

# REFORMING THE UK RETIREMENT SYSTEM: PRIVATIZATION PLUS A SAFETY NET

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## Executive Summary

The British retirement income system is perhaps more dependent on private programs than any in the industrialized world. The government provides a modest and uniform “Basic Pension” to career workers, and now to carers and the disabled. But as benefits are indexed to prices, not wages, the Basic Pension is projected to replace a steadily declining share of earnings. The government also has a second tier earnings-related plan. But as most workers “contract out,” they will rely on employer and/or individual “personal pensions” to maintain pre-retirement living standards.

Reform efforts had three objectives: limit public expenditures on the elderly; enlarge and strengthen private plans; and assure an adequate retirement income for all.

The reforms succeeded in controlling expenditures. Public programs for the elderly are projected to cost just 5 to 6 percent of GDP for the foreseeable future.

Private plans, however, have neither been enlarged nor strengthened. Damaging scandals hit both employer plans and personal pensions in the 1990s, and the response to those scandals has not been especially effective. Employers of late have also been exiting defined benefit pension plans at a rapid rate. The risks, low level of contributions, and generally inadequate financial management of personal pensions also raise serious questions about their ability to maintain living standards in retirement.

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## A Series of Global Briefs

This brief is the third in a series that profiles national retirement income systems and their response to the impending demographic transition. Modern retirement is an outgrowth of industrialization and the transfer of a nation’s workforce from family and communal production to organized wage employment. The transition created an enormously productive economy. But wage workers face increasingly uncertain employment prospects as they age, and eventually a complete loss of earnings. Only rarely can a worker’s savings offset this loss of wages. So governments, employers, and unions responded by organizing formal retirement income systems.

The maturation of these systems over the past half-century has made retirement a generally secure and well-defined stage of life. Thanks to extended longevity and ever-earlier withdrawals from the workforce, retirements now last about twenty years, on average, and have emerged as one of the great blessings provided by modern industrial society. But declining fertility and rising longevity have placed this blessing at risk.

Each nation’s retirement income system has emerged out of its particular history and ideological commitments. Thus the roles played by social security, employer pensions, individual savings, and continued work vary dramatically. Each nation’s response to the current challenge reflects its institutional set-up and its economic prospects, social commitments, and ability to reform large and complex institutions.

The retirement income challenge is generally framed as a financing problem, which requires benefit cuts, larger contributions, increased saving, and/or higher-yielding investments. But the challenge is fundamentally a labor-market problem, involving the work/retirement divide and even continued work when “retired.” So in addition to reviewing financial reforms, this series focuses on initiatives that redefine the labor market opportunities and incentives that older workers face and the role of work as a source of old-age income; whether the reforms to date are consistent with this redefinition; whether they are sufficient; and what remains to be done.

Initiatives to assure an adequate retirement income for all meanwhile transformed both the government's earnings related pension program and means-tested assistance for the elderly. The government transformed its second tier pension into essentially a flat benefit program for lower wage workers that will cushion the erosion of Basic Pension allowances. In its means-tested program, the government also replaced its £-for-£ reduction in benefits with a 40 pence reduction for income above the threshold amount. This change will affect incentives to work and save in different ways for different groups. For those individuals currently receiving means-tested allowances, the less draconian reduction in benefits will improve work and saving incentives. However, expanding the phase-out range for means-tested benefits will make the great majority of elderly British households eligible for such assistance. This newly-eligible group will face a disincentive to work and save, because each additional £ of income will reduce their benefits by 40 pence.

Going forward, Britain's retirement income system will increasingly rely on individual accounts and means-tested assistance. The individual accounts are not well funded and carry significant risk. The disincentive to work or save created by the expanded means-tested program across a broad range of households further clouds the system's prospects. As a result, observers generally expect an increase in public expenditures on the elderly and further reforms to the system.

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## The Origins of the Retirement Income System

Britain was the first nation to gain its livelihood from wage and salary earnings and market-supplied goods and services. Its elderly thus became the first to face the problem of gaining a replacement income when they could no longer work or find employment.

Under the nation's traditional Poor Law, local governments had been responsible for supporting the needy. But the new economy that emerged in the nineteenth century left such a large number of elderly poor in its wake that it overwhelmed local community resources. So in 1908 Parliament enacted a national means-tested old age income program. It assured those age 70 and over a stipend equal to a fifth of the average male wage, reduced shilling for shilling for other income above a minimal level. By 1912, 60 percent of Britons age 70 and over, mostly women, collected a means-tested benefit.<sup>1</sup>

This general take-up, pressure on the Treasury, and the notion that a loss of household earnings was the basic source of old age poverty led Britain to introduce a mandatory old age social insurance program in 1925. It covered manual and clerical workers, about 70 percent of employees, and would pay a similar 20 percent of the average male wage from age 65, as a matter of right, not need. The Labor Party government extended this program in 1946 to all workers who earned more than a minimal amount. The new "Basic State Pension" (BSP), funded primarily by mandatory "National Insurance Contributions" (NIC), remains to this day the "first pillar" of the British retirement income system.<sup>2</sup>

The BSP was quite low. Many women, the disabled, and low-wage intermittent workers also failed to qualify for a full BSP pension.<sup>3</sup> So local governments continued to provide significant means-tested assistance to the elderly, especially housing subsidies and tax relief. And individuals with only a BSP pension generally qualified for national means-tested top-ups.<sup>4</sup>

In addition to government programs, employer pensions were the other main source of income for the elderly. Employer plans, first created in the nineteenth century by large employers such as governments, railroads, and utilities, were often limited to white-collar workers; required employee contributions; and at the stated retirement age paid an annuity based on salary and years of service. This annuity was worth far more than the worker's accumulated contributions plus interest. But those who left prior to the stated retirement age generally got back only their own contributions without interest. The pension was thus an incentive to remain with the firm — compensation for the worker's contribution of a long and faithful career. It also functioned as a severance device, inducing workers to retire at an age when their productivity typically fell below their wage.

