Country Report

United Kingdom

Current pension system: first assessment of reform outcomes and output

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UNITED KINGDOM

The Institutional Architecture

The British pension system embodies two features that are peculiar for the European pension panorama: i) its institutional complexity is unmatched and is the result of continuous reform layering; ii) it did not undergo a golden age of benefit expansion and a silver age of retrenchment but was (and still will be) characterized by insufficient protection of the most disadvantaged social groups. This is a direct continuation of Titmuss's 'two nations in retirement', a problem that appeared already in the 1950s, adding insult to injury with regards to the country's Beveridgean aspirations.

In fact, the social inadequacy of retirement in the UK has never been a secret and the failure of the market to protect against the risk of poverty in old age has been openly acknowledged. Hence, the British multi-pillar system has witnessed a number of structural improvements under the New Labour in the last decade.

The first, public pillar has become flat rate and more generous, thereby constituting a social safety net with redistributive features. The second and third pillars – constituted mainly by private occupational and individual savings schemes, as people contract out of state-managed arrangements – have been re-regulated (following the Maxwell and other scandals), rendered less voluntaristic (by the introduction of auto-enrolment mechanisms) and less dependent on contributory records (contracting out is now restricted to defined benefit schemes).

Although the New Labour clearly distanced itself from the neo-liberalism preached by previous, Conservative governments, the problem of the so-called 'under-pensioned' has been mitigated but not solved. Low-income workers, atypical jobs and women still accumulate disadvantages that jeopardize their income status during old age.

The **first (state and mandatory) pillar** consists of the *Basic State Pension (BSP)*, introduced already in 1946. It is a PAYG, flat rate scheme, whose benefits are very meagre, leading to social exclusion in old age. The full BSP for 2009-2010 is GBP 95.25 a week and for couples GBP 152.30 a week. In order to stop the slow reduction of BSP's replacement rate, its indexation has shifted from prices to earnings.

BSP (and the State Second Pension, S2P) is financed by National Insurance Contributions (NICs), which are compulsorily paid on income above the Primary Earnings Threshold (ET), which amounts to GBP 5,715 in 2009-2010. Employees pay Class 1 NICs and self-employed Class 2 and Class 4 NICs. Voluntary insurance is possible for low income employees, non-employed and self-employed persons with low profits (Class 3 NICs – flat rate of GBP 12.05 per week). Class 1 NICs are paid by employers in full – 12.8% of gross payroll above the ET. Employees pay a contribution rate of 11% for earnings between the ET and the Upper Earnings Limit (UEL), that is GBP 43,875 in 2009-2010, and 1% above that. If one earns an amount below the Primary Earnings Threshold and above the National Insurance Lower Earnings Limit (LEL), i.e. GBP 4,940 for 2009-2010, these contributions are being credited to you. Class 2 NICs are paid by self-employed at a flat rate of GBP 2.40 a week and Class 4 NICs are calculated as a percentage of annual taxable profits – 8% between GBP 5,715 (ET) and GBP 43,875 (UEL), and 1% above that.

To qualify for the Basic State Pension (BSP), people need to: i) contribute; ii) have been treated as having contributed; iii) have credits for 90% of their potential working lives. That means that to be entitled to a full BSP, women/men have to contribute for 39/44 years. State pension age, currently 60/65 for women/men, will be equalized (65 for both) between 2010 and 2020. There are no early retirement provisions. Deferred retirement has been further encouraged in 2005: any time restrictions were removed and each year of deferral increases the state pension by 10.4%. After one year of deferral a lump sum can be claimed as well: the foregone state pension with a guaranteed accrual rate of 2% above the Bank of England base rate.

As a result of the Pensions Act 2007, state pension age increases to 66 during 2024-2028, to 67 during 2034-2036 and 68 during 2044-2046.Otherwise the BSP is proportionally reduced, to a minimum of 25%. The Pension Act 2007 reduces the number of years of contributions or credits required for a full BSP to 30 for all (from 2010). Reduced state pensions will be available already with one year's contribution or credits for people reaching state pension age. This reform is helpful for all people who do not have long contributory records, women in particular. In fact, it is projected that whereas currently only one sixth of women are entitled to a full BSP (as opposed to 90% of men), this proportion should increase to 75% in 2010 and to 90% by 2025.

The BSP is clearly not enough to be socially included (the full rate for individuals is equal to just 19.5% of the 2009 gross median weekly salary in the UK). Hence, the state now tops up low pensionable incomes by granting the Pension Credit, introduced in 2003. This includes two components: the Guarantee Credit and the Savings Credit.

The Guarantee Credit is income-related and independent of NICs. It is a tax-free weekly benefit for people over 60 with low earnings. This eligibility age will increase in line with the women's state pension age. The Guarantee Credit is the continuation of the Minimum Income Guarantee, which tops up weekly income to GBP 130 for individuals and to GBP 198.45 for couples.

