PENSION REFORM IN THE
UNITED KINGDOM
INCREASING THE ROLE OF PRIVATE PROVISION?

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Abstract

This paper describes the current UK pension system and both the motivations behind, and the implications of, the direction of reforms seen over the last twenty years. Issues such as the sustainability of the pension system, and the advantages and costs of the increasing reliance on means-tested benefits are discussed. Employees are shown to have a large degree of choice over how much and the form that they save for their retirement. Making appropriate savings decisions is made more difficult by the complexity of the present system and the frequent reforms that have tended to add uncertainty and new complexities. Also discussed are the difficulties faced by the Government as it attempts to expand private pension coverage further down the earnings distribution and eventually increase the proportion of pensioner income that comes from private sources. The paper also describes issues related to the coverage of different types of pension arrangement, their transferability and portability and the potential consequences for competition in the provision of private pensions and labour market flexibility.

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1. Introduction

The UK pension system is particularly interesting due to the frequent and significant reform that it has undergone over the last 25 years. The incomes of the current generation of pensioners comprise state support together with a slightly smaller but very significant amount from private sources. This is in sharp contrast to many other EU countries such as France, Germany and Italy where a much larger proportion of pensioner income comes from the state (Disney and Johnson, 2001).

The number of pensioners is forecast to grow by just over 40% in the next 50 years while the working age population is expected to remain approximately constant. Given that the public pension system in the UK is financed on a pay-as-you-go basis this ageing of the population might have been expected to lead to financing problems in the future. This is not the case. The reforms introduced in the UK since 1980 have left the state system sustainable in terms of future costs. These have taken the form of reductions in the future generosity of the state system – through increases in the state pension age for women, reductions in the earnings-related component of the public pension system and the formal price indexation of the flat rate pension. When additional state spending has been made available it has often been focussed at lower-income pensioners through increasing means-tested benefits. The result is that means-tested benefits are a very important part of the state system.

While no-one is, at present, allowed to ‘opt-out’ of the Basic State Pension the UK pension system allows employees with a large degree of choice over their second tier pension coverage. Historically, this reflects the fact that a significant earnings-related state pension scheme was only introduced in 1978 by when the coverage of occupational pension schemes was already high. Employees have to be a member of a pension scheme, but if offered the chance to join their employers scheme they are free to decide whether to accept this offer, or to remain in the State Earnings-Related Pension Scheme (SERPS), or
alternatively whether to make their own individual arrangements. Higher earners are much more likely to be members of an occupational pension scheme. Coverage of personal pensions is highest among those in the middle of the earnings distribution. Those who have chosen to remain in the state scheme tend to have lower earnings. The latest reforms to SERPS, the first stage of which was introduced in April 2002, will eventually lead to even greater incentives for those on middle and high earnings to join a private pension scheme.

The current system is certainly not without problems and further reform is likely. It remains to be seen whether the UK public pension system will prove to be sustainable politically with future projected state expenditures remaining broadly constant as a share of national income despite increasing proportions of the electorate being above the state pension age. Furthermore the frequent reforms have left the UK system looking very complex. This complexity and the regularity with which the system is reformed will hinder individuals who are trying to make appropriate decisions over how much, and in which form, to save. The reliance on means-tested rather than universal benefits leads to problems with some pensioners falling through the social security safety net since they do not claim the benefits that they are entitled to. It also means that those individuals who expect to be on a relatively low income in retirement will face a disincentive to save through the high marginal withdrawal rates arising from potential eligibility to a number of means-tested benefits.

This chapter starts by discussing the demographic changes expected in the UK over the next 50 years and provides an outline of the UK pension system. Section II looks at the expected costs of both the current pension system and the system of means-tested support to pensioners and recent proposals from both the Labour Government and the opposition Conservative Party. Section III looks at the private pension arrangements that
individuals have made and how these vary by characteristics such as age and earnings. It also discusses the difficulty in trying to extend coverage of private pensions further down earnings distribution. These difficulties centre around the characteristics of those who do not already have a private pension and the Government’s increasing reliance on means-tested benefits to deliver increased incomes to those aged 65 or over. Section IV discusses the important issue of transferability of pension funds and how this might affect both competition among pension providers and also improve labour market flexibility. Section V concludes.

1.1 Demographic trends

The latest demographic forecasts from the Government Actuary’s Department are shown in table 1.1. The number of pensioners in the UK is set to increase from 10.5 million in 2000 to 14.4 million in 2050. Over the same period the number of individuals aged below the state pension age is set to fall slightly from 36.3 million to 35.8 million. This is despite the planned increase in the state pension age for women from 60 in 2010 to 65 in 2020. These trends reflect both previous birth rates and also improving life expectancies.

Also shown in table 1.1 is the number of people expected to be contributing to the UK’s National Insurance fund and the corresponding number of people expected to be claiming a pension. The latter being higher than the number of people in the UK aged over the state pension age due to the pension claims of individuals who have moved overseas. The ratio of contributors to pensioners is set to fall from around 1.8 today to 1.3 by the mid-century.

[TABLE 1.1 ABOUT HERE]
The expected ageing of the UK population over the coming century is not as severe as that expected in many other countries. For example the percentage of the UK population aged over 65 is forecast to increase by 14.7 percentage points between 1990 and 2030 (from 24.0% in 1990 to 38.7% in 2030). This compares to increases of 27.5 percentage points in Germany, 18.3 percentage points in France and 17.7 percentage points in the US (Bos, Vu, Massiah and Bulatao, 1994).

This ageing of the population is likely to have a number of effects on the public finances. The extent to which it is ‘healthy’ or ‘unhealthy’ ageing will be a major determinant of the future demands placed on the National Health Service and the demand for long-term care. Initial work suggests that the increase in demands on the NHS over the next 50 years from changing demographics may be around the same magnitude as the increase seen over the last fifty years (Emmerson, Frayne and Goodman, 2000). Increasing numbers of the population at older working ages and whether ageing is healthy or unhealthy ageing will also have implications for numbers of recipients of disability benefits. In contrast with regards to education spending the effect of demographics is actually likely to reduce pressures (HM Treasury, 1999). As is shown in section II the costs of the UK State pension system, in its current guise at least, is sustainable in terms of cost in that large future tax increases are not expected to be needed. This is despite the expected increase in pensioner numbers and the fact that it is financed on a pay-as-you-go basis. Whether the system is politically sustainable remains to be seen.