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**By the 1950s, all workers could earn a flat Basic State Pension and one out of three was covered by an employer plan.**

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Employer plans covered just 5 percent of British employees by the turn of the century. The emergence of more large employers, especially in manufacturing, pushed this figure to 13 percent by the mid-1930s. By 1956, the efforts of Britain's powerful trade unions, and the appeal of the pension's preferential tax treatment during a period of rising taxation, resulted in employer plans covering a third of the work force.<sup>5</sup>

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<sup>1</sup> Hannah (1986).

<sup>2</sup> Hannah (1986); DWP (2000).

<sup>3</sup> A full BSP required NIC contributions over 90 percent of a "working career" — from age 20 to the stated retirement age of 65 for men and 60 for women. Contributions over a shorter period, but over at least 25 percent of a full career, earned a proportionally smaller stipend.

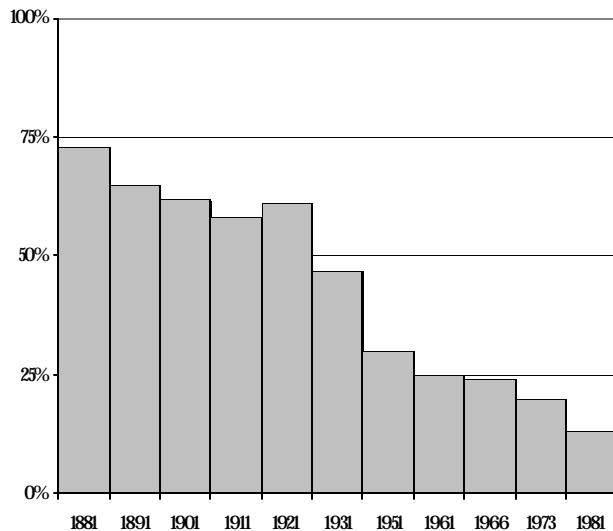
<sup>4</sup> Liu (1999); Emmerson (2002).

<sup>5</sup> Contributions were tax deductible; investment income tax exempt; beneficiaries paid tax only on income received; and at retirement workers could take tax-free a lump sum equal to a quarter of the value of the annuity (Hannah 1986).

## The Maturation of the British System

The economics of aging changed dramatically after the Second World War. The availability of government and employer pensions had led to a sharp increase in the percentage of the elderly who no longer worked (Figure 1). As longevity was also rising rapidly, “retirement” had emerged as an expected, extended, and well-defined stage of life.

**Figure 1.** Percent of UK Males Still Working, Age 65 and Over <sup>a</sup>



Source: Hannah (1986).

<sup>a</sup> After 1981, the labor force participation rate of British men age 65 and over consistently remained at just over ten percent (Blundell and Johnson 1999).

The elderly nevertheless remained a distinctly poor population. Their incomes in 1950 were only 40 percent of non-pensioner incomes. So, as the long postwar boom progressed, the financial standing of the elderly stood in increasingly sharp contrast to the rising prosperity of most working age adults. A consensus emerged that the elderly should share in this prosperity and that income should be spread more evenly across the lifespan.<sup>6</sup> The question was how.

In the 1950s, many in the Labor Party would have public pensions assume the income-spreading function. Programs emerging on the Continent were doing just that, taking a substantial share of earnings to pay for pensions that replaced a significant portion of earnings in retirement. Britain’s Conservatives, however, successfully

resisted such an expansion of government’s role. They created generous income-spreading pensions in Britain’s nationalized industries. And to forestall Labor’s more ambitious plans, in 1959 they enacted an extremely modest public earnings-related pension atop the BSP.<sup>7</sup>

By 1970, employer plans had solidified their position as the nation’s income-spreading vehicle. They covered half of the workforce and two-thirds of the men. The limitations of employer plans, however, had also grown clear. Employers used pensions to support long-term employment relationships. Leavers, the self-employed, those employed by small firms, part-time and low-wage workers, and women, who spent much of their lives caring for children, got few if any benefits and had inadequate old age incomes.

Labor responded to these limitations in 1975. Most importantly, it gave credit toward the BSP to those who stayed at home (primarily women) to care for children and other family members; and enacted the State Earnings Related Pension Scheme (SERPS). The new earnings-related scheme was a residual plan, designed for workers outside the employment mainstream who would not get an adequate employer pension. Employers with a suitably generous plan were allowed, indeed encouraged, to “contract out” of SERPS — a feature carried over from the Conservatives’ earlier earnings-related program.<sup>8</sup>

Because SERPS targeted women and workers with intermittent work histories, it required only 20 years of contributions; based benefits on a worker’s highest 20 years of earnings; and included a generous 100 percent survivor benefit. SERPS pensions replaced 25 percent of average covered earnings — earnings between the “lower earnings limit” (at about the BSP level) and the “upper earnings limit” (7.5 times the lower earnings limit). The “average” earner with twenty years’ participation would thus get a government pension replacing over 40 percent of average earnings, about half from the BSP and the other half from SERPS.<sup>9</sup>

The government allowed employers to “contract out” of SERPS, and get a “rebate” on their NIC contributions, if they had a plan that gave all employees at least a SERPS-based Guaranteed Minimum Pension (GMP). The GMP was somewhat less generous and significantly less risky than SERPS, with the government making up any shortfall to the workers’ SERPS benefits. Employers were essentially contracting to provide a portion of

<sup>6</sup> The rule-of-thumb estimate is that old-age income needs to replace between 65 and 80 percent of pre-retirement earnings to support a comparable standard of living (Hannah 1986).

<sup>7</sup> Hannah (1986); Whiteside (2002).

<sup>8</sup> Davis (1997); Whitehouse (1998).

<sup>9</sup> In calculating SERPS pensions, past earnings were indexed to wage growth and benefits were indexed to prices (DWP 2000).

the SERPS-defined pension, with the government retaining responsibility for benefits seen as too risky or difficult for employers to provide. As an incentive to contract out, the government set the NIC rebate somewhat above the estimated average cost of providing the GMP.<sup>10</sup>

This expansion of social insurance proved short lived. In 1979, only a year after SERPS went into effect, the Conservatives returned to power promising to privatize and deregulate the economy and to lower the overall tax burden. The NIC, at about 15 percent of covered earnings, was a major component of overall taxation, especially for low and middling earners. Reputable studies also began projecting rapid population aging after 2010, with a sharp increase in pension expenditures and NIC rates rising to 35 percent of covered earnings. As private plans were funded in advance and had a strong voluntary component, they promised a smoother and less costly transition to an older society. The fiscal implications of societal aging thus reinforced the Tory impulse to privatize the retirement income system.<sup>11</sup>

The campaign began in 1980, when the Tories indexed the Basic State Pension to prices. This set the “first tier” of the British system on a path of replacing an ever-smaller share of pre-retirement earnings. By the end of the 1990s, the BSP would fall from 25 to 16 percent of average earnings and by 2030 is projected to replace just 10 percent.