The Savings Credit is an extra amount for people aged 65 or over, who have made modest provision for their retirement. It can be drawn together with the Guarantee Credit. The Savings Credit amounts up to GBP 20.40 a week for individuals and GBP 27.03 a week for couples. Eligibility for Savings Credit is rather complex, but it is still available for incomes up to GBP 181 a week for individuals and GBP 266 for couples.

Both the amounts of the Guarantee and Savings Credits may be more in case of disability, caring responsibilities or certain housing costs, such as mortgage interest payments.

The **second and third pillars** consist of supplementary state- or privately-run pensions. The pillars are again extremely complex and allow for various options. The default scheme is the State Second Pension (S2P). However, one can contract out of the S2P by choosing either

i) traditional, lightly regulated private plans
    a. second pillar company (occupational) schemes
        i. contracted-out occupational pension schemes – Contracted-out Salary-related Schemes (COSRS), Contracted-out Money-Purchase Schemes (COMPS), Contracted-out Mixed Benefit Schemes (COMBS), Contracted-out Hybrid Schemes (COHS)
        ii. voluntary occupational contracted-in schemes – Construction Industry Scaffolders Record Scheme (CISRS), Contracted In Money Purchase Schemes
        iii. third pillar personal schemes – Personal Pensions Scheme (PPS), Appropriate Personal Pension Schemes (APPS), Group Personal Pension Scheme (GPPS)

ii) newly established, heavily regulated private-public schemes
    a. Stakeholder Pension Schemes since 2001
    b. Personal Accounts (PA) since 2008.

Given the intricacy of the two pillars, the fact sheet will analyze the S2P and briefly mention the shortcomings of traditional contracted-out occupational and personal plans. Greater attention will be devoted to Stakeholder Pensions and Personal Accounts.

The *State Second Pension (S2P)* was introduced in 2002 and substituted the State Earnings-Related Pension Scheme (SERPS). S2P covers most employees but not the self-employed.

Contributions and credits for the S2P cumulate now for various categories that were previously discriminated by the SERPS, due to their excessively low incomes.

Employees earning at or above the annual LEL (GBP 4,940 in 2009-2010) up to the Low Earnings Threshold (LET), i.e. GBP 13,900 for the tax year 2009-2010, are treated as if they had earnings equal to the LET for State Second Pension purposes. However, the protection of periods outside employment varies greatly. Both the BSP and S2P provide protection for various types of care: for children under six and receiving Child Benefits; for ill or disabled persons and getting Home Responsibilities Protection (HRP); for those entitled to Carer's Allowance. In all these cases S2P accumulates as if the carer earned the LET. As of 2010, according to Pensions Act 2007, HRP is being replaced with National Insurance credits. For the S2P, years caring for a child under 12 are credited at the LET.

Likewise, disability is also fairly treated and provides contributions to S2P if one is entitled to long-term Incapacity Benefit, contributory Employment and Support Allowance, protected Severe Disablement Allowance or Income Support.

Unemployment is not protected this well: contributions are credited to the BSP only and not to the S2P. Being inactive or working in the informal economy does not give you any rights and may relegate you to social assistance.

As for S2P benefits, under current rules, these build up at different rates depending on one's income. The way the State Second Pension is calculated will be simpler from 2010-2011. Instead of using three bands of earnings, the top two earnings bands will be merged. S2P will gradually become flat rate, worth around GBP 1.60 a week, for each qualifying year. People earning above the LET are entitled to an extra earnings-related payment. By 2030 this will be phased out. Provided that the S2P flat benefit does not increase, this means that the combined BSP and S2P benefits will again socially exclude their recipients.

Contracting out of SERPS was traditionally connected to the role private financial institutions played in the UK. Contracting out guaranteed various rebates on NICs, under the conditions that private benefits be at least equal to those guaranteed by the public scheme. This was not a particularly difficult condition since the Conservatives started retrenching public benefits back in 1986.

However, two decades later, the market clearly proved incapable to warrant social inclusion to the least protected social groups – low-income workers, employees in small firms, the self-employed and atypical contract holders. Voluntary, additional savings proved to be and entirely inadequate solution for low-income workers as the incompatibility between means-tested benefits and the propensity to save was far too evident.

Hence, due to a number of market failures – excessive complexity, high fees, patchy and sector-biased coverage, mis-selling, vulnerability to financial crises and a massive shift from defined benefit to defined contribution schemes – contracting out has changed in two ways: i) new plans have been added, which combine simplified rules and lower costs (Stakeholder Pensions in 2001 and Personal Accounts in 2008); ii) the Pensions Act 2004 introduced tougher solvency rules and the Pension Protection Fund to safeguard against the sponsor's insolvency and underfunding; ii) the Pensions Act 2007 ends (the date is still undefined) contracting out on a money-purchase (defined contribution) basis and allows only for contracted out salary-related (defined benefit) schemes.

