Broken English: The United Kingdom's Troubled Experiment with Personal Pensions

ISSUE BRIEF #5

As Americans consider various proposals to privatize some or all of the Social Security system, they would do well to consider the experiences of other countries. The United Kingdom, for example, was a pioneer in this as in so many other privatization efforts.

For more than forty years, the British, like Americans, financed their retirements based on the familiar model of a three-legged stool consisting of public funds, employer pensions, and personal savings. In 1986, the United Kingdom began a process intended to curtail the government share of total pension funding and to reduce employer contributions as well. In addition to shrinking the role of government, the approach was designed to increase individual saving and investment by creating Personal Pensions. The plan was designed to do exactly what many of the proposals currently advocated by some Americans would do: empower individuals to invest for their retirement without government interference while freeing the government (and employers) from considerable expense. The effects of the plan were the equivalent of cutting Social Security benefits, reducing employers' contributions to the Social Security Trust Funds, and encouraging workers to invest their IRA and 401(k) money as wisely as they could. In practice, Personal Pensions have had a mixed record. The spotty performance over the past twelve years suggests that they may be an example to avoid rather than imitate.

How the United Kingdom Privatized Pensions

The United Kingdom has a two-tier pension system. Since 1945 it has provided a Basic State Pension (BSP) funded by employer and employee payroll deductions. This flat-rate pension is determined by the number of years in which a worker has contributed, regardless of earnings. It seldom provides sufficient support to retirees. In 1994, it replaced only 15 percent of the average male worker's wages at the time of retirement. In the future, the BSP is expected to replace an even smaller percentage of earnings--by 2030, merely 9 percent, according to one estimate. As a consequence, one-third of U.K. pensioners rely on additional means-tested benefits such as income support and housing subsidies.

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The second tier of the U.K.'s pension system is earnings-related. In 1975, the government instituted the State Earnings Related Pension Scheme (SERPS). Funded by additional employer/employee contributions, it originally guaranteed workers, on top of their Basic State Pension, 25 percent of their average annual wages (within limits) during the most highly paid twenty years of their working careers. SERPS was compulsory. Employers and employees had to contribute to it unless the employer provided a pension plan whose benefits equaled or exceeded those of SERPS.

But in 1986, concerned about rising costs as the ratio of retirees to workers increased, the government reduced the SERPS benefit by recalculating it on the basis of 20 percent of average annual earnings over a lifetime. Whereas in 1995 the BPS and SERPS together replaced a third of the average male worker's wages at retirement, the Government Actuary has estimated that in 2030 they will replace only a quarter of earnings. (In contrast, Social Security provided 44 percent of the average U.S. worker's wages for individuals retiring at the age of sixty-five in 1997, and according to the intermediate assumptions of the Social Security Trustees' Report, it will replace 42 percent of the average U.S. worker's wages for individuals retiring in 2030.) Moreover, the United Kingdom encouraged workers to forego this public benefit altogether by creating private Personal Pensions. As if the reduced SERPS benefit weren't incentive enough, the government also gave tax breaks to workers who struck out on their own.

What Went Wrong

By 1993, the number of workers choosing Personal Pensions reached 5.7 million; by 1997, that number had doubled. Today, one in four British workers has a Personal Pension, but not all of them have chosen wisely. A 1997 report by the United Kingdom's Office of Fair Trading notes that 570,000 such pensions have been under investigation for having been misrepresented to potential buyers. Fifty thousand of these cases had been reviewed, and 12,000 offers of compensation accepted. Estimates for the total cost of review and compensation have grown to 18 billion dollars. Many workers, a large percentage of them female and poorly paid, had been misled by deceptive advertising to abandon pension plans provided by their employers or by SERPS for private plans that actually offered inferior benefits.

"Many personal pension plans are . . . simply poor value," the Office of Fair Trading report notes, adding that even after some reforms were enacted in 1995, "a number of products of doubtful value remain on the market."

While many workers lost money, so did the government. The Secretary of State for Social Security has reported that between the years 1987-88 and 1994-95, the latest date for which certified figures were available, the government spent £21.7 billion on insurance rebates and incentives—three times as much as the £7.2 billion it saved in reduced SERPS liabilities.

In the meantime, Personal Pensions have lined the pockets of the companies that sell them. The Institute of Actuaries has estimated that fees may consume 10 to 20 percent of a worker's contributions to a Personal Pension plan (compare this to American Social Security's administrative costs of somewhat less than 1 percent of benefits). Using a comprehensive database of the costs charged by insurance companies offering individual accounts in the U.K., three economists conducting research for the World Bank estimate that fees and cots will consume an average of 43 percent of the value of an individual account over the course of a typical, 40-year working career. These fees and costs include not only the cumulative costs of administering and managing an account, but the costs incurred when a worker switches from one provider to another or drops out of the work force, and when a retiring worker converts his or her personal pension into an annuity. (Peter Orszag, "Administrative Costs in Individual Accounts in the United Kingdom," Center on Budget and Policy Priorities, March 16, 1999). Ten private firms have captured four-fifths of the Personal Pension market. According to the Office of Fair Trading report, these firms compete "not on the basis of the cheapest product, that is, the one with the lowest expenses, but on the basis of specious claims about investment returns." Since 1995, profit margins have exceeded 22 percent.

It is difficult to forecast what kind of retirement U.K.'s Personal Pensioners can expect. Some economists are concerned that the compulsory contributions to Personal Pensions are insufficient to assure a comfortable retirement, especially for lower-paid workers--yet these workers in particular are unable or unwilling to make the necessary additional discretionary contributions. There are similar concerns in the United States, of course, where by some measures at least a third of the members of the baby boom generation are not saving enough money for retirement. The difference is that Americans are not entirely

on their own. So far, at least, they can still expect adequate Social Security benefits and, in many instances, employer pensions to supplement their own savings.

Since the U.K.’s Personal Pensioners are predominantly younger workers, their retirement is a long way off. But that retirement is at considerable risk. Selecting a fund, the Office of Fair Trading warned, "is something of a lottery."

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