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Pension Reform in the United Kingdom: Lessons for Canada?

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Background

- UK pension program has much in common with Canada:
  - Multi-pillar public provision
  - Mixture of private provision (employer-provided pension plans, individual retirement saving accounts, etc.)
- UK has tendency to reform programme, frequently:
  - Major reforms: 1975, 1986, 1995, 2000, 2004, 2007
  - Frequency increasing from every 10 years to every 3 years!
- First lesson for Canada – reforms too frequent to permit proper evaluation (*ex ante* and *ex post*).

This paper....

- Focus on two aspects of 2007 UK reforms which may be of particular interest in Canada:
- Reform of multi-tiered social security programme:
  - implications for future generations of pensioners
- Reform of private pension provision:
  - Introduction of new Personal Accounts
  - Illustrate change in ‘default option’

A ‘time line’ in UK pensions/social security history

- Beveridge: 1911/1948:
  - A universal minimum; state should not be responsible for income replacement beyond minimum
- 1970s: state should provide income replacement if private sector would not (SERPS/’contracting out’)
- Thatcher: 1980s:
  - Reduce future costs to state, ‘privatise’ by extending ‘contracting out’
- Blair/Brown:
  - People not saving enough (Blair); tax credits rather than universality (Brown)
- Pension Commission 2004-05:
  - ‘semi-compulsion’ to increase saving; tax credits reduce incentives, restore universality (but topped up by private saving)

→ May 2007 legislation (social security changes) + proposed legislation on personal accounts

Social Security: Parallel structures?

- Canada
  - Old Age Security
    - Flat benefit, withdrawn at high incomes
  - CPP/QPP
    - Earnings-related, accruals up to max. ceiling
  - Guaranteed Income Supplement
    - For low income households; tapered at 25%/50%

- United Kingdom
  - Basic State Pension
    - No withdrawal, indexed below income-tested benefits
  - SERPS/Second State Pension (S2P)
    - SERPS similar to CPP; S2P explicitly flat benefit in long run
  - Pensioner Credit/Saving Credit
    - Originally tapered at 100%; now reduced to 40%

Principal 2007 reforms to UK social security programme

Background

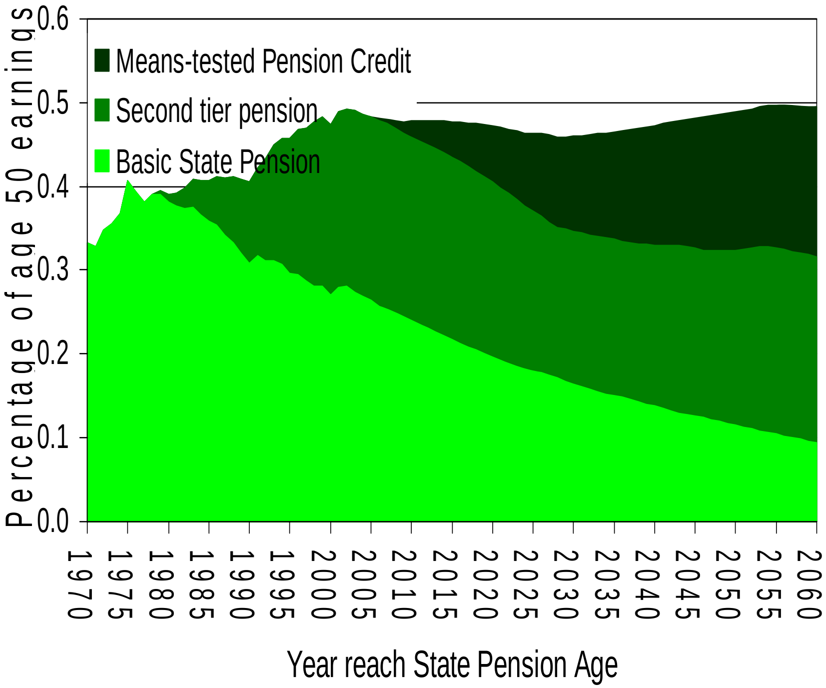
- Basic State Pension has usually been indexed in payment to inflation since 1980
- Whereas income-tested benefits had been indexed to earnings since 1997.