The main problem with occupational plans is their variability and low coverage. Circa 47% of employees are members of an occupational pension scheme and 19% have personal plans. Since plans overlap, overall coverage of voluntary private pensions is 59%. The size of the firm matters mostly: 71% of workers in small firms were not covered in 2003, 56% in medium and 40% in large enterprises. Public sector was far more encompassing: 83% of male and 81% of female employees were covered in 2003. Being coverage entirely voluntary for the self-employed, these are of course the least covered group - only 43%/35% of self-

employed men/women contributed to a private scheme in 2003. In general, women working part-time are the most discriminated. Hence, Stakeholder Pensions and Personal Accounts were introduced to cover low-income groups and atypical employment contracts.
As for the calculation formulae, in the public sector there are only defined benefit schemes, but in the private sectors money-purchase and hybrid schemes were steadily gaining ground, thereby shifting all the risk onto the employee. For new labour market entrants, defined contribution schemes are becoming the norm, hence, the New Labour decided to stop this by allowing contracting out only to defined benefit plans.
As mentioned a number of times, to reduce the negative effects of voluntarism, the Welfare Reform and Pensions Act 1999 introduced Stakeholder Pensions and the Pensions Act 2008 introduced *Personal Accounts (PA)*.
Stakeholder Pensions were meant especially to cover low-income employees. They are money-purchase personal schemes with limited charges, which allow members to vary contributions. They are managed by insurance companies and have a link with employers, since all firms but the smallest (below 5 employees) have to grant access. However, since employers do not have to mandatorily contribute, the take up rate is very low among the targeted group of working poor.
Personal Accounts seem more promising. They are multi-employer occupational schemes. Via the auto-enrolment of workers through their employer, most problems related to the limited access to company funds should be resolved. The total contribution rate will be 8% (slightly less than the 9% average for defined-contribution occupational schemes): 4% for employees (with an income floor and ceiling), 3% for employers and 1% tax relief.
To keep costs low, a clearinghouse, inspired to the Swedish Premium Pension, which collect contributions for Personal Accounts, keep the records and match schemes and workers. Management and administration of the plans remains private. Failure to select a fund will result in the enrolment into a ‘default fund’ with low investment risk.
Personal Accounts should be beneficial for employees and employers. Among underprotected employees, four groups shall gain from Personal Accounts: i) the 2 million workers who have employer contributions lower than 3%; ii) 9 million employees not covered by occupational schemes will be auto-enrolled; iii) circa 3.5 million employees not eligible for auto-enrolment may choose Personal Accounts voluntarily; iv) people under 22 may opt in and receive the 3% employer contribution. However, auto-enrolment falls short of quasi-mandatory or mandatory participation. People earning less than the LEL are not eligible. Roughly 3 million self-employed and 9 million economically inactive cannot be auto-enrolled and are not eligible for employer contribution. They can choose to voluntarily opt in into Personal Accounts as an alternative form of saving.
However, given the poor record of voluntary savings inclination, it is questionable whether huge numbers will actually start saving. Hence, the problem of patchy second pillar coverage has been mitigated but definitely not solved.

Information needs

In addition to brochures, annual statements etc, prospective British pensioners have a capillary access to information and data about their pensions. The most reliable source is Directgov (http://www.direct.gov.uk/en/index.htm), which includes all fundamental information on pensions as well as benefit calculators.

The Administrative Structure

The pension system is under the responsibility of the Ministry of Social Security and Labour. Inland Revenue collects social security contributions via regional and local National

Insurance Contributions Offices. The management of accounts and the payment of public pension benefits (BSP, Pension Credit, S2P) are administered by the Pension Service, part of the Department of Work and Pensions (renamed in 2002), through the National Insurance Fund. Social partners do not participate to the administration of public provisions.