The Tories turned to the income-spreading “second tier” in 1986, cutting SERPS and shifting more of the burden to employer plans. They cut SERPS pensions to 20 percent of lifetime covered earnings (from 25 percent of the worker’s best 20 years) and the survivor benefit to 50 percent (from 100). Employer plans, however, had to vest workers after two years of service and assume a greater portion of the inflation-proofing burden. They now

had to index GMP pensions as well as accruals up to 3 percent and accruals above the GMP up to 5 percent inflation.<sup>12</sup>

The privatization campaign was stymied, however, by the stagnation in employer plan coverage. Despite the creation of SERPS and its offer of NIC rebates, participation had peaked in 1967, at 53 percent of the workforce. The spread of employer pensions had stalled as the economy shifted away from large enterprises and career employment toward smaller firms and the employment of women and mobile knowledge workers.<sup>13</sup>

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## The 1978 State Earnings Related Scheme guaranteed higher pensions and encouraged employer provision.

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As a retirement income vehicle, individual savings accounts are far better suited than traditional defined benefit (DB) pensions for smaller firms and workers with multiple employers. Employers avoid the significant risks involved in delivering a distant income stream and workers simply take their balances with them when they change employers. To expand the reach of private plans, and to promote a more fluid, non-corporate, non-union, “market-driven” economy, the Tories now vigorously promoted individual account retirement plans. The 1986 Act that diminished SERPS allowed firms and workers to contract out using “money purchase” (MP) plans — individual accounts that annuitized the balance at retirement. NIC rebates could now be deposited into either individual “personal pension” policies offered by insurers or employer money purchase plans. To encourage the adoption of personal pensions, the

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<sup>10</sup> The GMP was based on earnings across a worker’s entire career, not the best 20; accruals prior to retirement were indexed to inflation, not wage growth, and only to 3 percent, and benefits were not inflation-proofed; and surviving spouses got just a half-pension benefit. In the inflation-wracked 1970s, inflation proofing was seen as especially risky. Basing pensions on earnings over a portion of a worker’s career — the best 20 — was also difficult for employers to fund and administer. For a thorough treatment of leaver’s benefits see Blake and Orszag (1997).

The government set the rebate at about .5 percent of covered earnings above the estimated cost. The estimate included administrative expenses, which increased costs above the government alternative; and a significant use of equities in funding the benefit, which reduced costs far below the present value of the GMP discounted at the riskless government rate. The rebates were funded out of NIC contributions and would increase the levy by about 3 percentage points. The NIC thus came to include a significant advance-funding component which was directed to private plans; increased the burden on those

who remained in SERPS; and benefited future contributors. Both the advance funding and the burden shifting effects increased with the rate of contracting out (Daykin 2001).

The arrangement shifted the incentive to offer a plan from personnel management toward financial gain. Leavers now got a pension at least equal to the public benefit, diminishing a plan’s value in retaining workers. But many employers were able to provide the GMP for less than the NIC rebate. This was especially so for employers with a relatively young workforce, as the distant pensions were quite inexpensive and NIC rebates were invariant with age. Contracting out also seemed attractive in periods of prosperity, when employers expected a higher return on pension-fund assets than the rate implicit in the rebate.

<sup>11</sup> Whitehouse (1998); DWP (2000).

<sup>12</sup> DWP (2000); Hannah (1986); Blake (2000); Whitehouse (1998); Davis (1997); Nobles (2000).

<sup>13</sup> Davis (1997); Nobles (2000).

Tories offered an additional 2 percent NIC rebate between 1988 and 1993. They also allowed workers to opt out of an employer DB plan and direct their rebate, and even the cash-out value of their DB plan accruals, to a personal pension.<sup>14</sup>

Because of these initiatives, Britain retained a retirement income system uniquely dependent on private programs compared to other industrial nations. Both the universal BSP and SERPS would replace a small and shrinking portion of pre-retirement earnings. But private plans covered 63 percent of workers with second tier coverage — a substantial majority. To maintain living standards in retirement, Britain clearly relied on employer and personal pensions. Table 1 shows the sources of old-age income in 1979. Table 2 shows a breakdown of second tier coverage and how it was affected by the introduction of money purchase plans.

**Table 1. Sources of Old-Age Income, 1979**

Government Benefits	61%
Occupational Pensions	16
Investment Income	11
Earnings from Work	12
Other	1

Source: Davis (1997).

**Table 2. Distribution of Workers Covered by Second Tier Earnings-Related Plans, 1979-80 and 1987-88**

	1979-80	1987-88
Employer Defined Benefit Pension Plan	53%	48%
Money Purchase Plan	0	15
SERPS	47	37

Source: Whitehead (1997).

## Reforming the British System

The British retirement income system had three main objectives going forward:

**Limit public expenditures on the elderly.** While spending per pensioner was already low, policymakers were intent on limiting the impact of population aging on future government budgets.

**Enlarge and strengthen the private plans.** With the scheduled decline in public programs, private plans assumed primary responsibility for providing a secure and comfortable old age.

**Assure an adequate retirement income for all.** As public pensions receded, the elderly at the bottom became increasingly vulnerable and avoiding “two nations” of pensioners — one well-off and one poor — became a major policy objective.

The British system now has four major components, two private and two public: (1) employer DB pensions; (2) money purchase savings plans; (3) BSP and SERPS social insurance; and (4) means-tested welfare programs. In pursuing the above agenda, Britain would dramatically reform each component and the way they came together to form the larger retirement income system.

