and 1993, the "real returns on UK pension funds were almost the highest in Europe with an average real return of 10.23 percent...with up to 80 percent invested in equities."[114] In Britain, company plans are not tightly restricted by the government with respect to the kinds of investment options available. In 1993, 27 percent of British pension funds were invested in overseas equities.[115]

The situation could be even better for future workers if the British government succeeds in expanding private investment opportunities. Projecting future income in U.S. dollars, the Conservatives' 1997 pension privatization proposal, as noted, would enable a British worker making average wages and paying in a minimum of contributions to accumulate a personal fund worth $208,000 upon retirement at age 65 and to secure a tax-free pension of $1,120 per month.[116] According to Peter Lilley, "If returns are 1 percent higher than assumed, [British workers] will get a pension nearly 30 percent above the basic pension. If the yield is 2 percent higher, the pension could be over 70 percent better."[117]

Problem #3: A further erosion of public confidence in Social Security. In the United States, there is a growing lack of confidence, especially among younger workers, in the assumption that Social Security will be able to pay promised benefits. A notable survey reveals that young Americans believe they are more likely to encounter alien spaceships than future payments from Social Security.[118] Although this may reflect a more general disillusion with the red tape of inept bureaucracy, it also is understandable that many Americans would like to remove their Social Security funds from the grasp of a politically driven and deficit-plagued Congress and Administration. Moreover, younger Americans increasingly want more control over how and where their pension savings are invested.

112 C. Eugene Steurle, *Retooling Social Security for the 21st Century* (Washington, D.C.: Urban Institute, 1994).

113 Blake, *Pension Schemes and Pension Funds,* p. 452.

114 Oonagh McDonald, *The Future of Continental European Private Pension Funds and Their Impact on the Equity Markets* (London: Apax Partners and Company, December 1996), p. 10.

115 Budd and Campbell, *The Roles of the Public and Private Sectors,* p. 13.

116 Projected in British currency, "An individual on average earnings would, after 44 years, have built up a pension fund from their 9 pounds plus 5 percent rebates amounting to 130,000 pounds at today's prices, using the Government Actuary's Department's assumptions, for example, assuming a four and a quarter percent real rate of return. A 1 percent higher rate of return would increase the fund by about 30 percent." *Basic Pensions Plus: A Technical Note,* Conservative Government Talking Points, March 6, 1997, p. 4; see also Lilley press statement, p. 2.

117 Lilley press statement, p. 2.

118 "Social Security: The Credibility Gap," an analysis of a Third Millennium survey conducted by the Luntz Research Companies in conjunction with Mark Siegel and Associates, September 1994. The survey covered young adults from 18 to 34 years of age.

Problem #4: A lower standard of living for working and retired Americans. The United States cannot retain its high standard of living without a higher level of savings. There is growing recognition that the overall savings rate in the United States is too low. Failure to secure higher savings will guarantee a lower standard of living for too many of America's 77 million baby boomers and succeeding generations.

Even though Britain's savings rate is higher than that of the United States, and even though—because of its partially privatized pension system—it now has more funds for future retirement than any other European country, senior officials are still not satisfied. "The problem with state schemes is that they are pay as you go," says Peter Lilley. "Nothing is saved or invested for the future. People may think their National Insurance Contributions are being saved in a fund to pay their pensions. In fact, what they put in goes straight out to the taxman."[119] Recent proposals to expand personal pensions, advanced by both Conservative and Labor spokesmen, are designed to promote an even higher rate of savings and investment in the future.

TWELVE LESSONS FOR THE UNITED STATES

The British have grappled successfully with the major problems that now plague the U.S. Social Security system, particularly the fiscal pressures that accompany an aging population. Roderick Nye argues that "Britain is not alone in facing this demographic and fiscal time bomb, but it may have made the greatest strides in addressing the problem."[120] John Blundell of the Institute for Economic Affairs notes that "For a large part, older Britons are not a financial burden on the next generations. They have saved through various market instruments. They are in this sense quite different from their continental counterparts."[121]

Congress and the Administration can learn at least 12 key lessons from Britain's very productive political and economic experience:

Lesson #1: Don't underestimate either the appeal of freedom of choice or the popularity of personal pension investments. When the British government gave workers the chance and the tax relief to opt out of one part of the government pension system in favor of alternative private plans, it was not clear how many would take advantage of the option. It proved to be vastly more popular than anyone—even optimistic proponents of the policy—ever imagined.[122] Congress therefore should not underestimate the popularity of a Social Security reform program that would let individuals and families own and control their own money and their own future retirement. Many Americans, wrestling with an outdated federal tax code that penalizes savings and investment,[123] already are trying to plan safely for retirement. From 1984 to 1993, the number of employment-based 401(k) plans alone jumped from 17,000 to 154,000.[124] Today, 43 percent of adult

119 Lilley press statement, *op. cit.*

120 Nye, "Pension Reform: Is Britain the Model?"

121 Blundell, "The EMU Threat to Our Pensions."

122 Finkelstein interview, March 6, 1997; Jenkin interview, March 5, 1997; and interview with Andrew Dilnot, director of the Institute for Fiscal Studies, London, March 6, 1997.

123 For a description of the bias against savings in the complex U.S. federal tax code, see Mitchell, "Creating a Better Social Security System for America," p. 27.

124 "President Clinton Announces Pension Security Steps," press statement, Pension Benefit Guaranty Corporation, March 31, 1997, p. 1.

Americans own stocks; more than 50 percent of investors are below age 50; almost half of these are women; and most have incomes between $40,000 and $100,000 per year.[125]

Lesson #2: Combining a flat pay-as-you-go defined benefits program with a fully funded set of private options can work more effectively for workers and retirees than a one-tier system. The British have a flat-rate Basic State Pension with a mandatory "additional" second tier that includes funded private options. The second tier thus offers the opportunity to opt out of the state pension system into either a funded defined benefit plan or a defined contribution private pension plan. The British experience, especially since 1988, shows that such a system can function more effectively than the standard single-tier, pay-as-you-go system and give workers superior benefits with a lower unfunded government liability. It also presents Congress with a solid basis for developing the proper administrative framework needed to construct a new program that combines defined benefit and defined contribution elements.

By initiating a similar reform of Social Security, Congress can help alleviate the inevitable fiscal pressures caused by the retirement of America's 77 million baby boomers—men and women who will begin to reach retirement age in 2010. By mandating a funded second tier, the British government has partially funded the pension benefits for Britain's baby boomers and is preparing new proposals to fully fund the benefits of the next generation of workers. The Conservatives' 1997 plan not only would increase private pension funding, but also would simplify the process for contracting out for private plans and allow a greater variety of contracted-out private plans as long as they pass a government quality test.

Lesson #3: In any structural reform of Social Security, make sure to protect current beneficiaries, proceed carefully, and frame policies for a more prosperous future. Careful review of the British experience—including the rationale behind the most recent proposals to expand private pension options—will show Congress how to make the proper changes. For example, in making specific adjustments in the existing government pension system in the 1980s and 1990s, such as cutting back on the generosity of SERPS or equalizing the age of retirement, Parliament took pains to make sure that changes would affect future workers and retirees and that current beneficiaries or workers remained largely insulated from their effects.

Although cutting back on the state pension system, Parliament established a superior alternative for British workers, enabling them to receive tax rebates and contract out into private company plans or open personal pension plans with higher rates of return and the likelihood of higher retirement income. Between 1988 and 1992, Parliament further encouraged individuals to open up personal pensions with an incentive rebate of 2 percent and tax relief for contributions to such funds. This made personal pension options a good deal for ordinary workers. As Frank Field has written, "While it would be foolish to idealize private pensions as the answer to all our problems, they have been unique in their ability to provide generous pensions for a lucky and growing proportion of the population."[126] By doing it right—proceeding carefully, protecting current beneficiaries, and establishing guarantees for current workers—Congress also can avoid the need to make extensive revisions several years down the road.

125 Donald Lambro, "Anemic Personal Savings Rate," *The Washington Times,* February 27, 1997.

126 Field, *Private Pensions for All,* p. 7.

Lesson #4: Don't let the problem of transition costs delay change; be candid about the costs and spell them out. Personal freedom is not without cost, and moving from a government social insurance system to a pension system that is either partially or fully privatized inevitably will incur a transition cost: The younger generation taking advantage of private pension options will pay not only for its own retirement, but also—through taxation—for that of the older generation. If the goal of reform is to move to a superior Social Security system, it is essential that the issue of transition costs be faced honestly.[127] They will have to be paid in any case, and officials should ensure their credibility and enhance the public debate by being clear about the actual costs of change.