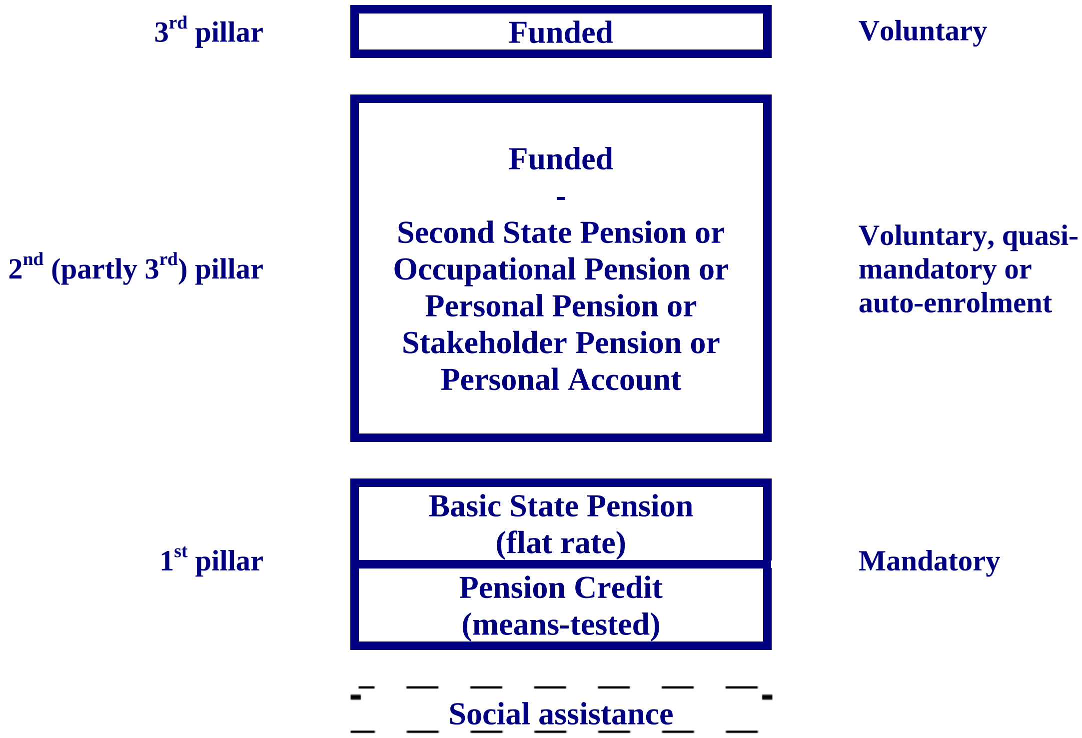
Private schemes, by contrast, can be administered by different private actors: employers, financial services companies and various organizations. Since 1995 reform at least two employee representatives have to sit on the board of trustees (up to 1/3 of the board). The governing body of these organizations is the National Association of Pension Funds (NAPF). The Pension Regulator (renamed in 2005) monitors the occupational pension sector.

The Financial Services Authority (FSA), the statutory regulator for financial services since 2001 monitors personal pension schemes.

Assessment and Future Challenges

As stated in the introduction, the British pension system is excessively complex as well as discriminatory against certain working categories (low-income employees, the self-employed, atypical job holders and workers in smaller firms) and social groups (women, unemployed, those employed in the informal sector). The main reason for the lack of social inclusiveness is the imperfect interaction between the ungenerous public pension system (BSP, Pension Credit and S2P) and contracted out occupational and personal schemes (more generous, but costly and hence leading to patchy coverage). Continuous amendments to the system have mitigated but not eliminated the problems of high risk of poverty in old age. A more radical move, such as mimicking the Dutch or Danish solutions, and the introduction of a sound and generous Beveridgean social safety net could solve the impasse.

Figure 1 The Main Pillars in the British Pension System



1st Pillar, universal;
2nd Pillar, occupational schemes;
3rd Pillar, individual programmes.

Annex 1

Key Data about the Pension System in Britain

Contribution rates			
Class 1	**Class 2**	**Class 3**	**Class 4**
Employer: **12.8% above the ET**	**Self-employed:** **GBP 2.40 a week**	**Voluntary:** **GBP 12.05 a week**	**Self-employed:** **8% on profits between ET-UEL** **1% above UEL**
Employee: **11% between ET-UEL** **1% above UEL**			

Supplementary schemes	
Contribution rates	**9% on average in occupational contracted out schemes**
Coverage (of employees)	**59% total (47% occupational plans, 19% personal plans)**
Assets in EUR bln (2007)	**1,490.00**
Taxation	**Exempt Exempt Taxed**
Investment principles	**Prudent Person Principle**

Theoretical replacement rates	**Gross**			**Net**
	1st pillar	**2nd pillar**	**Total**	**Total**
2005	**17%**	**50%**	**66%**	**82%**
2050	**19%**	**50%**	**69%**	**85%**

SILC income 2005	**Total**	**Male**	**Female**
Relative income of 65+	**0.720**	**0.738**	**0.713**
Aggregate rep. ratio	**-**	**-**	**-**

Eligibility retirement age	
State pension age	**60/65 for women/men, equalized to 65 by 2020, increased to 68 by 2046**
Early retirement	**No**
Deferred retirement	**Unlimited**

Indexation	
BSP and Pension Credit	**Earnings**
S2P	**Prices**

Public pension spending (as % of GDP)	**2005**	**2020**	**2050**
	6.6%	**-**	**8.6%**

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