2007 reforms

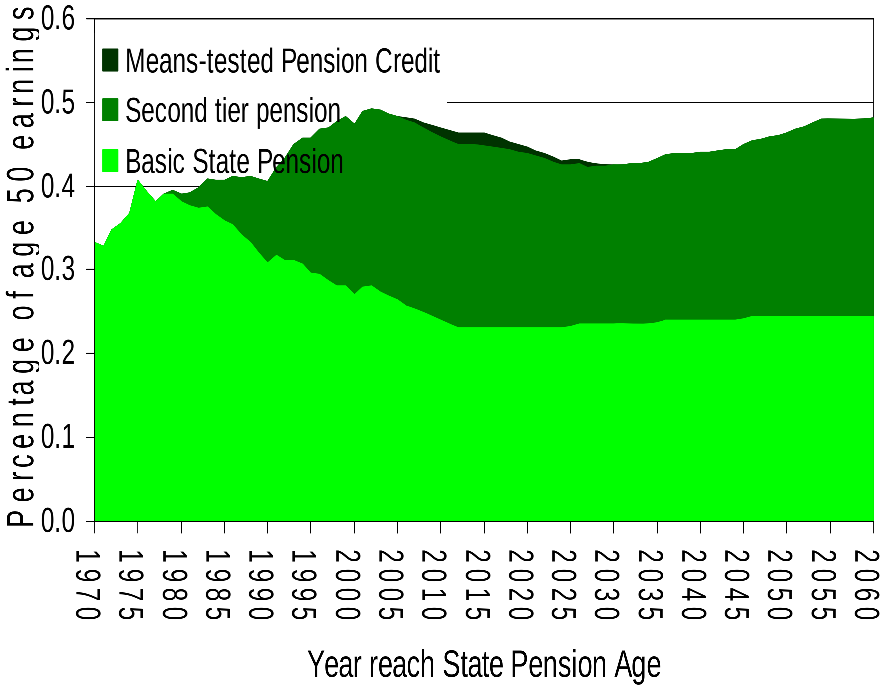
- Basic State Pension is to be earnings indexed from (probably) 2012
- Some of these gains will be clawed back from higher earners through cuts to maximum State Second Pension
- Maximum means-tested support from income-tested programme (Pension Credit) to be reduced