### Reforming Employer DB Pension Plans

A series of far reaching reforms to employer plans was initiated by the Maxwell scandal of 1991. Robert Maxwell, who controlled a large publishing empire, had used pension fund assets to prop up the securities of companies he controlled. This became public with the collapse of his empire and the resulting outcry, combined with the sheer size and importance of DB plans, led to a series of reforms that addressed the overall soundness of employer plans.

In the Pensions Act of 1995, Parliament imposed stricter rules on fiduciary conduct, created new enforcement mechanisms, and set up an insurance fund to protect participants against fraud.

The 1995 Act also imposed new regulations on employer plans that reflected their expanding importance to the retirement income system. It:

- Eliminated the Guaranteed Minimum Pension (GMP) as the condition for contracting out,

<sup>14</sup> On balances created by NIC rebates, at least three-quarters had to be annuitized using unisex rates, with payments rising at least 3 percent per annum to accommodate expected inflation and spouses getting at least a 50 percent survivor benefit (Daykin 2001; Davis 1997).

instead requiring that employer plans provide benefits generally as good as SERPS.

- Required plans that contract out to index pension payments and leaver's accruals up to 5 percent inflation (formerly 3 percent inflation), and eliminated the government's SERPS-based top-ups.
- Established the Minimum Funding Requirement (MFR). Earlier rules only required actuarial certification of assets sufficient to pay the GMP. The MFR required assets sufficient to meet at least 90 percent of the entire obligation should the plan terminate.<sup>15</sup>

The growing size of employer plans also drew the attention of the investor community — a community ironically dominated by employer pension funds. Investors now clearly needed to know the condition of the pension plan to evaluate a firm's financial position. So the accounting profession issued Financial Reporting Standard 17 in 2000, requiring sponsors to report the current market value of plan assets and liabilities in their financial statements. The investor community, as well as the government, assumed a new role in supervising the soundness of employer plans.

### Reforming Individual Savings Plans

The reform of money purchase plans also began in scandal. The government's aggressive promotion of private pensions had sparked a stampede by financial services firms to sign up personal pension business. Commission-driven agents convinced millions of Britons to take out private pensions, including 500,000 to switch from an employer plan. Many of these workers, and most of those in employer plans, were seriously misadvised.<sup>16</sup>

Workers in their mid-40s or over were better off in SERPS, let alone in a far more generous employer DB plan.<sup>17</sup> Opting out of an employer plan typically meant the loss of the employer's pension contribution, the plan's risk pooling and administrative economies, and ancillary disability and life insurance benefits.<sup>18</sup> Workers dissatisfied with a personal pension or their particular provider,

or unable to continue contributing, also discovered that most plans had very low cash values in the early years of the program: a large portion of their initial contributions went to pay commissions and set-up fees.<sup>19</sup>

An eruption of complaints at the end of 1993 initiated the "mis-selling" scandal, which in time resulted in the insurance industry being forced to pay an estimated £11 billion as compensation to mis-sold workers. The scandal also led to much tougher fiduciary controls on the financial services industry. To transfer accruals in employer DB plans to a personal pension, for example, a worker would need a written explanation, prepared by a trained expert and checked by the insurer, demonstrating the gain. Personal pension providers must now also disclose commissions and surrender values over the first five years of the contract.<sup>20</sup>

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## Margaret Thatcher, and the specter of the demographic transition, led to rapid "privatization" after 1980.

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While personal pensions were a big mistake for many, for others they were exceedingly advantageous. The government offered all workers the same NIC rebate, regardless of age. For young workers, who had a very long stretch of time to accumulate investment income, this was an exceptionally good bargain. They could also return to SERPS later in life, when the government pension had more value than the rebate. Over the first 10 years of the program, the government lost £10 billion on personal pension rebates as large numbers of young workers took up the offer.<sup>21</sup> Employers also lost out, as over half of all new employees opted for a personal pension and took their mis-priced rebates with them. Government policy responded only haltingly to this mis-pricing problem. After 1993 it offered an additional 1 percent personal pension rebate only to workers

<sup>15</sup> To value future pension obligations, sponsors had to use a discount rate derived from a benchmark portfolio whose mix of stocks and bonds varied with the maturity of the plan. In 2001, the government announced its intention to replace the MFR with a "scheme-specific funding statement" that required sponsors to project the plan's obligations, assets, and contributions; to discuss the assumptions and risks in the program; and to evaluate performance against these projections (Blake 2002).

<sup>16</sup> Blake (2000).

<sup>17</sup> In employer DB plans, accruals at the end of a worker's career have the greatest impact on retirement income; SERPS rewards each year more equally; in personal pensions, contributions in the early years of a worker's career have the greatest impact.

<sup>18</sup> Some workers opted out of an employer plan to increase their take-home pay. They contributed just the NIC rebate to their personal pension and pocketed their former contribution to the employer plan. Such decisions could reflect tremendous liquidity constraints, a low value placed on their own future well-being, or simple financial ignorance.

<sup>19</sup> Blake (2000, 2002); Davis (1997, 2000); Murthi, et al. (1999).

<sup>20</sup> Davis (2000); Blake (2000, 2002).

<sup>21</sup> Between 1988 and 1994 the rebates had lost the Treasury a net amount of about £6 billion: they cost £9.3 billion and reduced future obligations by an estimated £3.4 (Davis 1997).

over age 30. Then in 1997 it moved to age-adjusted rebates, now ranging from 5.2 percent at age 15 to 13.1 percent at age 52 and over.<sup>22</sup>

### Reforming the Public-Private Divide

Despite these scandals and challenges, the Conservatives continued their campaign to privatize the retirement income system. The Pensions Act of 1995 again halved the size of SERPS by raising the retirement age for women, from 60 to 65 between 2010 and 2020, and by adopting a formula that reduced the band of SERPS-covered earnings. The increase in the women's retirement age also applied to the BSP, so it also reduced the size of that program.<sup>23</sup>

In 1997, the Tories attempted the final step. They proposed the complete elimination of both the BSP and SERPS, to be replaced by mandatory participation in a private plan with contributions of at least 9 percent of earnings. This would have reduced the relative size of setup and marketing costs, which had taken a huge bite out of personal pension contributions made by low and middling earners. Improving access to the capital market, the Tories argued, was the key to raising the retirement incomes of those at the bottom and to smoothing the nation's transition to an older society. As a fail safe, the Tories would have guaranteed an income at least equal to the BSP on the "first tier" portion of the mandatory contributions.<sup>24</sup>

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## Scandals in employer pensions and the new individual plans highlighted the risks in private provision.