Once again, the British example is worth emulating. The movement to personal pension plans, for example, is costing British taxpayers an estimated £3 billion ($4.8 billion) annually, but the transition is projected to reduce the country's future pension liabilities.

The crucial groundwork for even larger future savings was established by the significant pension reforms of the 1980s. In promoting a further expansion of private options in 1997, Peter Lilley has outlined clearly how the full transition to private pension options—phased in over a generation—is to be financed. First, all young people entering the British workforce would continue to pay national insurance contributions to the state pension system, but they also would receive a rebate of £9 ($14.40) per week, indexed to inflation, and a rebate of 5 percent of any earnings paid into the National Insurance Fund that they have allocated to their personal pension funds. Second, the tax treatment of personal pension contributions would be changed; contributions to personal pensions would become taxable income, thus raising an additional £8 billion ($12.8 billion) in revenue per year. Future pension income would be tax-free. According to Lilley, "The proposed changes in tax timing, combined with the gradual phasing in of the new system, will make the impact on public finances quite manageable."[128]

Lesson #5: Explain to taxpayers that there are great public as well as private benefits in moving toward a system based on private savings accounts. As the British experience indicates, there are solid financial opportunities for workers and retirees in moving toward a privatized system. But there are great public benefits as well. For example, the latest Conservative proposal for phasing out SERPS in favor of more private pension plans would result eventually in savings to British taxpayers of £40 billion ($64 billion) per year.[129] Labor's Frank Field argues that a universal system of private pensions would reduce the need for welfare and thus cut welfare costs: "the universal nature of personal private pensions would lift the great majority of pensioners free from dependence on state support."[130] On balance, such public and private opportunities clearly outweigh the costs of staying in an unreformed system financed by higher taxes and plagued by ever lower rates of return on those taxes.

Lesson #6: Clarify the amount of basic pension in a two-tiered system and give careful consideration to the desirable degree of redistribution. The British system, by establishing a funded tier of private pensions, limits the intergenerational transfers from young workers to old retirees in that current workers are required to save ahead for their

127 Jenkin interview, March 5, 1997.

128 Lilley press statement, p. 3.

129 *Ibid.*

130 Field, *Private Pensions for All,* p. 14.

pension benefits. These benefits will be affected at least somewhat by these savings and the investment income they produce. The current U.S. system provides for redistribution between higher and lower wage earners (based on the weighted benefit formula)[131] and between generations (based on the inflation-indexed pay-as-you-go scheme). If Congress changes Social Security to a two-tiered system, the amount of the basic pension and the method for indexing should be calibrated with great care.

Even though the partial privatization of the British state pension system enjoys broad support, some critics are concerned that the Basic State Pension has become too low. The flat benefit structure allows for the maximum redistribution between high and low wage earners, but if it is set too low, it can become a problem if pensioners receiving only the basic pension fall below the poverty level. Paul Johnson observes,

> The advent of Personal Pensions has provided a new pensions savings instrument for millions of previously uncovered people. If we believe people have the right to make choices then we have to accept that they will sometimes make the wrong choices. With an adequate social safety net they can be protected from the worst of them. But it is important not to lose sight of the importance of providing that safety net."[132]

Another inescapable issue in designing a first tier of government benefits is the eligibility criteria for the basic pension. If earnings over the normal working life are required for eligibility, as in the British system, then it seems that the basic pension should be set to provide a reasonable floor of retirement above the poverty level. If a universal minimum income for the elderly is to be provided regardless of work or contribution history, this floor logically might be set at a lower level, although the formal provision of a second-tier pension or means-tested welfare benefits will still be necessary.

Lesson #7: Realize that covering low-income or part-time workers with a defined contribution system of personal pensions may not be easy. Yet another inevitable difficulty is how to address the problem of an entire class of part-time or low-paid employees who move in and out of the workforce. These persons do not earn enough to invest significantly in private equity funds or stocks. Moreover, according to Andrew Dilnot, director of the Institute for Fiscal Studies, most private-sector fund managers in Britain show little enthusiasm in marketing to these people.[133] Considering the special characteristics of this sector of the workforce, Congress might wish to consider a privately managed defined benefit plan with investments in safer government securities or limited stock options.