Man at 20th percentile of earnings distribution

Before 2007 reform

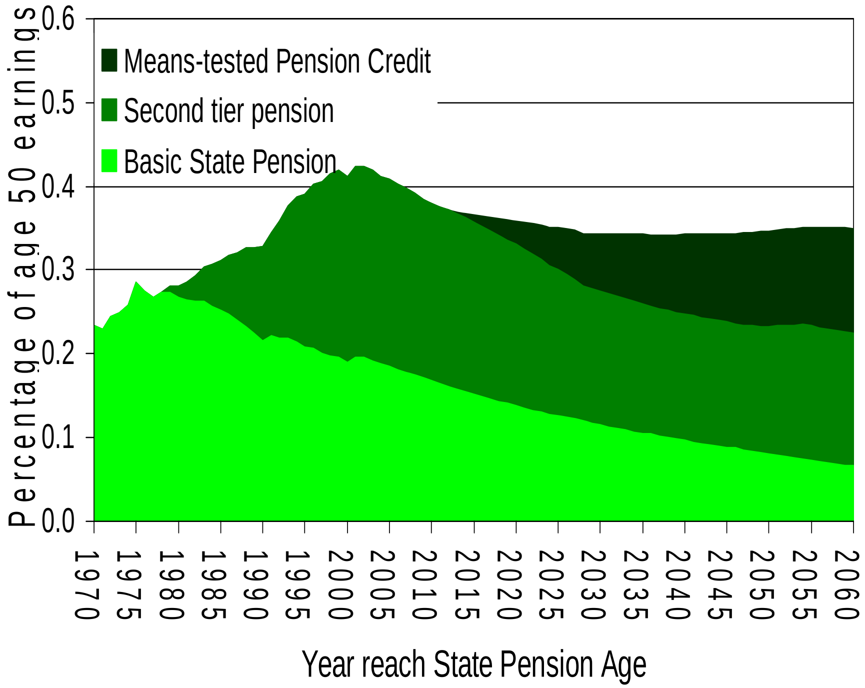


After 2007 reform

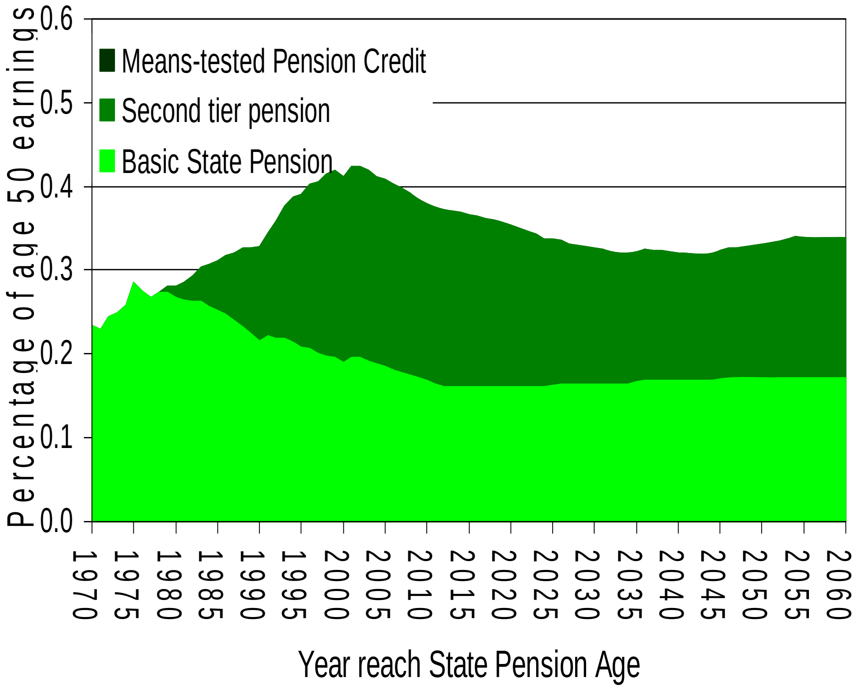


Man at 50th percentile of earnings distribution

Before 2007 reform

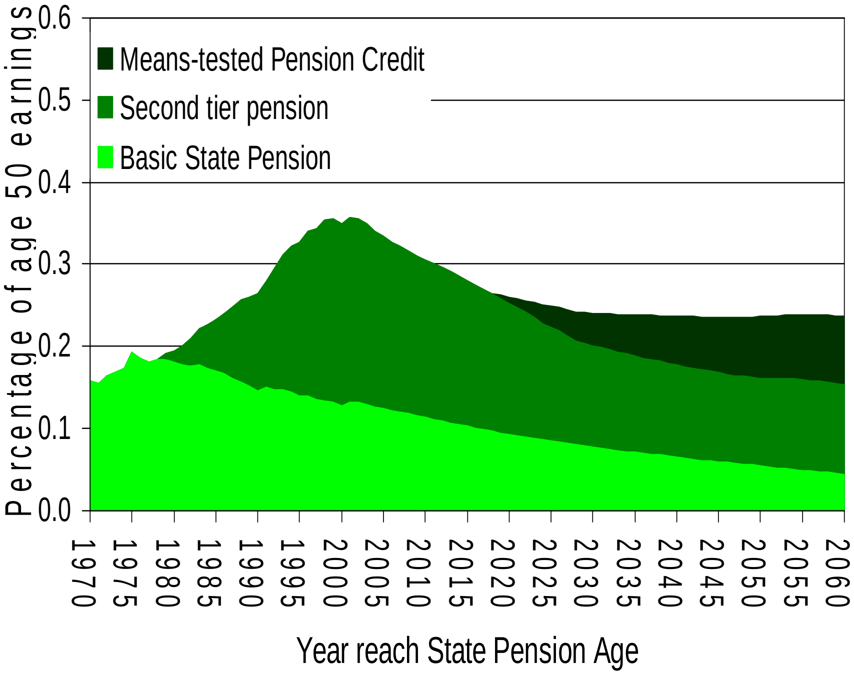


After 2007 reform

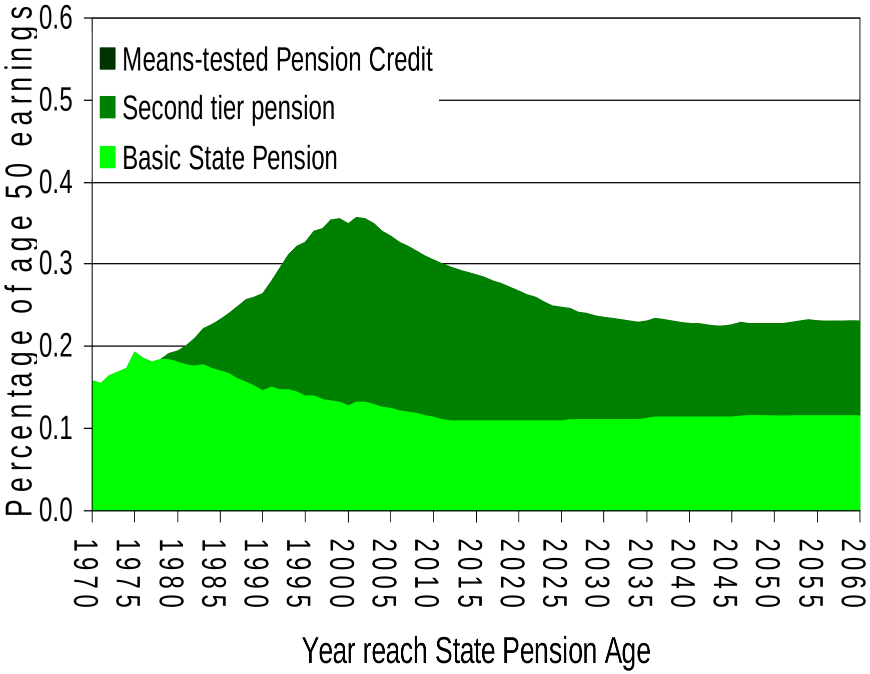


Man at 80th percentile of earnings distribution

Before 2007 reform



After 2007 reform



Saving for retirement in the UK: The new Personal Account proposals

- Background:
  - Shift from DB to DC pension plans
    - DB plans increasingly public sector-dominated
  - Decline in overall pension saving
    - Fall in coverage, low growth in total saving in early 2000s
    - Benchmark of 'saving adequacy' – c.25% not saving 'enough'
  - 'Failure' of 2000 reform to increase number of retirement savers
  - (And it's asserted that) – people don't respond to incentives: 'choice paralysis', high discount rates etc;
  - So government will 'pick up tab' in future through S2P and income-tested benefits

Some evidence….

Pension plan coverage stagnating in early 2000s

Pension coverage by type of pension: 1999–2000 to 2002–03

Employees only