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The privatization campaign, and the Tory control of Parliament, came to an end in the election of 1997. Privatization became a major campaign issue and the debate contributed to the Conservative's worst defeat since 1832.<sup>25</sup>

Labor strengthened social insurance for those at the bottom. But it also retained Britain's

commitment to private programs, declaring its desire that private plans provide 60 percent of old-age income by the middle of the new century. So Labor created a new retirement savings vehicle to meet the needs of low and middling earners. Labor hoped these initiatives would in time lift the bulk of the elderly out of the means-tested system. Within a few years, however, it would redesign the welfare system in a way that would make means-tested benefits a central component of the British retirement income system.<sup>26</sup>

### Reforming Social Insurance

Labor kept the BSP essentially unchanged. While it increased benefits upon coming to office by more than the price-indexed amount, these were one-time adjustments, not a permanent policy change. The "first tier" of the British retirement income system will thus continue its steady decline vis-à-vis pre-retirement earnings.

Labor's key social insurance reform replaced SERPS with the State Second Pension (S2P), a program that systematically redistributed retirement income. All workers with average lifetime earnings below 45 percent of the average wage got the same S2P pension — equal to twice the SERPS benefit for the 45 percent earner. Benefits for higher earners were somewhat greater, gradually returning to the SERPS accrual rate at wage levels where most workers contract out. As S2P accruals vary by earnings, NIC rebates do so as well; they run as high as 17.8 percent for low earners, age 50 or over, funding a personal pension. The S2P also gives pension credit to carers and the disabled. It thus functions more like the Basic State Pension than SERPS, assuring a minimal old age income rather than spreading income across the lifespan.<sup>27</sup>

Even for low earners, however, the S2P's higher benefits only partially offset the expected decline of the Basic State Pension. The upshot of Labor's social insurance reform was thus to use the government's scarce resources to preserve pension benefits for workers without private coverage, and leave those in private plans with just the dwindling BSP.<sup>28</sup>

hammered away at this loss of deductibility, emphasizing the political risk that future governments could reimpose a tax on retirement benefits (Whitehouse 1998).

<sup>22</sup> Davis (1997).

<sup>23</sup> Blake (2000, 2002); Whitehouse (1998).

<sup>24</sup> Whitehouse (1998); Murthi, et al. (1999).

<sup>25</sup> A Tory proposal to change the taxation of private plans — in response to the financing crisis that would be created by privatization — emerged as a major election issue. Privatization would eliminate social insurance revenues but not the government's obligation to honor pensions and benefits accrued in the past. To pay for these pensions, the Conservatives would bring the taxation of pensions forward: they would eliminate the deductibility of contributions and make benefits tax-exempt. This did not cover the entire liability, but made the remaining burden manageable. Labor, however,

<sup>26</sup> DWP (1998, 2000, 2002); Emmerson (2002).

<sup>27</sup> The government expected eighteen million workers to benefit from the new program: five million with earnings less than 45 percent of National Average Earnings, mainly part-time women; nine million with earnings above that level; two million carers; and two million disabled. Labor has actually proposed making the S2P a flat benefit program, at twice the SERPS pension for the 45 percent earner. This would create two flat-rate public plans: the BSP for essentially all retirees and the S2P for those without private coverage (DWP 1998, 2000).

<sup>28</sup> PPI (2003).



## Reforming Money Purchases: Stakeholder Pensions

The greatest challenge to expanding private sector coverage has always been the inclusion of low and middling earners. To reach this population, the Tories promoted personal pensions and relied on market competition to drive down costs and produce suitable low-risk products.<sup>29</sup> Their 1997 privatization proposal would have further reduced the overhead burden by enhancing the size and regularity of contributions.

Labor adopted a different tack. In 2001 it introduced the “stakeholder pension” — a funding vehicle that limited fees to 1 percent of assets and allowed no charges for initiating or exiting an account. The design explicitly addressed the cost problem exposed in the mis-selling scandal and would hopefully rehabilitate the reputation of personal pensions. This was especially important as stakeholder plans required enormous economies of scale to be commercially viable. By sanctioning the design, and by requiring employers without their own plan to offer workers a stakeholder option, the government hoped to accelerate its acceptance in the marketplace.<sup>30</sup>

## Reforming Means-Tested Benefits

Because of Britain’s meager social insurance program and the limited reach of private plans, one-third of the elderly in the 1990s received means-tested benefits, with one out of six collecting national cash allowances. Labor quickly enacted the Minimum Income Guarantee (MIG) that assured the elderly at least 20 percent of National Average Earnings, the traditional means-tested amount. This increased incomes and raised the number of recipients to about one out of five.<sup>31</sup>

In 2003, Labor replaced the MIG with the “Pension Credit,” a far-reaching reform. Instead of reducing means-tested top-ups £-for-£ for income above the guarantee level, the new program reduced benefits only 40 pence per £. In other words, it lowered the effective “tax” on such income from 100 to 40 percent. This reduced the sense of unfairness and the draconian disincentive to work or save that the traditional approach imposed on low and middling earners. This is especially important as the BSP declines. Otherwise an increasing proportion of the elderly would have seen income earned through work or saving merely reduce their means-tested top-ups £-for-£.<sup>32</sup>

<sup>29</sup> The Tories also addressed the risk of short-term bumps in annuity prices in a way that expanded personal freedom. Falling interest rates had led to higher prices and complaints about the riskiness of requiring annuitization upon retirement. So the Finance Act of 1995 allowed workers to postpone annuitization to age 75, allowing draw downs no larger than the amount an annuity would pay (Blake 2000).