Lesson #8: Realize that Social Security represents only one aspect of the current income transfer from young working persons to older retired persons. In any reform of Social Security, the legal relationship between financing and benefits in both Social Security *and* Medicare must be taken into account.[134] Today, for every $1 paid into the

131 Under the current Social Security formula, low wage earners receive a 58 percent replacement rate (the percentage of covered pre-return earnings); average wage earners receive a 42 percent replacement rate; and high wage earners receive a 28 percent replacement rate.

132 Johnson, *The Reform of Pensions in the UK,* p. [20].

133 Dilnot interview, March 6, 1997.

134 See Stanford G. Ross, *Domestic Reforms: The Importance of Process* (Washington, D.C.: Urban Institute, 1996).

Medicare program by the elderly, young working families pay roughly $5 in payroll taxes and general revenues. If the considerable intergenerational transfer of funds from younger workers to older retirees is to remain through the current Medicare program, this transfer should be a factor in calculating the amount of intergenerational transfer in the Social Security pension benefits system.

Lesson #9: Understand that establishing a tier of mandatory savings in a national pension system can improve the overall savings rate of the economy. In the first quarter of 1997, the personal savings rate in the United States was 5.1 percent.[135] Britain does much better: about twice the rate in the United States. In addition, the personal savings rate in Britain has changed very little during the past 15 years: It was 11.8 percent in March 1982 and 11.7 percent in September 1996, and ranged from a low of 5.4 percent in 1988 to a high of 12.9 percent in 1982.[136] In contrast, the savings rate of Americans has been on a general downward slope over the past 15 years: It was 8.5 percent in March 1982 and 5.2 percent in September 1996, and ranged from a high of 9.3 percent in June 1982 to a low of 2.8 percent in March 1994.[137]

Meanwhile, the relentless amassing of private pension funds has given Britain broader opportunities for economic growth. The buildup has been impressive. In 1970, for example, pension assets in both Britain and the United States amounted to 17 percent of GDP. By 1985, Britain had surpassed the United States with assets at 47 percent of GDP compared with 37 percent for the U.S. By 1990, British pension funds had reached 55 percent of GDP, compared with 43 percent for the United States.[138] Over the past several years, the size of the British pension pool has been growing rapidly. Between 1980 and 1988, real annual growth in pension fund assets averaged 13.3 percent, compared to 8.8 percent for the United States.[139] Today, with a working population of slightly less than 23 million people, Britain has amassed more than $1 trillion in pension reserves—a stunning achievement and more than the rest of the European Union combined. As Field notes, "This gives Britain a head start in terms of personal savings that in turn will pave the way for higher investment."[140]

The size of the British funds represents only a fraction of private pension assets in the United States; the U.S. workforce—producing 25 percent the world's gross national product—is well over 100 million. Yet despite its enormous size and productivity, the overall rate of savings among American workers remains a matter of genuine concern. Over the long term, Americans will have to increase both their personal savings and their domestic investment rates if the United States is to compete favorably in the global economy. Mandatory personal savings plans or funded pension schemes could help increase these ratios. Although broader economic considerations should not be the only factors pension designers weigh, they cannot and should not be ignored.

135 "U.S. Economic Review," WEFA Econometrics, May 1997.

136 Data extracted from tables compiled by the Office of National Statistics in the United Kingdom and the U.S. Department of Commerce.

137 *Ibid.*

138 E. P. Davis, *Pension Funds* (Oxford: Oxford University Press, 1995), p. 55.

139 *Ibid.*

140 Field, *Private Pensions for All,* p. 16.

Lesson #10: Make sure that workers and retirees are protected against fraud, abuse, and the mismanagement of private pension funds, but don't over-regulate. Several problems in Britain could have been avoided or minimized with stronger disclosure rules and an effective oversight body. Frank Field also notes the need for commonsense rules: "Lots of these changes are simple consumer protection measures that place a duty on fund managers to disclose relevant information on fees, capital growth and leaving penalties in an agreed format."[141]