1.2 The current UK pension system

The UK pension system is very complicated due to numerous reforms over the last quarter of a century. Figure 1.1 provides a ‘simplified’ picture of the current UK pension system, which can be split into three main tiers. The first tier is mandatory, flat
rate and publicly funded on a pay-as-you-go basis. There is also a significant, and growing, amount of means-tested benefits available to lower income pensioners. The second tier is also mandatory to employees although individuals are faced with a large degree of choice over the type of pension that they can accumulate. The state second tier pension is financed on a pay-as-you-go basis, as are most of the occupational pension schemes that are offered to public sector workers. Private sector occupational schemes, personal pensions and Stakeholder Pensions are all financed on a funded basis. The third tier consists entirely of voluntary private savings, again all of which operate on an individual and funded basis. This subsection provides a brief outline of each tier in turn – more detailed descriptions can be found in, for example, Disney (1996) and Disney, Emmerson and Tanner (1999) and Disney, Emmerson and Wakefield (2001).

[FIGURE 1.1 ABOUT HERE]

The first tier of pension coverage

This tier is entirely publicly provided and funded on a pay-as-you-go basis. The largest single item of Government expenditure is the Basic State Pension, which for a single pensioner will be worth £75.50 a week from April 2002. Over the period from 1948 to 1975 is was increased on an ad hoc basis and actually grew relative to average earnings. The Social Security Act of 1975 formally linked the Basic State Pension to the greater of either growth in prices or average earnings and this lasted until the early 1980s. Since then it has been automatically been increased in line with prices, although occasionally above inflation increases have been announced, for example in April 2001 and April 2002.iii
The structure of the Basic State Pension has largely been unreformed since it was introduced in 1948. It is a flat rate benefit payable to men from the age of 65 and to women from the age of 60. In contrast to the pension systems of many European countries the Basic State Pension is payable regardless whether individuals have actually retired or not.\textsuperscript{iv} Rights to the Basic State Pension are established through National Insurance Contributions. All those who earn over the primary earnings threshold (PET, £89 a week in 2002–03) have to pay National Insurance Contributions. Those earning between the lower earnings limit (LEL, £75 a week in 2002–03) and the primary earnings threshold have contributions made on their behalf. This is also true of those in periods of illness, unemployment and disability. In order to qualify for the full amount individuals need to have contributions for 90% of their working lives (44 years for men and 39 years for women) though this can be reduced through years spent looking after a dependent. If only one partner in a couple qualifies for the Basic State Pension then they receive an extra dependant’s addition worth around 60% of the single allowance for their partner.

In theory at least, no individual is left reliant on just the Basic State Pension for income in retirement. This is due to the level of means-tested benefits being higher than that the level of the Basic State Pension. This has generally been the case over the last fifty years, although this was not the original pension system envisaged by Beveridge or the one established in 1948 when the Basic State Pension was £1.30 a week and the national assistance level of support set at £1.20 a week. In April 2002 the Minimum Income Guarantee (MIG) is worth £98.15 a week for a single person aged 60 or over, some 25% higher than then level of the Basic State Pension. Those over the state pension age may also claim other benefits such as housing benefit and council tax benefit or, depending on their health, certain disability related benefits. The last twenty years has
also seen a large increase in the numbers of people receiving disability benefits prior to reaching the state pension age (Blundell and Johnson, 1998).

The second tier of pension coverage

The next tier is compulsory to all those in paid employment who earn above the LEL (although not the self-employed). Individuals have a significant amount of choice over the way in which they save within this tier. The default is for individuals to be a member of the state scheme which, like the Basic State Pension, is funded on a pay-as-you-go basis. Contributions made since April 2002 accrue rights to the State Second Pension which initially will be an earnings-related pension, although the Government has stated that in the near future this will become a flat rate top up to the Basic State Pension (Department of Social Security, 1998). It is more generous towards lower-earners than its predecessor, the State Earnings-Related Pension Scheme (generally known by its acronym SERPS). SERPS was introduced in 1978 and individuals were able to accrue rights to the scheme up until March 2002. The change will mean that SERPS payments will continue to be made for a considerable time to come. This highlights that a pension reform that does not create losers will often lead to extremely long transition periods – for example an individual aged 20 in 2000 will not reach the state pension age until 2045 but may still have accrued a small entitlement to SERPS.

Since SERPS was first introduced in 1978 individuals have been able to ‘opt out’ of the state scheme into a private pension. Between 1978 and 1988 this had to be a defined benefit (final salary) scheme that guaranteed to pay at least as generous a pension as the state alternative. Over this period individuals whose employer offered them the chance to join an occupational pension scheme had to join that scheme. In return for forgoing their rights to SERPS individuals and their employers paid a lower rate of National Insurance contribution.
From 1988 onwards individuals were able to choose instead to ‘opt out’ of the state scheme into a defined contribution (money purchase) pension scheme. More controversially individuals were also allowed to choose not to join their employers pension scheme and instead choose to open their own personal pension or instead to revert to the state scheme. These defined contribution schemes could either be provided by employers or on an individual basis in accounts known as approved personal pensions. Since these schemes could not guarantee to pay a certain pension the Government instead paid part of individuals’ National Insurance Contributions directly into their fund.\textsuperscript{vi} In retirement this part of the pension fund is used to purchase a ‘protected rights’ annuity the rates on which do not vary by gender.

From April 2001 individuals could also choose to ‘opt out’ into a Stakeholder Pension. This is a ‘no frills’ personal pension with a regulated cost and charging structure. Employers currently have to designate a scheme to their employees and enable them to make contributions directly from their pay.\textsuperscript{vii} There is no requirement, as yet, for employers to make any contribution to these schemes.

While personal pension and Stakeholder Pensions operate on a defined contribution (money purchase) basis the majority of occupational pension schemes (weighted by membership of scheme) still operate on a defined benefit (final salary) basis.