Year	*1999–2000*	*2000–01*	*2001–02*	*2002–03*	*Increase*
Type of pension:	%	%	%	%	*% point*
Personal Pension	11.9	10.8	10.3	8.9	*– 3.0*
Stakeholder pension	0.0	0.0	0.8	1.3	*+ 1.3*
Employer pension plan	50.3	50.3	50.3	50.2	*– 0.1*
Combined	2.0	2.2	2.3	2.5	*+ 0.4*
Aggregate coverage (%)	*64.3*	*63.3*	*63.6*	*62.9*	*– 1.4*
Sample size	*19,549*	*18,711*	*20,418*	*21,648*	*80,326*

Source: Family Resources Survey data. From Disney, Emmerson & Wakefield: "Tax reform and retirement saving incentives: Evidence from the introduction of Stakeholder Pensions in the UK" Institute for Fiscal Studies (IFS)

Defined benefit (DB) plans are now predominantly public sector

DB pension coverage by age, sector, sex, education level, 2001

	% covered								
	Age 20-39			Age 40-59			All 20-59		
	Public	Private	All	Public	Private	All	Public	Private	All
All	*69.8*	*26.7*	*36.9*	*70.0*	*33.2*	*45.7*	*69.9*	*29.4*	*40.9*
Men	71.0	28.2	34.5	79.8	39.1	47.8	75.8	32.8	40.5
Women	69.3	24.7	39.4	65.6	25.0	43.7	67.3	24.8	41.4
Education									
High	73.9	30.1	43.9	75.2	40.1	55.3	74.6	33.9	48.8
Mid	67.1	27.9	34.8	72.2	37.8	48.3	69.5	31.0	39.4
Low	57.3	21.7	26.7	59.0	26.6	34.4	58.4	24.1	30.7