The Pension Credit taper means that a much larger share of the elderly population will qualify for means-tested payments. Retirees can now get a means-tested top-up with a full BSP and a second pension of up to 13 percent of average earnings (versus 5 percent prior to the Pension Credit program). As a result, about half the elderly now qualify. By 2025, when the BSP is projected to fall to about 10 percent of average earnings, retirees with additional income of about 25 percent of average earnings could get a Pension Credit top-up. By mid-century, estimates of the eligible population range from 65 to 80 percent of the elderly. The great majority of households will thus be eligible for means-tested benefits — if not at retirement then later in life.<sup>33</sup>

## Will the Reforms Succeed?

The economic position of the elderly clearly improved over the last two decades of the twentieth century. Average incomes rose from 50 to 60 percent of average earnings as employer pensions and investment income expanded to provide 43 percent of old age income, up from 27 percent two decades earlier (see Figure 2). Nor were the elderly any longer a distinctly poor population. They were half the lowest income quintile in 1979, but less than a quarter in 2000. Nevertheless, the income gains were concentrated at the upper end of the income distribution, among those with pensions and capital

Figure 2. UK Disposable Income by Source, Age 65 and Over



Source: Yamada (2002).

<sup>30</sup> DWP (1998, 2002).

<sup>31</sup> Davis (1997); DWP (2002); PPI (2003).

<sup>32</sup> Clark (2001, 2002); Clark and Emmerson (2003).

<sup>33</sup> PPI (2003); Clark and Emmerson (2003).

income. The bottom elderly quintile had incomes averaging just 21 percent of average earnings, less than two decades earlier.<sup>34</sup>

### Limit the Expansion of Public Old-Age Pension Expenditures: Yes

Total public expenditures on the elderly, including both social insurance and means-tested programs, absorbed a bit more than 5 percent of GDP in 1998-99. Projections out to mid-century show this share staying relatively stable, with a decline in social insurance spending offset by an increase in means-tested expenditures.<sup>35</sup>

Net tax expenditures should also decline as a share of GDP. The Treasury foregoes 2.3 percent of GDP in support of private plans (assuming sheltered income would otherwise be fully taxed): £19 billion by exempting contributions, investment income, and lump sum distributions less £6 billion collected on benefits paid out. As the private system matures, benefits rise faster than contributions and investment income; in a fully mature system with a static population, benefits equal contributions plus investment income. Private pensions will still involve a loss of government revenue as pensioners have lower effective tax rates than workers. But even if the system expands, the revenue loss should be a smaller share of GDP.<sup>36</sup>

### Enlarge and Strengthen the Private Provision of Retirement Income: No

Participation in private plans has not expanded. In the mid-1990s, private plans still covered a bit more than 60 percent of participants in earnings-related plans, and less than half the active workforce (See Table 3).<sup>37</sup> Pensions do contribute a greater share of old age income. Assets in 2001 were 80 percent of GDP, up from 21 percent in 1978, and most plans are still in the accumulation phase. Nevertheless, the private sector will not easily provide secure and comfortable retirements to the bulk of the population.<sup>38</sup>

**Table 3.** Participation in Retirement Income Programs, 1994-95

	Number (Millions)	Percent
Total Working Population	24.9	100%
Covered by the BSP	21.0	84
With Second-Tier Provisions:	18.9	76
SERPS	7.1	29
Contracted Out:		
Employer DB Plans	8.1	33
Personal Pensions	3.7	15

Source: Liu (1999).

### Employer Plans

The reforms to the employer plan institution, as well as external economic shifts, inadvertently reduced the size and strength of employer DB plans.

The Finance Act of 1986, enacted to limit deductible pension contributions at a time of serious budgetary pressure, all but assured the financial precariousness of employer plans. The law allowed plans to be at most 5 percent overfunded. So rather than build up surpluses during the boom years of the 1980s and 90s, sponsors took “funding holidays,” reducing their contributions from 2.7 to 1.2 percent of GDP between 1980 and 1992, and used “excess” assets to sweeten early retirement benefits.<sup>39</sup>

Various reforms then heightened the cost, risk, and sensitivity to risk in DB plans. The 1995 Pensions Act shifted the risk of inflation, up to 5 percent, to employer plans. The proposed scheme-specific funding standard would require sponsors to explicitly identify and explain the risks in their program. FAS 17, which becomes mandatory in 2005 but which most large employers adopted earlier, required the sponsor’s financial statements to reflect the sharp surplus/deficit swings characteristic of “marked-to-market” DB plans.<sup>40</sup> In

<sup>34</sup> DWP (2002); OECD (2000); Emmerson (2002); Whitehouse (1998).

<sup>35</sup> DWP (2003a); Clark (2001, 2002); Davis (2003).

<sup>36</sup> DWP (2002); Davis (1997).

<sup>37</sup> The table presents figures on 1994-95 from Liu 1999, which gives a snapshot of participation across the entire workforce and which excludes participants with inactive personal pension plans

from the personal pension totals. Figures from other sources indicate that the overall participation percentages are little changed from 1994-95 (DWP 2003b).

<sup>38</sup> Davis (2003).

<sup>39</sup> Davis (1997); Davis (2003); Blake (2002).

<sup>40</sup> The traditional approach used by actuaries smoothed the figures for assets and liabilities rather than using the values based on current asset values and interest rates.

response, sponsors shifted pension fund assets from equities to bonds, which immunize their plans against a major source of risk — the effect of interest rate changes on the present value of distant pension obligations.<sup>41</sup> This shift toward bonds, however, reduced the expected return on pension fund assets and increased the cost of a plan.<sup>42</sup>

The appeal of DB plans also declined due to changes in the labor market. One factor was the aging of the workforce. The cost of DB accruals rises sharply with age and government funding limits did not allow sponsors to pre-fund this predictable uptick in expense. The value of pensions in personnel management was also declining. Employers had to give leavers increasingly generous benefits as a condition of contracting out, diminishing the value of a pension as compensation for those remaining with the firm. The projected slowing of labor force growth also suggested coming labor shortages, making the severance incentives in some DB plans less valuable, if not dysfunctional. DB plans also lost favor among firms adopting more fluid, American-style employment relationships that did not presume lifetime career attachments.