The third tier of pension coverage

Individuals can also make additional contributions (up to a limit depending on their age and earnings) to a private pension. Contributions are made from income before tax, there is no income tax or capital gains tax on any returns to the fund and one-quarter of the fund can be taken tax-free on withdrawal. The remaining three-quarters of the fund
has to be used to purchase an annuity before the individual reaches 75, the income from
which is subject to income tax.\footnote{8}

Individuals can also save for their retirement in many other tax privileged ways
such as housing or in an Individual Savings Account (ISA). Returns to funds held in an
ISA are not subject to income tax or capital gains tax, and there is a 10\% dividend tax
credit on any dividends received from UK equities, at least until April 2004. Funds held
in an ISA have the advantage of being more liquid than those held in a private pension
and there is no requirement to annuitise funds. Offsetting this is the fact that tax
advantages are, at least for those individuals who expect not to be on means-tested
benefits in retirement, not as great as those given to savings held in a private pension
(Emmerson and Tanner, 2000).

As shown by this discussion the UK pension system provides individuals with a
large degree of choice over their pension arrangements. This choice comes at the expense
of an extremely complicated pension system. The next section looks at the financial costs
of the state part of the current system including the relatively large expenditures on
means-tested benefits. The clear attractiveness of this system in terms of its ability to
focus state expenditures on those with the lowest incomes in retirement is also
highlighted.

2. THE FRAMEWORK OF DEBATE

The current UK pension system certainly does not need further reform to make it
sustainable in terms of its likely cost. Despite the forecast ageing of the population
spending as a share of national income is expected to remain relatively stable over the
next forty years, while National Insurance Contribution rates should actually be able to
fall. This is shown in table 2.1. This is due to the assumed indexing of the Basic State
Pension to prices (which rise more slowly than national income), the planned increase in the state pension age of women and two reforms to SERPS which substantially reduced its future generosity and hence the expenditure on it. The Basic State Pension, worth £75.50 in 2002–03 would have been worth slightly over £100 a week had it been indexed to earnings since 1981–82. While the Basic State Pension is forecast to cost £51.2 billion in 2050 this would more than double (to approximately £108.8bn) if it were continually increased in line with earnings instead of prices.

TABLE 2.1 ABOUT HERE

There are several reasons why the figures presented in table 2.1 understate Government expenditure on future generations of pensioners:

First the National Insurance rebates that are paid to individuals who have chosen to ‘opt out’ of SERPS or the State Second Pension. In the past these have been more generous than would have been required to provide an incentive for individuals to ‘opt out’ of the state scheme. In part this reflected the drive to move towards privatisation of part of the second tier of pension coverage. The cost of reduced National Insurance Contributions, after netting off the reduced entitlement to SERPS, was £5.9bn for the period 1988 to 1993. In 1999–2000 National Insurance Contributions were £8.8bn (1.0% of GDP) lower than they would have been in the absence of the contracting out arrangements. This is equivalent to between a 2½ and 3 percentage point increase in the NI Contribution rate (Disney, Emmerson and Smith, 2002).

Second, these estimates, like any other projections are subject to forecasting errors. In the past these have tended to underestimate future numbers of pensioners due to an underestimate of future improvements in mortality (Disney, 1998). For example the
1996 population projections published by the Government Actuary’s Department forecast that there would be 8.2 million people aged over 75 in 2051 compared to a forecast of 8.7 million made just two years later (Emmerson, Frayne and Goodman, 2000).

Third the Government Actuary’s projections, shown in table 2.1, do not include the cost of means-tested benefit and other (non means-tested) benefits that go to pensioners. Table 2.2 shows that a total of £60.3bn (6.0% of GDP) is spent on benefits to those above working age, of which on only £42.0bn (4.2% of GDP) is on the flat rate and earnings related pension schemes. Other than these the biggest items being expenditure on the MIG (£4.4bn) and housing benefit (also £4.4bn). How these expenditures change in future will depend on whether the Government’s aspiration to increase the MIG in line with earnings is fulfilled and the private incomes of future generations of pensioners. The latter will depend on how much these individuals save for their retirement and the return that they receive on those funds. Further reform, which is discussed further in section II.1, represents a further increase in spending on means-tested benefits of around £2bn a year. It is also the case that pensioners will benefit disproportionately from some other aspects of state spending such as that on the NHS and subsidised public transport.

The increasing reliance on means-tested benefits has been due to the Government concentrating additional resources on low-income pensioners. This has come with at least two possible disadvantages. First many pensioners do not take up the means-tested benefits to which they are entitled. The result is that the poorest pensioners are those left reliant on a level of income below the means-tested floor. The most recent Government estimates suggest that only between 64 and 78 percent of eligible pensioners claim the
Second the presence of increased reliance on means testing will lead to some individuals having a reduced incentive to save for their own retirement (this is discussed further in section III).

Rather than increasing the generosity of the state pension system the successive Conservative Governments from 1979 to 1997 tended to focus any additional resources on means-tested support for pensioners. The Labour Government since 1997 have increased state spending on pensioners by a greater extent, and again a very large proportion of this has been targeted at lower income pensioners. Interestingly the large increase in means-tested income safety net for pensioners has not led to an increase in the number of people aged 60 or over on income support (or its successor) (Brewer, Clark and Wakefield, forthcoming). Given that take-up rates have been relatively stable this is probably due to younger cohorts having higher private incomes then previous generations.

For a government wanting to target additional resources at low-income pensioners increasing the Minimum Income Guarantee rather than the Basic State Pension is attractive because all the funds will go to the low-income target group. This is highlighted in figure 2.1 which shows the gains across the income distribution from increasing the Basic State Pension to the level of the MIG. In total this measure would cost around £5½ billion (0.5% of GDP). Those pensioners with no private income except the Basic State Pension, who currently receive the MIG, would not gain at all since it is currently withdrawn with a 100% taper. The biggest cash gains would go to pensioner couples who are not in receipt of any means-tested benefits. In particular those couples where both individuals have full pension entitlement in their own right will receive the biggest cash gains. These are more likely to be found towards the top of the pensioner income distribution. The poorest twenty percent of pensioners would gain an average of
£14 a week compared to £18 a week among the richest twenty percent of pensioners. An important consideration is that many of the poorest pensioners do not take-up the benefit to which they are entitled. The modelling below does not capture this non-take-up and hence the gains to the bottom quintile in particular will be understated. However the picture clearly shows that a significant part of the additional spending goes to the top of the income distribution which, if the objective is to help the poorest pensioners, is badly targeted.