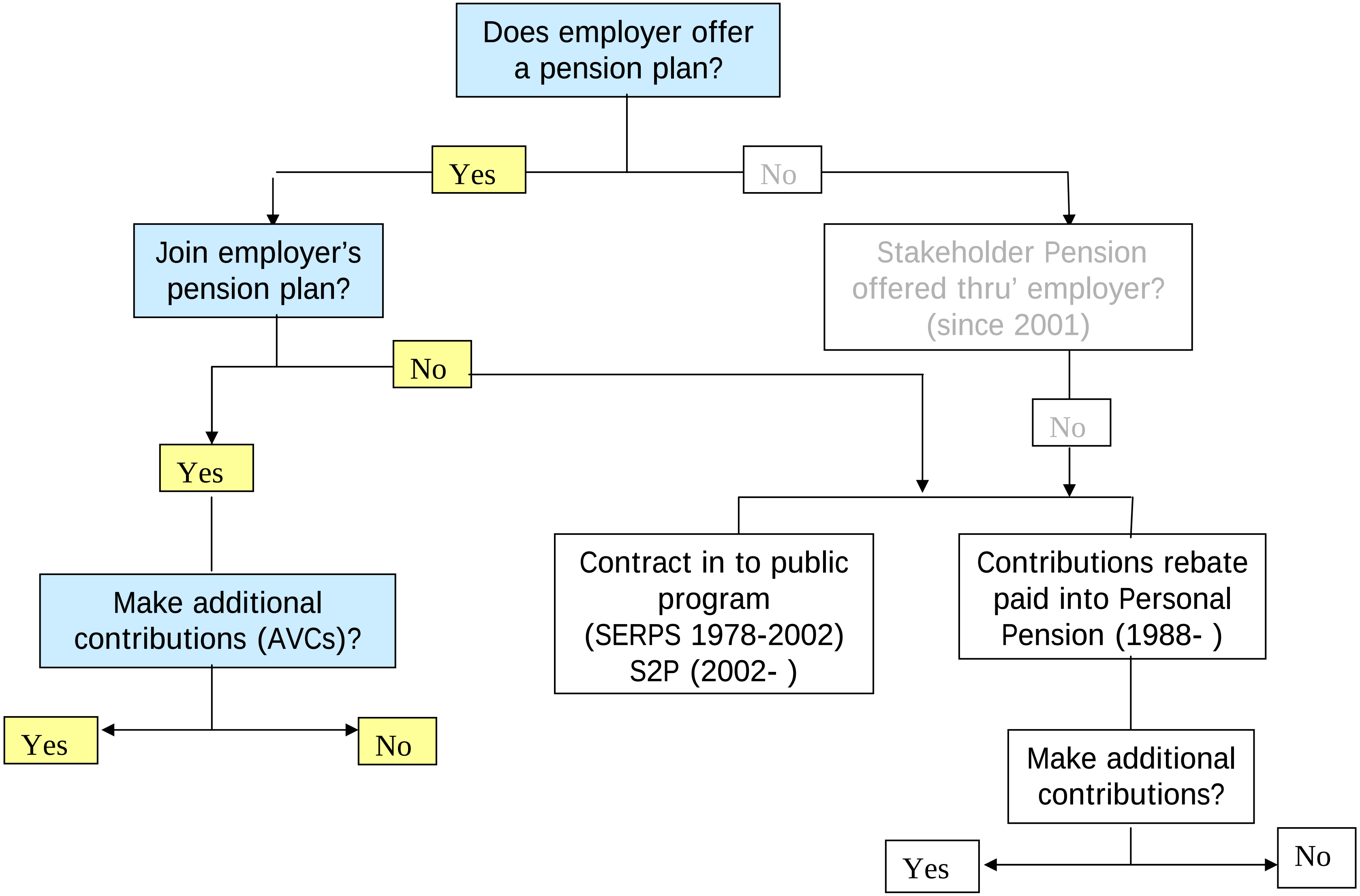
Source: British Household Panel Survey data 2001. From: Disney, Emmerson &, Tetlow: 'What is a public pension sector pension worth?' IFS *Working Paper* W17/07

