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Learning from Britain's Next Step in Privatizing Social Security Benefits

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As Congress and the Clinton Administration continue to search for a consensus on how best to proceed with Social Security reform, they would do well to consider the experience of their peers in Britain.[1] The British Social Security system is already partially privatized. Virtually every British worker is eligible for a basic state pension, and most can enroll in a second tier of state pension benefits. But they also can choose to divert a portion of their national payroll taxes to invest in private pension plans.

The results of the British reforms have been impressive. For example:

- Private pension options are popular. The number of British workers who have chosen to opt out of the government pension system to earn a higher return through private pensions when given the opportunity to do so has greatly exceeded official expectations. More than two-thirds of British workers are "contracted out" of the second tier of the government pension system and enrolled in private plans.
- Private pensions are generating more wealth for workers and retirees. British workers have enjoyed a 10 percent *real* return on their pension investments over the past few years. And over the past two decades, the income of British retirees has increased by 60 percent—more than for any other segment of the British population.
- Private pensions contribute to Britain's wealth. The pool of private pension funds in Britain now exceeds

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1. For a description of the British Social Security reforms, see Louis D. Enoff and Robert E. Moffit, "Social Security Privatization in Britain: Key Lessons for America's Reformers," Heritage Foundation *Backgrounder* No. 1133, August 6, 1997; see also Daniel Finkelstein, "The Policy and Political Lessons of Britain's Success in Privatizing Social Security," Heritage Foundation *Committee Brief* No. 30, September 29, 1997.

> £830 billion (almost $1.4 trillion in U.S. dollars). This is slightly more than the size of the British economy, and larger than the private pension funds of all the other European countries combined.

Prime Minister Tony Blair, who heads Britain's Labor government, is hoping to build on this success by expanding workers' access to private pension options and by fixing specific problems that have accompanied the British privatization effort thus far. The government's latest proposals would:

- Create new "stakeholder pensions." This new kind of low-cost, flexible pension plan would combine the best features of current employer-based and personal pension plans, which are the dominant private plans in Britain.
- Establish a strong safety net. A minimum income guarantee would be instituted for all retirees, and the existing State Earnings Related Pension System (SERPS) would be replaced with a second-tier government pension system that offers better benefits to low-income workers.
- Provide annual statements of future benefits. Based on the best data available, the British reforms would require the government to provide "an annual statement for all those in public and private schemes detailing their current predicted pension, so they can see for themselves if they should save more for retirement...."[2]

Summarizing Britain's recent pension proposals, Secretary of State for Social Security Alistair Darling has observed that

> Everyone who can save for their retirement has a responsibility to do so. So, everyone who *can* should have a funded, second pension, where they can make additional contributions towards their retirement. And we'll help them do that. In turn, the government has a responsibility to provide security for those who *cannot* save enough.[3]

America's Social Security reformers can learn a great deal from the British experience. Specifically:

1. Relying on private pension plans to increase the future financial security and prosperity of retirees is both prudent and possible.
2. By moving from a pay-as-you-go system of government financing of retirement benefits to a funded system, Washington could tap into enormous private resources to reduce the crushing burden of debt and taxation the current system will place on future generations.
3. Benefits statements detailing what each worker can expect in retirement benefits would make it clear what they need to save to ensure a secure retirement.
4. U.S. Social Security reforms should be crafted to prevent lapses in consumer protection and avoid Britain's complicated tax and regulatory treatment of private pension plans.

THE BLAIR PROPOSAL: BUILDING ON SUCCESS

In December 1998, the Labor government unveiled a major proposal to create another category of funded private pensions for British workers. The plan would create "stakeholder pensions" as another alternative to enrolling in the government's second-tier pension system. The new stakeholder pensions target middle-class workers who have not enrolled in the existing private pension plans. They are designed to be both flexible and low cost, and to reduce welfare dependency of the elderly in the next century.

In instituting this new plan, Tony Blair's Labor government is building on decades of experience

2. Department of Social Security, *A New Contract for Welfare: Partnership in Pensions—A Summary*, London, December 1998, p. 12. Available at *http://www.dss.gov.uk*.
3. Department of Social Security, press release, December 15, 1998, p. 1.

in partial privatizing of Britain's Social Security system. Much of the existing law on Britain's pension plans—including the ability of workers to take a portion of their payroll tax and opt out of the government pension program to invest in private pension plans—is actually the product of successive Conservative governments. On the desirability and superiority of funded, private pensions as the way to enhance the financial well-being of the next generation of retirees, the British today seem to enjoy a sound bipartisan consensus.

The current British program is a two-tiered system of government and private-sector pensions. The government pension system is financed by a national payroll tax (which the British call "national insurance contributions"). Virtually every British worker is eligible for the Basic State Pension, which pays a flat rate benefit. Workers, excluding the self-employed, are also eligible for a second government pension, the State Earnings Related Pension System (SERPS), which is financed by the payroll tax and pays benefits on an earnings-related basis.