[FIGURE 2.1 ABOUT HERE]

Future reform, or at least more expenditure than that implied by the current plans, might become politically necessary. State expenditures remaining broadly constant as a share of national income during a period of increases in the proportion of the population aged over the state pension age (as discussed in section I.I) imply that the proportion of national income publicly spent on each pensioner is set to fall. Table 2.1 shows that by 2050 state expenditure on each pensioner per unit of national income will be just 68.3% of the level seen in 1999–2000. Without the replacement of SERPS with the more expensive State Second Pension this figure would have fallen further to 56.2%. Whether or not this is politically sustainable is likely to depend on the views of the increasing proportion of the electorate aged above or near the state pension age. More specifically it may depend on how the retirement income that they receive from the state compares to the expectations they held during their working lives. I know turn to look at proposed reform from both the Labour Government and the opposition Conservative Party.
2.1 The current debate and proposed future reform

The Government will from October 2003 introduce a new means-tested benefit to individuals aged 65 or over. This is called the Pension Credit. The motivation behind this is that under the present system the 100% withdrawal rate on the MIG means that it is not necessarily the case that a pensioner with a small amount of private income will be any better off in retirement than someone with no private income. The Pension Credit will remove this feature since it will introduce a withdrawal rate of 40%. (Retired women aged 60 to 64 will not receive the Pension Credit. Furthermore those with non-means tested income of less than full Basic State Pension entitlement will still face a 100% withdrawal rate, at least on part of their income.) The Pension Credit will cost around an additional £2bn a year from 2004–05 onwards. Naturally, as the generosity of means-tested benefits is increased, this will lead to more people being eligible. The result will mean that while 53% of over 65 year olds are currently in families who are entitled to at least one means-tested benefit this will rise to 61% as a result of the introduction of the Pension Credit.

The Conservatives have suggested a different direction of reform. At the 2001 general election they proposed that individuals should be allowed to ‘opt out’ of the Basic State Pension. This would have increased further the amount of privately provided pension provision and would also have increased further the amount of choice that individuals had over their pension savings. The effect on the public finances would be a deterioration in the short run due to the National Insurance rebate on offer, but an improvement in the long run arising from the reduced future state expenditures. The overall effect on the public finances is ambiguous since it depends on what level of Government contribution is required to persuade individuals to forgo their entitlement to the Basic State Pension. It would also have the effect of shifting further away from a pay-
as-you-go pension system towards a funded pension system. The desirability of this reform depends in part on attitudes towards individual choice and risk taking and also the possible advantages from portfolio diversification from at least a portion of future state pension liabilities being paid for on a pay-as-you-go basis (Emmerson, 2001).

The next section turns to examine in more detail current coverage of private pensions and assesses the difficulty that the Government faces in its attempts to extend coverage of private pensions further down the earnings distribution.

3. **Redrawing the Public-Private Divide: Domestic Issues**

As shown in section II.1 the UK State pension system appears to be financially sustainable. As discussed this has been achieved by large reductions in future state expenditures. In fact by international standards there has always been a relatively low level of UK State expenditure going on the pension system. Alongside this there has always been a significant amount of private pension provision. State spending on pensions as a share of national income increased from 2.5% of GDP in 1957 to just over 5 percent in 1982 and has fallen since (Banks and Emmerson, 2000).

Membership of occupational pension schemes fluctuated around 50% of employees from the late 1960s to the late 1980s (Government Actuary’s Department, 2001). This has translated into a relatively high proportion of pensioners income coming from private sources. Currently around 40% of pensioner income is from private sources and 60% from public sources. The 1998 Green Paper stated that the Government wanted to reverse this by the middle of the current century (Department of Social Security, 1998). One of the mechanisms by which this is to be achieved is through the introduction of Stakeholder Pensions. The Government hopes that these will be more suitable for
individuals with lower earnings and therefore will extend private pension coverage further down the earnings distribution.

Current coverage of private pensions, by age, gender and type of employment is shown in figure 3.1. Among full time employees 54% of men and 58% of women have an occupational pension, with coverage highest among the 35–44 year old age group (as shown in the left hand panel). The higher level of coverage among full-time women is due to the fact that they are more likely to work for employers that offer such schemes – for example women are more likely to work in the public sector.

Coverage of personal pensions is lower, with 23% of men and 14% of women employed full-time having made their own arrangements in this way (as shown in the right hand panel). The average age of individuals with a personal pension is younger than those with an occupational pension. The relatively young age of those who have chosen to open a personal pension is perhaps unsurprising since these schemes have only been around since 1988. In addition younger workers were initially provided with a far stronger incentive through the original NI rebates to opt out of SERPS (Disney and Whitehouse, 1992).

Coverage of private pensions also varies considerably by earnings level. This is shown in figure 3.2 using data from the 9th wave (1999) of the British Household Panel Survey. In total 46% of those in paid employment report being a member of an occupational pension scheme, with a further 7.4% reporting that they also have a personal pension in that year\textsuperscript{v} and 10.1% having just a personal pension. Those with higher earnings are much more likely to be members of an occupational pension scheme with
82.1% of those in the highest earning ten-percent of the population having either an occupational scheme or an occupational scheme and a personal pension. This may appear counter-intuitive since those employers that offer an occupational pension might have been expected to pay less since the overall package could still be as attractive to employees as that offered by other firms who do not offer an occupational pension. Empirical evidence suggests that this is not the case. Gustman and Steinmeier (1993) show using US data that, even among the same individuals, jobs that offer occupational pensions tend to be better paid. Disney and Emmerson (2002) find a similar result using data from the UK.