Employer provision of pensions

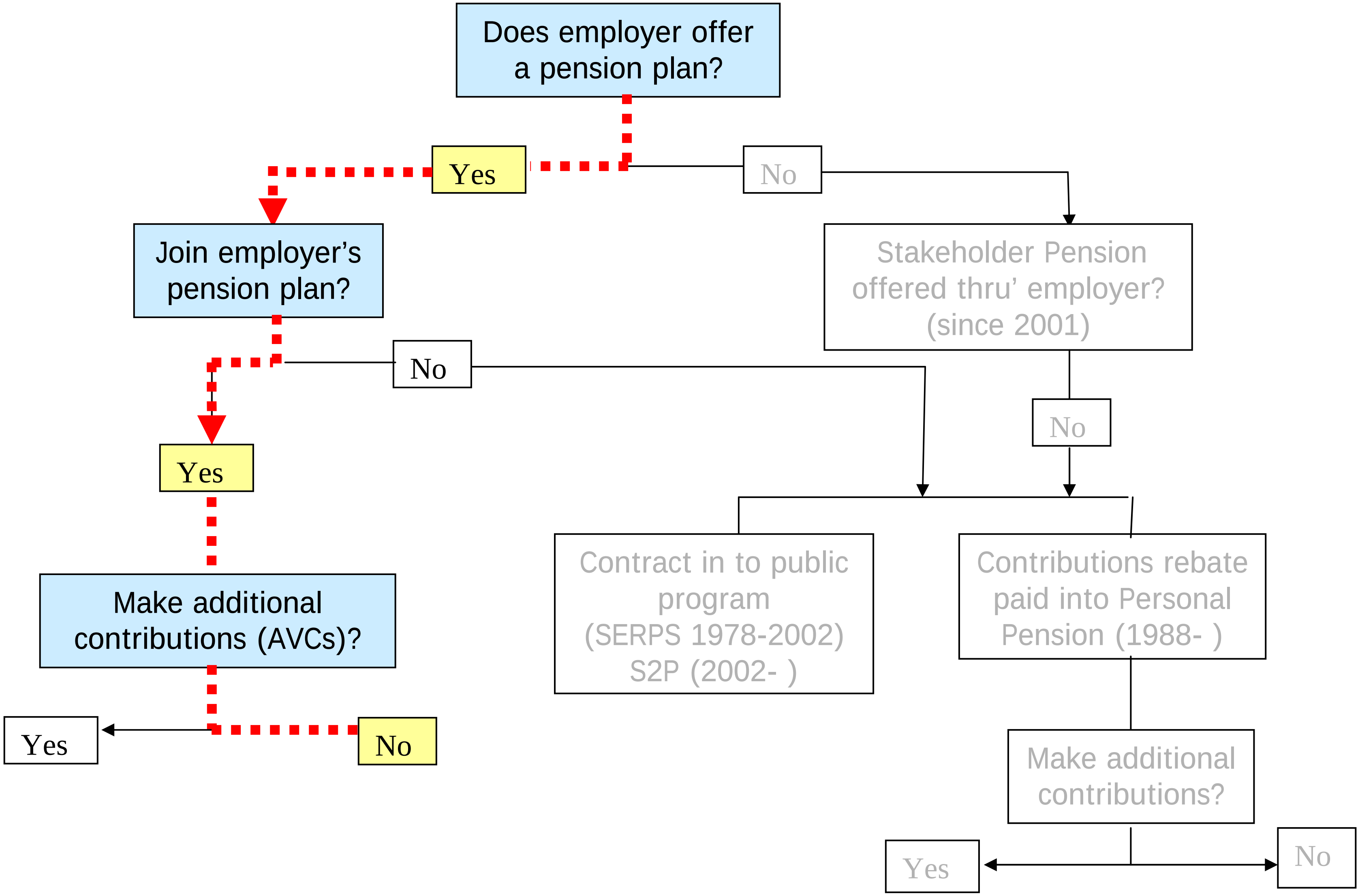
- From employer provision survey data:
  - Only 6% of *employers* have a DB pension plan
  - Among employers with more than 1000 workers, 74% have plans, among those 500-1000, 51%
  - But proportion of employers with *open* DB plans (to new members) *halved* between 2003 and 2005.
  - Employers who make *any* kind of provision for employee pensions (DB/DC plan, group Personal Pension, contribution to individual's Personal Pension) *rose* from 29% to 52% 2000-03, *fell* to 44% in 2005.