These pressures on DB plans came to a head in the financial downturn that began in 2000. Funding levels fell sharply as asset values declined (plans were still heavily invested in equities) and as liabilities ballooned with the fall in interest rates. By year-end 2002, funding levels at Britain's top 100 firms averaged just 80 percent of plan liabilities. As most large firms had adopted the new accounting rules, they reported these losses in their financial statements. Government funding rules also required sharply increased contributions — at a time when the operating business was struggling.<sup>43</sup>

The response has been a significant move away from DB pension plans. As early as the mid-1990s, 80 percent of new employer plans have been money purchase; and since 1997, sponsors have terminated 10,000 DB plans, with 300,000 participants. Even more dramatic, employers with over half of all private-sector DB participants have recently closed their plans to new entrants. Workers in government agencies and enterprises have retained their DB plans. But in the private sector, retirement plans will increasingly be organized around individual money purchase accounts, either as personal or stakeholder pensions or in an employer sponsored DC plan.<sup>44</sup>

## Individual Money Purchase Accounts

The shift to money purchase plans strengthened the retirement income system in various ways. Workers clearly value a monetary balance far more than a claim on an indeterminate future income stream. They are thus more willing to reduce current consumption to fund the plan. Individual MP accounts are also more portable than DB accruals, and accommodate labor mobility. But MP plans have serious shortcomings in the area of financial risks, overhead costs, and plan management.

The most obvious limitations of MP plans are the financial risks borne by individual workers. Risks in the accumulation phase are reduced by the widespread use of pooled investment funds, managed either by an insurance company or by the employer with some employee representation. But workers are still exposed to two significant risks: 1) temporal risk: the possibility that returns will be low or even negative during the ten or so years prior to retirement; and 2) longevity risk: not knowing how long one will live creates the possibility of outliving one's assets, or of underconsuming to avoid that fate. The government mandates annuitization to offset this risk. But this rule applies only to balances created by NIC rebates and requires only partial inflation-proofing. The government also let workers postpone annuitization up to age 75 — a response to the temporal risk that interest rates at retirement could be unusually low. But this introduced adverse selection — the likelihood that unhealthy individuals will postpone so that their heirs could inherit their account balance should they die prior to age 75 — and this reduced the income that a given account balance could purchase at age 65.

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## Increased burdens and adverse financial conditions sparked a rapid decline in employer provision.

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High overhead costs, especially on the small accounts and contributions of low and middling earners, are a second limitation of MP plans. The Stakeholder design has attempted to address this problem by fiat. But administration remains costly. So does providing the complex advice that low and middling earners need to decide whether to stay in the S2P and to optimize access to means-tested

<sup>41</sup> Bonds and plan liabilities rise and fall in tandem in response to interest rate changes.

<sup>42</sup> Davis (2003); Blake (2002).

<sup>43</sup> Davis (2003).

<sup>44</sup> Whitehouse (1998); Davis (2003); DWP (2002).

benefits. Financial services firms are concerned that if they give erroneous advice they could be accused of mis-selling and face financial penalties. So they have not aggressively pursued this business and take-up has been disappointing.

This need for advice highlights the third limitation of MP plans: their lack of proper management. The challenges of retirement income planning are much the same in MP and employer DB plans: the need to adequately fund the plan, invest the assets, and then generate the desired income stream. But employer plans bring tremendous sophistication to the task, and workers bring little or none.

This lack of proper management is illustrated by the low level of contributions to MP plans. Funding levels in employer DB plans, largely determined by actuarial analysis, averaged 16.1 percent of earnings in 2003. Contributions to MP plans above the NIC rebate are largely set by individual workers and averaged half that amount.<sup>45</sup> This level of contributions, together with the steadily declining BSP, cannot be expected to provide future pensioners a reasonable approximation of pre-retirement earnings.<sup>46</sup>

Nor does the experience with MP plans demonstrate proper management in investing or annuitizing plan assets. MP investment returns are low, perhaps because the managers in pooled MP funds are excessively averse to showing a loss. Workers also demonstrate limited rationality when annuitizing account balances. They often annuitize with the firm that managed the accumulation phase, even when other providers offer far more income. Retirees also tend to select flat annuities, without inflation protection, on non-NIC balances. Whether this reflects excessive present-mindedness or “money illusion” (that monetary units, not purchasing power, is the relevant factor), it demonstrates a lack of effective long-term planning.<sup>47</sup>

### Assuring an Adequate Retirement Income for All: No

Britons in the lower half of the income distribution rely on three different sources of old-age income: social insurance, private retirement plans, and means-tested welfare benefits. These sources keep the elderly out of poverty, but hardly assure an

adequate standard of living. One-quarter of all pensioners currently live in “relative poverty,” with incomes too low to assure “health and social integration.” Half cannot afford “a healthy lifestyle with the opportunity to play a full part in society” — requiring incomes of roughly half average earnings for a single renter. Looking ahead, even this minimal income floor is at risk.<sup>48</sup>

Social insurance will replace an ever-declining amount of pre-retirement earnings. As real wages rise, the combined state pension for a full-career average earner is projected to fall to 28 percent of average earnings. For the worker making half the average wage, the combined pension would be just 21 percent of average earnings.<sup>49</sup>

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### The emerging reliance on individual accounts and means-tested benefits is risky and fraught with moral hazard.

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Private plans and capital market investments have been key to comfortable British retirements. But high overhead costs and risk have impeded access by low and middling earners. As the take-up of Stakeholder plans has been disappointing, costs remain a serious issue. As contributions have also been notoriously inadequate, low and middling earners need robust investment returns, especially toward the end of their careers, to secure a reasonable retirement income. And they have no assurance that this will be the case.

Due to the decline in social insurance, the problems in private plans, and the introduction of the Pension Credit taper, the elderly in Britain should become increasingly dependent on means-tested benefits. By the middle of the century, about three out of four are expected to qualify for Pension Credit top-ups. With the BSP at about 7 percent of NAE, these top-ups would end with total income below 40 percent of average earnings. Three-quarters of the elderly would thus have incomes at or below this “near poverty” level.<sup>50</sup>

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<sup>45</sup> DB plans have an older workforce, which significantly increases required contributions. But defined contribution plans often have higher overhead costs, bear more risk, and their liabilities are not reduced when a worker leaves the firm.

<sup>46</sup> Davis (2003).

<sup>47</sup> Davis (1997, 2003).