In contrast to occupational pensions, with personal pensions there is not a monotonic increase of coverage with regards to earnings level. Those with lower levels of earnings are less likely to have a private pension arrangement. These people will either be contracted into SERPS (and from April 2002 the State Second Pension), or will have earnings below the LEL and hence will not be accruing any second tier pension rights.²⁶

It is important to note that figure 3.2 only provides a snapshot of pension coverage at a point in time. As shown by Disney, Emmerson and Wakefield (2001), 60% of employees accrued rights to more than one type of pension scheme over the 7 year period from 1991 to 1998.

3.1 Are further increases in coverage of private pensions likely or desirable?

The Government has stated that it would like to increase private pension coverage further. Stakeholder Pensions, introduced in April 2001, were intended to be primarily targeted at ‘middle earners’, defined as those individuals who earn between £9,000 and
£18,500 a year who do not already have a private pension. This would represent a further shift towards individual funded provision rather than collective provision financed on a pay-as-you-go basis. The fact that employment status, earnings and pension status change considerably over time suggests that there are likely to be problems with a pension policy that is designed on the basis of each individual’s current earnings and pension status. Life cycle models of retirement saving suggest that as well as current income individuals would need to take into account a whole range of other considerations. These include the income that they expect to receive in the future as well as their current and future consumption needs (Attanasio, 1999). With these concerns in mind I now turn to look at empirical evidence on the characteristics of those in Governments target group for stakeholder pensions.

The target group for Stakeholder Pensions is very small. The majority of people whose earnings were in the target earnings range at some point between 1992 and 1995 already had some form of private pension. In addition those who did not were more likely to experience periods of unemployment and tended to have no, or very low levels of, savings. If they were able to save then it might well be more appropriate for them to hold these savings in a relatively liquid form rather than tie them away for retirement. This is discussed further in Disney, Emmerson and Tanner (1999).

The decision to exclude smaller employers from having to designate a stakeholder scheme is likely to reduce take up of Stakeholder Pensions among the target group. This is particularly true since those earning between £9,000 and £18,500 without a private pension are more likely to work for a smaller employer than those not in this group (Emmerson and Tanner, 1999).

While the current target group for Stakeholder Pensions is small, demand from future generations could be considerably larger. For example many individuals in the
current population who purchased a personal pension with up-front costs may not be well advised to switch provider but perhaps would have taken out a Stakeholder Pension in the first place had that option been available to them. This might be particularly true of those who are more likely to experience periods of unemployment, since the flexibility of contributions that Stakeholder schemes have to offer will be more attractive to those who are less able to commit to regular contributions. Of course this will still only apply to those who feel that they do want to lock their savings up until retirement rather than hold them in a more liquid form.

One important factor that could potentially hinder the Government’s efforts to increase take-up of private pensions further down the earnings distribution is the significant amount of means-tested support for lower income pensioners. Individuals who expect to retire on a relatively low income in retirement will face a disincentive to save due to the high marginal withdrawal rates arising from combinations of means-tested benefits. The MIG is currently withdrawn at a rate of 100%. As discussed in section II.1, the Pension Credit will be withdrawn at a rate of 40%. While this will reduce the marginal withdrawal rate faced by many lower-income pensioners it will also bring more people onto means-tested benefits and hence increase their withdrawal rate. In addition many pensioners will be eligible for council tax benefit and housing benefit which even post reform will combine to produce high marginal withdrawal rates. Around 30 per cent of the current generation of pensioners are expected to face a withdrawal rate of greater than 50% once the Pension Credit reform is in place (Clark, 2002). Whether this really matters will depend on how much these individuals would have saved in the absence of the high withdrawal rate.

Before the Pension Credit reform, and assuming that the Government’s aspiration of earnings indexation of the MIG was met, then a 65 year old retiring in 2050 with no
other income would receive just over £250 a week, in today’s prices, indexed to earnings for the remainder of their life (assuming real earnings growth of 2% a year). If they were to live for 14 years then, assuming a real discount rate of 4%, this would be worth nearly £170,000. If receipt of typical housing benefit and council tax benefit (£40 and £5 a week respectively, again indexed to earnings) are also included then this rises to over £240,000.

Those who had a contributory record of 49 years would be able to receive the maximum amount of Basic State Pension and State Second Pension. This would provide an income of £240 a week in today’s prices, indexed to prices (i.e. not earnings) for the remainder of their life. Hence it would start at over £10 a week below the level provided by the MIG with the difference widening over time. The value of the stream of income provided by the Basic State Pension and the State Second Pension would be worth around £140,000, some £30,000 less than the amount provided by the MIG alone.

While the introduction of the Pension Credit will mean that someone with just the full Basic State Pension will not face a 100% withdrawal rate some individuals will face a disincentive to save – in particular those who expect to be eligible for housing benefit and council tax benefit on top of the Pension Credit. Those who are eligible for all three benefits will face a 91% marginal withdrawal rate on any additional income.

An interesting question for future research is the decision facing individuals who are taxpayers during their working lives who expect to receive the Pension Credit once they reach 65. One option would be to save in a private pension, but it might be the case that they would be best advised to save in an Individual Savings Account. If the latter does turn out to be the case for many individuals then the Government may wish to consider more changes to the pension system. One possibility would be to look at the generosity of the State Second Pension. If this was to be made more generous it would reduce the number of people who will end up on high marginal withdrawal rates in
retirement. Originally the State Second Pension was set at a level intended to ensure that individuals with a full contribution record would not be reliant on the MIG in retirement.\textsuperscript{xvii} Given that the MIG is now more generous than it was when the State Second Pension was introduced the Government might decide to increase the size of the compulsory second tier of state provision. The fact that to receive the maximum amount of State Second Pension requires a full (49 year) contribution record might also need to be reconsidered given that many individuals will not be able to achieve this. For example those who remain in education beyond the compulsory school leaving age of 16 will be unable to achieve the maximum award of State Second Pension.