How the UK choice-based system works....

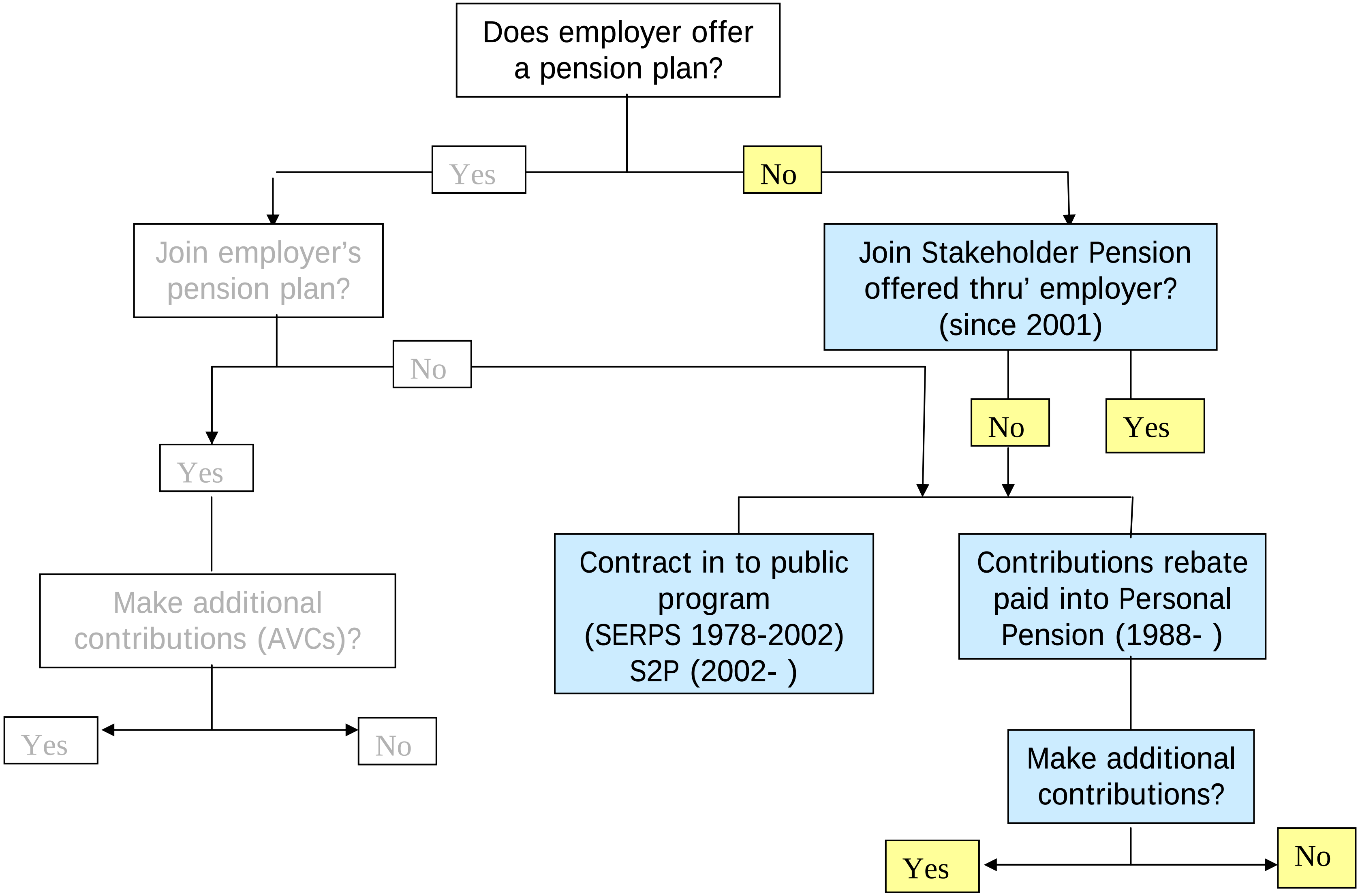
- People have a choice of pension plan:
  - Publicly provided v. private
  - Employer-provided v. individual saving account
- The incentives associated with choices are complex:
  - Disney, Emmerson & Wakefield ‘exploit’ policy changes to argue people don’t do too badly in choosing the ‘right’ option.
- But, maybe ‘default options’ matter
- And, if private retirement saving is too low..
- Change the default saving options...