Too many British workers were hurt by unscrupulous salesmen who sold on a commission basis, exaggerated rates of return, promised levels of benefit that could not be realized, or failed to disclose the extent of their commissions or the administrative costs of their plans. The Securities and Investment Board, the senior regulatory agency for Britain's financial services industry, responded by changing its regulatory framework, establishing guidelines for marketing, requiring descriptions of plan offerings and administrative costs and commissions in plain language, and forcing companies to disclose accurate projections based on reasonable assumptions concerning investment yields. Even though effective government action has cleaned up the industry, these scandals initially soured the public on the private pension industry and led more than 500,000 citizens to seek compensation for losses from the British government.[142]

As part of any change in the U.S. Social Security system, Congress must decide on the ultimate goals for reform and then construct the appropriate regulatory and organizational framework to achieve those goals. If Members of Congress are serious about expanding the market in private pensions, they should not authorize federal micromanagement. The current regulatory regime in the United States is not the appropriate mechanism for securing the necessary safeguards for a new nationally mandated system of private savings plans. Even some British analysts fear that, in their well-intentioned effort to protect consumers, British officials may have overshot that objective. British tax policy governing pensions is far too complex, and the regulatory regime governing company pensions and private investments in Britain today is much too cumbersome. As Dr. Ann Robinson recommends,

> The Government must tackle the mass of regulation which surrounds the provision of occupational pensions. Of course, members require security, but does it really take hundreds of often incomprehensible regulations to insure that pensions are paid? The cost to employers is formidable and the complexity confuses employees.[143]

Professor David Simpson, economic adviser to Standard Life Assurance Company of the United Kingdom, argues that British regulatory authority should be more streamlined; that prescriptive regulation of the "selling process" should be replaced by careful monitoring of the industry and tough enforcement of fair trading laws; and that the government should be engaged in disseminating information on comparative plan performance to promote consumer awareness and foster competition.[144]

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141 *Ibid.*, p. 20.

142 Interview with David Green, Institute for Economic Affairs, London, March 6, 1997.

143 Robinson, "Labour Faces an Age Old Problem," *op. cit.*

144 Simpson, *Regulating Pensions*, pp. 81–82.

In this respect, Members of Congress would be wise to review the existing Federal Employees Health Benefits Program (FEHBP) for federal government employees, as well as the rules that govern the private investment options for federal employees in the Federal Employees Retirement System. The FEHBP, in particular, is an excellent example of a program with a high degree of personal choice and market competition that at the same time maintains effective, but not burdensome, rules to guard beneficiaries against fraud or mismanagement.[145] The general success of both these programs can restore public confidence in the federal government's capacity to administer competent, targeted regulation in similar public programs.

As a technical matter, with any move toward a privatized Social Security system, Congress will have to examine how new federal regulatory efforts can be meshed with existing institutions like the Pension Benefit Guaranty Corporation, a federal agency created by the Employee Retirement Income Security Act of 1974 to guarantee payment of basic pension benefits earned by American workers.[146] Finally, Congress should consider what kind of federal re-insurance requirements or government guarantees should accompany any expansion of private or personal pension options under Social Security reform, just as the British government proposed in its 1997 pension reform package.

Lesson #11: Incorporate ways to give young workers the opportunity to set up personalized pension accounts that can rebuild their confidence in Social Security. The erosion of confidence in Social Security among Americans is indisputable. Part of the reason surely is that Americans in general have lost confidence in the federal government.[147] Personalized pension savings accounts, owned and controlled by workers and subject to reasonable regulation and market competition, would help to bridge this confidence gap. It therefore is crucial that Congress take great care in educating the public on the options available to them. Public confidence must be instilled in any government agency that is created to oversee and enforce compliance with regulations to protect the rights of the members of a privatized Social Security program. Otherwise, this regulatory effort will meet similar skepticism.

More important, the pre-funding of pensions obviates the need to depend on politicians' promises to pay future benefits. This becomes especially meaningful when the U.S. Treasury needs to begin paying off bonds to meet the need for Social Security benefits within the next 15 years.

While Congress and the President are working to bring the deficit under control, as promised, they should look for ways to insulate a large portion of Social Security funds from short-term political decisions. Legally protected private pensions that are gaining interest in personal accounts can reduce the anxieties of retirees over the historic inability of Congress and the President to meet their budgetary obligations under politically imposed time constraints.