An alternative proposal that has been suggested is to remove the State Second Pension and the Pension Credit and instead increase the Basic State Pension to the level of the MIG and uprate it in line with earnings rather than prices (Brooks, Regan and Robinson, 2002). This would certainly achieve a much simpler state pension system which should aid individuals trying to make appropriate saving decisions. The biggest gainers in terms of percentage increase in income would be those pensioners who currently receive just the Basic State Pension since they do not take up the means-tested benefit to which they are entitled who. It would however not benefit those lower-income pensioners who are in receipt of the MIG. Many lower income pensioners would also lose out from the loss of the Pension Credit. Given that over 50\% of pensioners will be entitled to the Pension Credit it is extremely difficult to think of any reform that would achieve simplification of the UK pension system while not being considered prohibitively expensive or leaving some of those eligible for the Pension Credit worse off. The proposed removal the State Second Pension would also lead to the removal of the current contracting out arrangements – the implications of this on the current private pension arrangements would need to be carefully considered.
So far the analysis of pension reforms has focussed on their implication for the Government’s finances and the incomes of pensioners, both today and in the future. Recent trends in pension coverage – for example towards greater funding and saving on an individual rather than a collective basis (through either the state or an employer) will potentially have a wide range of other economic effects. The next section discusses some of these.

4. REDRAWING THE PUBLIC-PRIVATE DIVIDE: INTERNATIONAL ISSUES

The 1986 Social Security Act, which extended the right to contract out of SERPS by allowing individuals’ to choose instead to save in a defined contribution (money purchase) scheme has a wide range of potentially interesting effects. These include the overall effect on the public finances, changes in saving rates, changes in retirement behaviour, and potentially, changes in labour market flexibility (Disney, Emmerson and Smith, 2002). The shift from state and occupational pension coverage towards greater take-up of personal and stakeholder pensions is a shift from collective pension provision to individual forms of saving for retirement. Moving from defined benefit (final salary) schemes towards defined contribution (money purchase) schemes might also increase labour market flexibility since it potentially removes a pension loss from changing employer. These arise due to the way in which occupational pension schemes typically operate in the UK with, for example, the fact that schemes operate on final salary tending to reward more highly those with long job tenures. The issue of pension portability and its potential consequence for labour market mobility is not just a domestic one – it is also of importance at the level of the European Union as it tries to promote greater labour market flexibility.
The issue of pension portability (whether there is a pension loss when an
individual changes employer) and pension transferability (whether funds held in a
pension can be transferred to another provider) are not the same. Some types of pensions
will have very low levels of transferability but might not be expected to have any effect
on job mobility. For example pension rights accumulated in the State Earnings-Related
Pension Scheme or the State Second Pension are not transferable since accrued funds
cannot be transferred into a private pension. However this lack of transferability of the
funds should not have any implications for labour market mobility since individuals can
accrue rights to these pensions when they change employers.

On the other hand the situation with pension rights accrued in occupational
pension schemes is often very different. While funds can be transferable between
schemes they can still act as a deterrent on labour market mobility due to the way in
which funds build up in the fund over time. UK occupational pension funds generally (in
the private sector at least) operate at the firm level. They also often work on a final salary
rather than (for example) a career average salary. This has the effect of tending to reward
longer stayers at the relative expense of those with shorter job tenures.

Part of the motivation behind the introduction of personal pensions was the
potential impact on labour market mobility. This is confirmed by the 1985 Green Paper
which stated that a “major factor in the demand for personal pensions has always been
that they should be fully portable. People must be able to take their own pensions with
them without any loss when they change jobs. The Government are committed to
ensuring that barriers in pensions do not affect job mobility” (Department of Social

Like SERPS and the new State Second Pension membership of a personal pension
or a stakeholder pension might not be expected to reduce labour market mobility since
individuals can continue to contribute to the same scheme regardless of whether they switch employer. Unlike the UK State pension schemes funds held in a personal pension can be moved between different providers. However this might often not be an optimal retirement savings strategy due to the charging structure of personal pensions. The obvious example is an individual who paid significant up-front costs when they opened a personal pension who subsequently decided to transfer the funds to another scheme. It seems likely, at least with hindsight, that this was not an optimal strategy. Furthermore personal pensions may charge individuals exit charges – again restricting transferability of funds.

The regulated charging structure imposed on Stakeholder Pensions, by only allowing funds to charge up to one percent of the fund each year, allows individuals to costlessly transfer funds between schemes. Indeed it is precisely this type of switching, or at least the threat of this type of switching, that the Government hopes will aid competition and place downward pressure on charges. If the introduction of Stakeholder Pensions does succeed in these aims then it is likely to also place downward pressure on the charges in personal pensions since providers of Stakeholder Pensions and personal pensions are likely to be competing for individuals’ pension funds (Emmerson and Tanner, 1999).

In addition to these theoretical arguments about the potential impact of different types of pension schemes on labour market mobility there is also some recent empirical evidence looking at job mobility within (although not yet between) different European Union countries. Andretti (2001) looks at the effect of pension coverage on labour market mobility using the European Community Household Panel (ECHP) survey in Denmark, Ireland, the Netherlands and the United Kingdom. He finds that pension covered workers are only less likely to move jobs in the United Kingdom. This is perhaps unsurprising for
Denmark, where the majority of occupational schemes are defined contribution schemes and for the Netherlands where the schemes are typically arranged at the industry level rather than at the company level. In the Dutch case we would only expect to see job moves between industries being affected by pension coverage rather than job moves between employers within the same industry.

Another test of whether pension covered workers are less likely to move job is provided by Disney and Emmerson (2002). This uses data from the British Household Panel Survey to look at the subsequent labour market mobility of the group of individuals who were offered the opportunity to join their employers’ pension scheme, but choose instead to make their own arrangements. They find that (after controlling for other important covariates, such as age and the estimated potential wage advantages of changing job) those who choose to open a personal pension instead of joining their employers scheme are 5.6 percentage points more likely to change job in the subsequent period. This gives some evidence that employer provided pension schemes might lead to lower job mobility. Given that the majority of individuals who were a member of an occupational pension scheme during the period of their study would have been members of a defined benefit rather than a defined contribution scheme it is also evidence that this effect is from the incentives in these schemes.