<sup>48</sup> PPI (2003).

<sup>49</sup> PPI (2003).

<sup>50</sup> Liu (1999).

## Conclusion

Britain has the world's oldest retirement income system, and it shows. It is a complex and unstable accretion of individual savings and employer DB pension plans, social insurance, and public welfare programs. All emerged when retirements were uncommon and short. But the design of these programs, their relative importance, and their interaction have shifted dramatically over the past half-century. Some change came in response to external factors, such as the emergence of retirement as a normal and extended stage of life, the new social and economic role of women, the decline of the career employment model, and the impending demographic transition. A significant source of instability, however, has been the sharp ideological conflict between Britain's two major parties and the nation's parliamentary system of government, which allows the party in power to make sweeping changes to existing programs.

Such disruptions are especially problematic for long-lived retirement income systems. Transitions generally take decades to complete, as credits in the new regime accrue slowly while those accrued in the old regime last the lifetime of the participant and surviving spouse. The ultimate size and sources of one's old-age income thus become highly uncertain. Accommodating new initiatives also increases the complexity of the system, as seen in the adjustment of NIC rebates by age and then income, the transfer of risk to employers and individuals, and the exemption of Pension Credit benefits from the means-test of other welfare programs. This complexity and instability increases administrative costs, generates confusion and mistrust, and opens numerous opportunities for gaming, mis-selling, and error.<sup>51</sup>

Nor has Britain achieved its retirement income objectives. In addition to the sheer complexity of the system, reformers were undermined by a fundamental conflict in their objectives. They limited public expenditures on the elderly by slashing social insurance. These programs, however, were critical sources of income for those at the bottom and took on risks and obligations that are extremely difficult for employers or individuals to bear. Privatizing these risks and obligations led many employers to terminate or close their plans to new members, which significantly weakened the private retirement income sector. Nor has the public response — the redistributive S2P and the

dramatic expansion of means-tested top-ups — assured the elderly a basic standard of dignity and comfort.

These limitations are widely acknowledged. But there is little appetite for increasing expenditures to shore up the system, say by restoring social insurance or by mandating retirement saving beyond the current NIC rebate levels. The major items on the policy agenda, presented in the government's 2002 Green Paper, *Simplicity, Security, and Choice: Working and Saving for Retirement*, require little or no new public spending.<sup>52</sup> They are programs designed to keep people employed for a longer stretch of time and educational initiatives designed to increase financial literacy and voluntary retirement saving.

Extending careers is of critical importance. While policymakers focused on trimming back the retirement income system, workers were retiring at ever younger ages. The major reduction came in the decade 1975 to 1985: the percentage of men age 60 to 64 in the labor force — either employed or looking for work — fell from 80 to 50 percent. Among men age 55 to 59, it fell from 90 to 70 percent. These early exits reduced contributions and increased the burdens on the retirement income system.<sup>53</sup>

The increased burden of providing DB pensions, with their various severance incentives, induced employers to end or wind down DB plans. It is unclear whether prospective labor shortages contributed to their introduction of money-purchase plans. The new arrangement nevertheless encourages workers to stay on the job and accumulate more contributions and investment income in their retirement accounts.

The government has clearly identified the extension of working careers as a major response to the retirement income challenge. It tightened access to disability pensions and hopes to maintain the labor market value of older workers through training, case-work support, and wage subsidies. The government is also encouraging "partial retirement" and part-time employment options. It has also raised the increment to social insurance pensions for delayed retirement.<sup>54</sup>

The new importance of means-tested retirement income programs, however, undercuts these initiatives. The S2P, which primarily serves intermittent and low-wage workers, gives a tremendous return on earnings that create a claim to S2P benefits, but little or no return on earnings

<sup>51</sup> Whitehouse (1998); Emmerson (2002).

<sup>52</sup> DWP (2002).

<sup>53</sup> Blundell and Johnson (1999).

<sup>54</sup> DWP (2002).

above that amount. The Pension Credit, which affects half the elderly today and perhaps 80 percent by mid-century, imposes a 40 percent tax on any income within the taper. The withdrawal of this and other means-tested benefits represents a significant disincentive to work past age 65 and could discourage saving for retirement. These incentives could even induce workers to retire early and live off their savings, rather than subject those savings to a Pension Credit haircut at age 65. The actual effect on work and saving, however, remains to be seen.<sup>55</sup>

The second new initiative, presented in the 2002 report, is a campaign to increase financial literacy. As the British system makes individuals key retirement income decisionmakers, the government has introduced financial education into the public school curriculum and launched various initiatives to simplify the retirement income system. Perhaps most innovative is a broad public education campaign, based on behavioral research on financial decisionmaking and loosely modeled on efforts to change behavior on issues such as “drink-driving.” The stated goal is for workers to save more, delay retirement, and annuitize their individual account balances.<sup>56</sup>

The obvious need for improved financial education raises a more fundamental issue. The Parliamentary debates that produced the current system are presumed to reflect the enlightened will of the people. But given the public’s state of financial sophistication, this can hardly be the case. The Parliamentary debates have often been excessively ideological and contentious. And the resulting system, involving a sharp decline in living standards and a high risk of near-poverty in the final two decades of life, is probably not the enlightened will of the people.

Improved financial education would make a major contribution if it helped the British electorate participate more effectively in this critical public debate. They must express how they want income distributed across their lifespan and the relative roles of social insurance and public welfare programs on the one hand, and markets, private providers, and the individual on the other. A better educated public could then help define that elusive national consensus needed to create a stable and effective retirement income system.

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<sup>55</sup> Emmerson (2002); Clark and Emmerson (2003).

<sup>56</sup> DWP 2002.

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# center for retirement research at boston college

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## About the Center

The Center for Retirement Research at Boston College, part of a consortium that includes parallel centers at the University of Michigan and the National Bureau of Economic Research, was established in 1998 through a grant from the Social Security Administration. The goals of the Center are to promote research on retirement issues, to transmit new findings to the policy community and the public, to help train new scholars, and to broaden access to valuable data sources. Through these initiatives, the Center hopes to forge a strong link between the academic and policy communities around an issue of critical importance to the nation's future.

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