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145 For an account of the Federal Employees Health Benefits Program, see Stuart M. Butler and Robert E. Moffit, "The FEHBP as a Model for a New Medicare Program," *Health Affairs,* Vol. 14, No. 4 (Winter 1995), pp. 47–61.

146 The Pension Benefit Guaranty Corporation insures the pensions of over 42 million workers in about 50,000 pension plans.

147 "Why Don't Americans Trust the Government?" *The Washington Post*/Kaiser Family Foundation/Harvard University Survey Project, 1996.

Lesson #12: Recognize that personal pension options can give workers flexibility in deciding on the age of retirement. Almost all Social Security proposals call for increasing the normal retirement age, but such changes are proposed despite a glaring inconsistency: Even though the retirement age in the U.S. system is scheduled to increase gradually from 65 to 67 as a result of the 1983 Social Security amendments, American workers continue to retire earlier each year. Although this trend has slowed during the past ten years, the age at which retirees take their first Social Security old age pension has been on a downward slope since the 1940s.[148]

Once again, Britain has experienced a similar pattern. Over the past several years, there has been a reduction in the number of men over age 55 in the workforce. The prevalence of defined benefit pension plans, based on final salary, is a contributing factor, for these plans become progressively richer as the years pass. Employers, to ease the company burden, encourage employees to take early retirement.[149] As David Willetts, a member of Parliament, has argued,

> This is a dangerous absurdity. Society might be able to handle the relatively modest and gradual increase in life expectancy. The strains, however, become serious if at the same time as life expectancy is increasing people leave the workforce when they are younger and younger. The *de facto* retirement age for men is rapidly moving down into the mid-50s. But the right policy is for retirement age to move gradually back upwards into the mid-60s and beyond.[150]

As Willetts points out, in the British case at least, this is a major economic benefit resulting from an expansion of personal pensions based on a defined contribution: "This is one of the most important yet least understood arguments in favor of encouraging personal pension ownership—it immediately creates an incentive for someone to stay on in work for as long as possible."[151]

It is, of course, not entirely clear what would occur if American workers had more control over their own retirement funds. Cultural factors, financial incentives, and behavioral changes all complicate retirement policy. Whether a larger number of older workers would choose to participate in the economy to a greater degree than is now the case because of today's complex retirement earnings test is a question that is not easily answered. But by allowing workers to contribute more to their own retirement accounts, Congress also might enable at least some of them to take early retirement or reduce their hours of work to accommodate their desired lifestyles. Or it might give them a powerful new incentive to change careers and work even longer, harnessing their wealth of experience and enhancing the productivity of the U.S. economy.

CONCLUSION

The British experience with state pension reform offers Congress and the Clinton Administration useful guidelines for designing changes in the U.S. Social Security

148 U.S. Social Security Administration, Annual Statistical Supplement, 1996, Table 6B5.

149 Willetts, *The Age of Entitlement,* p. 12.

150 *Ibid.*

151 *Ibid.*

system. This is especially true of Britain's Social Security Act of 1986, which broadened the options for British workers to allow them to opt out of the State Earnings Related Pension Scheme and showed that government can move from a traditional social insurance system to a partially funded system of private pensions. Reflecting on their own national experience, the editors of *The Times* have noted that

> Britain has nothing like the "pensions time bomb" that some other European countries face. Because this country's demographics are more favorable, and the pension age for women is to be raised, we shall have a healthier ratio of workers to pensioners. Because the basic state pension has been linked to prices rather than earnings, it costs the state less. And because the British have saved more for their retirement in occupational and private pensions than the rest of the EU put together, the burden on the taxpayer will be smaller.[152]

Using the 1997 Social Security Advisory Council Report as a starting point for the national debate, Congress and the President have time to consider and model a variety of solutions to the problems currently plaguing the system in the United States. But they have no time to waste. The longer policymakers delay, the more the taxpayers must make up for the current unfunded liabilities in a shorter period of time. Educating the American people on the current Social Security program and honestly discussing its problems in forums and town hall meetings around the country will take some time, not only because of its complexity, but also because several myths surround the issue.