In sharp contrast to the Social Security system in the United States, however, the British government allows workers to opt out of the second government pension system and divert a portion of their payroll taxes, in the form of "tax rebates," to an "occupational pension" (a company-based pension) or a "personal pension" (roughly similar to U.S. individual retirement accounts). Tax rebates vary from year to year, but now equal 4.6 percent of pensionable earnings.

The number of workers enrolled in Britain's private plans varies from year to year as well, but more than two-thirds of all British workers today are "contracted out" of the government pension program and enrolled in private pension plans. The rates of return on Britain's private pensions average 10 percent per annum. Consequently, over the past two decades, British retirees have enjoyed a dramatic increase in their retirement income—largely attributable to private and pension investments—and more so than any other group in the British population. The pool of private pension funds has grown dramatically and today, at £830 billion, is both slightly larger than the British economy and larger than the economies of all other European countries combined.

According to the Labor government's "green paper" on pension policy, *A New Contract for Welfare: Partnership in Pensions*, the government is now proposing a new system which would retain the basic state pension, with its flat rate benefit, but increase it in line with prices. It also would phase out SERPS in favor of the new "second state pension" geared to lower-income workers. Prime Minister Tony Blair and his ministers recognize the inadequacy of the government pension program for current low-income workers and retirees:

> Those on very low incomes can save through SERPS all of their working lives, and still need income related benefits in retirement. This means they gain nothing from their years of saving. This is because SERPS, being earnings related, gives least to those in greatest need.[4]

At the same time, Labor officials realize that the answer to the problem is not simply to expand the pay-as-you-go government pension system, but rather to expand private pension opportunities for those who can take advantage of them:

> We believe the state should spend more, but do not believe it would be right to commit enormous sums—over £30 billion [US $49.5 billion]—regardless of people's needs and the nation's ability to pay the bills in the future. That is why we are focusing extra state support on those who need it most, and are encouraging more people on middle and higher incomes to provide more for their own needs.[5]

The popular payroll tax rebates, which are at the heart of Britain's Social Security privatization program, will remain in place for both occupational pensions and personal pensions but will now be available for "stakeholder pensions," the new

4. Department of Social Security, *A New Contract for Welfare*, p. 4.

5. *Ibid.*, p. 13.

low-cost funded pension product envisioned by the government for workers who have neither employer-based nor personal pensions.

THE KEY INGREDIENTS OF LABOR'S SOCIAL SECURITY REFORM

The Labor government's pension reform proposals are extensive. Though perhaps not as bold or comprehensive as those offered by the Conservative government in March 1997,[6] they nonetheless set forth major changes in Britain's Social Security system. Among the key elements of the proposal to improve the British pension system are:

- The creation of a new private "stakeholder pension." Establishing the legal and regulatory framework for a new private pension product is at the heart of the latest pension reform. Details will be outlined later this year, but the Labor Government already describes the plan as a new type of funded pension: "This new type of pension combines the low overheads and high security of occupational pension schemes with the flexibility of the best personal pensions, and will be available to all."[7]

  Like Britain's occupational pensions, stakeholder pension plans would be managed by trustees who would be responsible for the investment strategies. They will be designed to be most attractive to workers who are not enrolled in occupational or personal pension plans. The tax treatment of these pension plans will be similar to the generous tax treatment now afforded personal pensions. Stakeholder pensions will also be subject to consumer protection rules and controls over their administrative charges as well as the level of minimum contributions that must be made. But there will be no government restriction on the pension investments of these new plans.

  The size of the payroll tax incentive for persons who wish to enroll in the new stakeholder pensions has not been specified, but British experts expect them to be generous enough for the approximately 5 million persons who are not enrolled in company-based pension plans to take advantage of them. The target group for the stakeholder pensions includes workers who make between £9,000 and £18,000 per year (US $14,850 and US $29,700, respectively). It is expected, therefore, that Parliament will make sure that payroll tax rebates for the stakeholder plans are "generous enough" to assure the desired number of enrollees in the new pension plans. Labor government officials argue that workers making more than £9,000 (US $14,850) would be better off in a funded, private pension than in the government pension program.

- Replacement of the old government pension plan with a new "second state pension" targeted to low-income workers. A minority of British workers are still enrolled in SERPS, the government's second-tier pension plan. Prime Minister Blair's government has proposed replacing SERPS with a "second state pension" targeted to workers who make less than £9,000 per year. This would affect approximately 4 million British workers, especially those who are in temporary employment or out of the workforce because of the need to care for families or because of illness or disability.

  Under the Labor proposal, the government will give extra help, in the form of tax rebates, to those who make between £9,000 and £18,000 per year in both the second state pension and the private pension funds. According to a summary of the Labor government proposal:

6. A major reform proposal to create a national system of private accounts for the next generation of British workers was advanced by Peter Lilley, former British Secretary of State for Social Security. For a brief description of the Lilley plan, see Enoff and Moffit, "Social Security Privatization in Britain," pp. 22–23.