Further research is required to unpack whether it is individuals who suspected that they might move job who chose not to join their employers pension scheme or whether it is because they didn’t join the scheme that they were subsequently more prepared to move job. The latter case would mean that further moves away from employer provided pension schemes, and more specifically moves away from defined benefit schemes, would increase labour market mobility and, through an improved match between workers and employers, potentially economic efficiency.
5. CONCLUSIONS

Future reform of the UK pension system is not needed to make it sustainable in terms of its cost. Forecast expenditures can be met without tax increases. This has been achieved by large cuts to the state pension system over the last twenty years, in particular through the price indexation of the Basic State Pension, the planned increase in the state pension age for women, and the reforms to the second tier of state pension provision that were carried out in 1986 and 1995 (which reduced future SERPS expenditure to around a quarter of what it would have been). It remains to be seen whether the current system is politically sustainable. Despite the recent introduction of the State Second Pension, which will increase future state expenditures, state spending per pensioner relative to national income is expected to be less than 70% of its current level by the middle of this century. Given that an increasing proportion of the electorate will be aged over the state pension age what they expect in terms of retirement income from the state may play a very important part in determining whether the current arrangements prove to be politically sustainable.

The reforms have also dramatically increased the amount of choice that today’s working population have over their retirement savings. Employees who are offered the chance to join their employers scheme can either choose to accept, or to decline and open a personal pension or a stakeholder pension, or decide to remain in the state scheme. If they have their own savings that they want to invest they will want to consider whether they should tie up their savings in a private pension, or whether they would be better off saving in a more liquid form such as an Individual Savings Account. The appropriate strategy for the majority of people has tended to be that the tax-treatment of private pensions makes them a more attractive retirement savings vehicle than other tax-favoured accounts. This choice is complicated by the increasing reliance on means-tested benefits.
in retirement. These provide a disincentive to save in a private pension for individuals who expect to be receiving benefits with high marginal withdrawal rates in retirement.

The increased choice that individuals now face also means that the current UK pension system is very complicated, perhaps overly so. It has also been frequently reformed in a way which makes it less rather than more easy to understand: reforms have tended to add new parts to the system without removing existing parts. At least in part this is due to a desire not to create immediate losers from any reform. It is now difficult to think of a simplifying reform to the UK state pension system that would not be considered prohibitively expensive or leave some lower income pensioners worse off. This complexity, and the frequency with which the system is reformed, make it harder for individuals to make appropriate retirement savings decisions (Banks and Emmerson, 2000).

The Government has a stated objective of increasing the proportion of pensioner income that comes from private saving. The majority of ‘middle earners’ already have a private pension. Those who don’t tend to have characteristics that suggest that they might be better advised to save in a more liquid form. Recent large increases in the MIG and also the introduction of the (means-tested) Pension Credit represent an increase in future state expenditures on lower income pensioners. These will make it more difficult for the Government to meets its stated objective to increase the proportion of pensioners’ incomes that comes from private sources.

While membership of occupational pension schemes is still relatively high it has been falling. One of the justifications used to introduce personal pensions was that it might help to reduce barriers to job mobility. Increasing labour market mobility is also a very important policy issue for the European Union. A potential constraint on this is the way in which pension rights accrue. Evidence from the United Kingdom suggests that
movements away from occupational pensions (and probably from final salary defined
benefit schemes) might lead to increases in labour mobility due to the reduction of
pension loses arising from job changes.

Given the frequency of pension reform in the UK more reform is not unlikely.
One possible reform is further increased generosity of the State Second Pension in order
to ensure that individuals with full contribution records during their working lives are less
likely to be on relatively high withdrawal rates in retirement. If further reform is to occur
it would seem sensible to consider ways in which the current system can be simplified so
as to make it easier for individuals to make sensible decisions over how much, and in
which form, they should save.
6. BIBLIOGRAPHY


Figure 1.1. Schema of the UK Pension System, 2002.
Figure 2.1. Average gain from increasing the Basic State Pension to the level of the Minimum Income Guarantee, £ per week.

Notes: Income quintiles are calculated by dividing the pensioner population into five equally sized groups according to the income of their family (adjusted for family size). The 1st quintile contains the poorest 20% of pensioners, the 2nd the next poorest 20% of pensioners up to the 5th quintile which contains the richest 20% of pensioners. An important caveat to this modelling is that the methodology will understate the gains to those pensioners who are not claiming means-tested benefits to which they are not entitled. These will be disproportionately found in lower income quintiles.

Source: IFS tax and benefit model, TAXBEN, using data from the 1999–2000 Family Resources Survey and the April 2002 tax and benefit system.
Figure 3.1. Private pension coverage among employees in the UK, by age, gender and type of employment, 2000.

**Occupational pensions**

**Personal pensions**

Note: Only a small proportion of men work part time in the UK and therefore are excluded from the analysis.

Figure 3.2. Private pension coverage in the UK, by earnings decile, 1999.

Note: Sample includes only individuals aged 20 to 59 who are not currently self-employed. Total sample size is 9,342 individuals. These are split between 2,422 in the zero earnings category and 692 in each of the ten earnings deciles.

Table 1.1. Demographic forecasts for the United Kingdom population, 2000 to 2050.

<table>
<thead>
<tr>
<th></th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2000</td>
</tr>
<tr>
<td>Working age population (million)</td>
<td>36.3</td>
</tr>
<tr>
<td>Pensioner population (million)</td>
<td>10.5</td>
</tr>
<tr>
<td>Ratio of working age to pension age</td>
<td>3.46</td>
</tr>
<tr>
<td>Ratio without equal retirement ages</td>
<td>3.46</td>
</tr>
<tr>
<td>Contributors (millions)</td>
<td>20.2</td>
</tr>
<tr>
<td>Pensioners (millions)</td>
<td>11.0</td>
</tr>
<tr>
<td>Support ratio</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Note: *State pension age for women is set to be increased from 60 in 2010 by sixth months every year so that it reaches 65 in 2020.

Source: Government Actuary’s Department (1999).
Table 2.1. Forecast state expenditures on pensioners, 2000 to 2050.