Coming to a national bipartisan consensus on the best approach to retirement in the 21st century, as well as developing a sound plan for transition to a new system, will take time. Any peripheral changes in the system, such as adjustments in the Consumer Price Index, should be based on their own merits, not tied inextricably to an agreement on future changes in the retirement program. Serious reform will tax the political imagination of both Democrats and Republicans. If Congress and the President make a genuine effort, however, systemic change could be in place before the year 2000. Meanwhile, Congress should avoid standard short-term political fixes at least until the overall framework for reform has been developed.

Britain has become a showcase of serious reform. The British have made mistakes and have scored impressive successes in changing their retirement system. Reformers in the United States can learn from both. Considering the strong cultural, linguistic, and historical ties between the United States and Britain, as well as their somewhat comparable demographic, fiscal, and political situations, Parliament's record can provide Congress with important lessons based on valuable insights. Perhaps best of all, Members of Congress and Members of Parliament can discuss these lessons face to face.

Louis D. Enoff
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152 "The Pension Plan," *op. cit.*

APPENDIX

Further information on Britain's government pension system and private pension plans is available on the following World Wide Web addresses.

BRITISH GOVERNMENT PENSION AGENCY LINKS

The Benefits Agency, which is responsible for paying state pension benefits: *http://www.dss.gov.uk/ba/*

The Contributions Agency, which is responsible for payment and recording of national insurance contributions: *http://www.dss.gov.uk/ca/index.htm*

The Department of Social Security, which administers Britain's social security system, for data and research on pension-related topics: *http://www.dss.gov.uk/asd/index.htm*

The Employers Charter, a code of conduct for Britain's government pension agency personnel in dealing with employers: *http://www.open.gov.uk/charter/employ.htm*

General government links to British and international government pension agencies: *http://www.econ.bbk.ac.uk:80/pi/vl/govorg.html*

The Inland Revenue, Britain's tax collection agency (the equivalent of the IRS), for information on pension topics: *http://www.open.gov.uk/inrev/irhome.htm*

The Securities and Investments Board, which is responsible for regulation of investment vehicles: *http://www.sib.co.uk/*

PRIVATE PENSION PROVIDERS

The Association of Unit Trusts and Investment Plans: *http://www.iii.co.uk/autif/facts/pep_pen/*

Independent Advice Ltd., a commercial retirement advisory and planning service based in Britain: *http://www.independent-advice.co.uk/ia/pensions.htm*

Infoseek, a Web site offering a list of British pension firms: *http://uk.infoseek.com/infosk/owa/pkg_search.p_cat_search?in_cat_id=474*

Moneyworld, a financial magazine, for articles on private pensions and additional links: *http://ww.moneyworld.co.uk/*

Money Management, a weekly magazine covering Britain's private pension issues: *http://www.fee.ifa.co.uk/*

The National Association of Pension Funds Limited (NAPF), the main organization for companies involved in designing, operating, investing funds, and advising occupational

153 The authors would like to thank several individuals in Britain who provided valuable information and comments, especially Dr. David Blake, The Pensions Institute, Birkbeck College, University of London; Peter Barnes, Department of Social Security; Bill Birmingham, National Association of Pension Funds Limited; Drs. Eamonn Butler and Madsen Pirie, Adam Smith Institute; Andrew Dilnot, Institute for Fiscal Studies; Daniel Finkelstein, Conservative Research Department; Dr. David Green, Institute for Economic Affairs; Bernard Jenkin, M.P.; and Roderick Nye, Social Market Foundation. The views and opinions expressed herein (and any errors) are those of the authors alone.

pension plans in Britain: *http://www.napf.co.uk*

The Pensions Institute, Britain's most prominent pension research organization, based at Birkbeck College, University of London, for a list of private pension providers: *http://www.econ.bbk.ac.uk:80/pi/vl/ppa.html*

POLICY AND RESEARCH INSTITUTES

The Adam Smith Institute, a private, independent economic policy institute that promotes market-based economic reform: *http://www.cyberpoint.co.uk/asi/*

The Institute for Fiscal Studies, a British think tank that publishes work on the British pension system: *http://www1.ifs.org.uk/research/index.htm#Pensions*

Pensions Virtual Library, which offers a large collection of links on pensions: *http://www.econ.bbk.ac.uk:80/pi/vl/index.html*

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