7. Department of Social Security, *A New Contract for Welfare*, p. 10.

> Once stakeholder schemes have established themselves as low cost, value-for-money second pensions, we expect in about five years time, the new state second pension will become a flat rate scheme for those with a significant amount of their working lives still remaining. The extra incentives for moderate earners will then only be available to those in stakeholder and other private funded schemes.[8]

Thus, the Labor government's policy is to move middle-income workers into private pension funds and target the new second government pension to low-income workers. According to Secretary Alistair Darling,

> In the long term, we are aiming for the radical re-balancing of state and private provision to ensure that those who can join secure, funded, non-state pensions do so.... Over the next 50 years the overall share of state spending on pensions will reduce as a proportion of national income as more people who can save do so.[9]

- The promotion of consumer information. Surveys indicate that too many British workers do not know how much they will get in retirement benefits from the government pension program, and do not understand their private pension benefits either. This lack of solid information to enable workers to compare the costs and benefits of private plans contributed to "misselling" scandals in the late 1980s and early 1990s, whereby British workers left lower-cost employer-sponsored (or "occupational") pension plans for higher-cost personal pension plans. The British government has taken steps to rectify this problem.

  Good information is crucial, and the lack of similar good information is a criticism of the U.S. Social Security system. Although the Social Security Administration issues workers a Personal Earnings and Benefit Estimate Statement (PEBES), workers get no clear idea of what they will need to maintain a decent standard of living in retirement. Indeed, a PEBES will report only half of the taxes paid by the worker and ignore the matching employer contributions. Moreover, there is no crucial rate-of-return calculation that would allow workers to compare future returns from their Social Security taxes to possible returns from private investment plans.

  The British government under Prime Minister Blair is proposing that, each year, all British workers be given a statement, written in clear and plain English, telling them how much they are to get in retirement benefits from both the government and their private pension plans. The statement will provide them with "better information on people's own need to save, including an annual statement for all those in public and private schemes detailing their current predicted pension, so they can see for themselves if they should save more for retirement...."[10] The dissemination of this crucial information will enable workers and their families to gain a better understanding of the benefits of private pension plans, which should "encourage more people to join them."[11]

- A minimum income guarantee for retirees. The Labor government's objective in improving private pension opportunities is to reduce poverty and welfare dependence among Britain's elderly and ensure that more citizens have a prosperous retirement with secure incomes. At the same time, the government is taking steps to guarantee that everyone in need will have a

8. *Ibid.*, pp. 5–6.
9. Department of Social Security press release, p. 3.
10. Department of Social Security, *A New Contract for Welfare*, p. 12.
11. *Ibid.*

"decent income" in their retirement years. According to the Labor government proposal:

> Our long term aim is that the new minimum income guarantee should rise in line with earnings so that all pensioners can share in the rising prosperity of the nation. This will mean that we can increase the income of the poorest pensioners at a faster rate than by raising the basic state pension, because help will go to those in greatest need, rather than to rich and poor alike.[12]

LESSONS FOR AMERICA

American reformers who are concerned about the safety and security of retirees' future income should emulate the decisive action of Britain's policymakers.

In the face of serious demographic and financial problems, the British demonstrated that it is possible to reform a major entitlement program and forge a consensus on the need for funded private pension plans. By taking prudent steps over time, they reduced the unfunded liability of the government pension program and dramatically reduced the tax burden on future generations of British workers. In the process, the British have amassed nearly $1.4 trillion (in U.S. dollars) in a pool of private pension funds, have improved their rate of return on payroll taxes, and have raised the standard of living for retirees.

The Labor government under Prime Minister Tony Blair is committed to the expansion of flexible private pension options for the British people. It also is promoting policies that will strengthen the safety net to help those who cannot save for their own retirement. And it is making sure that those who can provide for their own retirement have solid information on what they have earned and what they could earn in a private pension plan.

American reformers can learn from Britain's accomplishments and mistakes. Specifically, in reforming Social Security:

- It is both prudent and possible to rely on private pension plans to increase the future financial security and prosperity of retirees.
- It is pragmatic to move away from the current pay-as-you-go system of government financing of retirement benefits to a funded system that taps into the enormous private resources currently available in order to reduce the burden of debt and taxation on future generations.
- It is advantageous to give workers good information on what they can expect in retirement benefits, including rate-of-return information of the kind the U.S. Social Security Administration currently fails to provide on PEBES statements. In addition, annual benefits statements should show workers the current rates of return they can expect from their payroll taxes and contributions to pension plans.
- It is wise to craft reforms in a way that will protect consumers who transfer from one set of private plans to another, and to avoid Britain's complicated tax and regulatory treatment of private pension plans.

CONCLUSION

For Members of Congress and Clinton Administration officials who are considering how best to move from today's financially troubled, government-run Social Security system to a system that includes private retirement accounts, Britain's decades-long successful experience in privatizing part of its Social Security system should prove helpful. If Washington policymakers take the British lessons to heart, the next generation of American workers should enjoy a much more secure and prosperous retirement, based on sound private investment—one that is far less dependent on the promises and ploys of politicians.

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12. *Ibid.*, p. 8.