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2010</th>
<th>2020</th>
<th>2030</th>
<th>2040</th>
<th>2050</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic State Pension (£ billion)</td>
<td>34.4</td>
<td>38.0</td>
<td>41.3</td>
<td>49.4</td>
<td>52.8</td>
<td>51.2</td>
</tr>
<tr>
<td>SERPS / State Second Pension (£ billion)</td>
<td>4.9</td>
<td>9.5</td>
<td>12.8</td>
<td>17.8</td>
<td>22.5</td>
<td>30.2</td>
</tr>
<tr>
<td>Total State Pension (£ billion)</td>
<td>39.3</td>
<td>47.5</td>
<td>54.1</td>
<td>67.2</td>
<td>75.3</td>
<td>81.4</td>
</tr>
<tr>
<td>Total National Insurance expenditure (% of GDP)</td>
<td>5.4</td>
<td>5.5</td>
<td>5.4</td>
<td>5.6</td>
<td>5.3</td>
<td>4.9</td>
</tr>
<tr>
<td>Required NIC rate (%) (employers and employees)</td>
<td>20.2</td>
<td>19.0</td>
<td>18.2</td>
<td>19.2</td>
<td>18.5</td>
<td>17.7</td>
</tr>
<tr>
<td>GDP per pensioner spending (1999–2000 = 100)</td>
<td>98.7</td>
<td>92.2</td>
<td>88.1</td>
<td>78.8</td>
<td>70.7</td>
<td>68.3</td>
</tr>
</tbody>
</table>

Note: Total National Insurance cost includes some non-pension expenditure such as Incapacity Benefit and Jobseekers Allowance. Figures exclude the cost of expenditure on means-tested benefits to pensioners. Cost of the Basic State Pension excludes the cost of the above inflation increases in April 2001 and April 2002 that were announced in the November 2000 Pre-Budget Report. It also excludes the November 2001 Pre-Budget Report commitment to increase the Basic State Pension by a minimum of 2.5% if inflation falls below this level. Neither of these increases in generosity is sufficient to significantly change the long run picture.

Source: Government Actuary’s Department (1999; 2000); Authors’ calculations.
Table 2.2. State spending on those over working age (2001–2002)

<table>
<thead>
<tr>
<th>Payment</th>
<th>£bn</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retirement Pension – basic</td>
<td>36,470</td>
<td>3.6</td>
</tr>
<tr>
<td>Retirement Pension – earnings-related</td>
<td>5,500</td>
<td>0.5</td>
</tr>
<tr>
<td>Minimum Income Guarantee</td>
<td>4,405</td>
<td>0.4</td>
</tr>
<tr>
<td>Housing Benefit</td>
<td>4,365</td>
<td>0.4</td>
</tr>
<tr>
<td>Attendance Allowance</td>
<td>3,130</td>
<td>0.3</td>
</tr>
<tr>
<td>Disability Living Allowance</td>
<td>2,100</td>
<td>0.2</td>
</tr>
<tr>
<td>Winter Fuel Payments</td>
<td>1,700</td>
<td>0.2</td>
</tr>
<tr>
<td>Council Tax Benefit</td>
<td>1,365</td>
<td>0.1</td>
</tr>
<tr>
<td>Over 75 TV Licence</td>
<td>370</td>
<td>0.0</td>
</tr>
<tr>
<td>Other</td>
<td>880</td>
<td>0.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>60,285</td>
<td>6.0</td>
</tr>
</tbody>
</table>

Note: Figures are for estimated out-turns. Largest 9 items of spending listed separately – the remainder have been grouped in other.

Source: Department of Social Security (2002).
ENDNOTES

i This increase in the state pension age for women is to achieved by it being increased by six months every year between 2010 and 2020. The state pension age for men is set to remain unchanged at 65.


iii Banks and Emmerson (2000) provide details of the level of the Basic State Pension in real terms and relative to average earnings over time.

iv An earnings test did exist until October 1989 See Disney and Smith (2000) for more details.

v For a more detailed discussion of SERPS see Disney and Johnson (2001). The State Second Pension is discussed in detail in Agulnik (1999) and Disney, Emmerson and Tanner (1999).

vi For more details see Disney and Whitehouse (1992), Dilnot, Disney, Johnson and Whitehouse (1994) and Disney, Emmerson and Wakefield (2001).

vii Employers who employ less than 5 employees and those who offer membership of an occupational pension scheme or a contribution to a group personal pension scheme are exempt from this.

viii For more details see Banks and Emmerson (1999) or Inland Revenue and Department for Work and Pensions (2002).


x See Budd and Campbell (1998) for more details. The voluntary nature of contracting out means that the arrangements are likely to cost more than the savings to the state from the reduced future pension expenditure (Disney, Emmerson and Wakefield, 2001).

xi Figures for 1999–2000. Take-up by expenditure is estimated to be higher at between 74% to 86%. Pensioners are found to have a lower take-up rate than non-pensioners. Source Department of Social Security (2001).

xii Since income from the Basic State Pension is taxable basic rate paying pensioners would gain more in cash terms than the relatively small (but growing) number of higher rate taxpaying pensioners.

xiii For a discussion of the reform, including distributional effects, see Clark (2001 and 2002). Estimates of its long term costs can be found in Department for Work and Pensions (2002).
xiv A similar policy was proposed by the Conservatives at the time of the 1997 election (basic pension plus), but this was to be compulsory for new entrants to the labour market. It was proposed that the transition would be paid for by a move from taxation of pensions in payment (EET) towards taxation of contributions to pensions (TEE).

xv There are several possible explanations for individuals reporting that they have contributed to more than one type of pension. Perhaps most obviously some will have have changed pension status at some point during the last 12 months (for example if they have moved jobs). Another explanation is that those who are members of a group personal pension might report that are both a member of a scheme offered by their employer and also a member of a personal pension.

xvi The State Second Pension also provides credits for recipients of invalid care allowance and those caring for individuals receiving attendance allowance or disability living allowance, and those receiving child benefit where their youngest child is aged under 5.

xvii Since the MIG is increased in line with earnings whereas once in payment the State Second Pension only increases in line with prices, individuals with a full contribution record but no private income would have expected to be eligible for the MIG at around age 75 (Disney, Emmerson and Tanner, 1999).