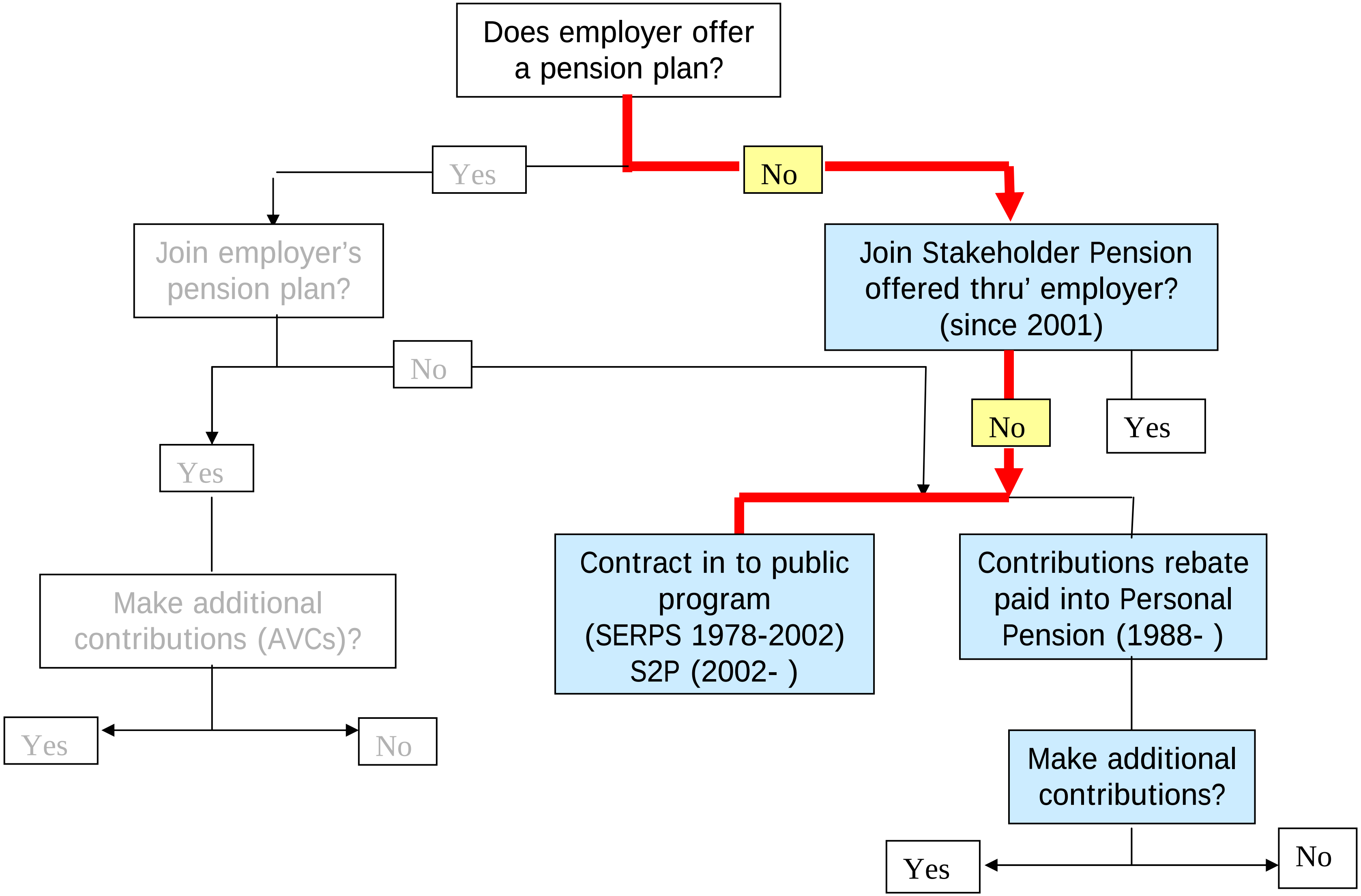
Second tier pension choice in UK 1988-2007
– if employer offers a pension plan



Second tier pension choice in UK 1988-2007
– if employer offers a pension plan – default option



Second tier pension choice in UK 1988-2007
– if employer does not offer a pension plan



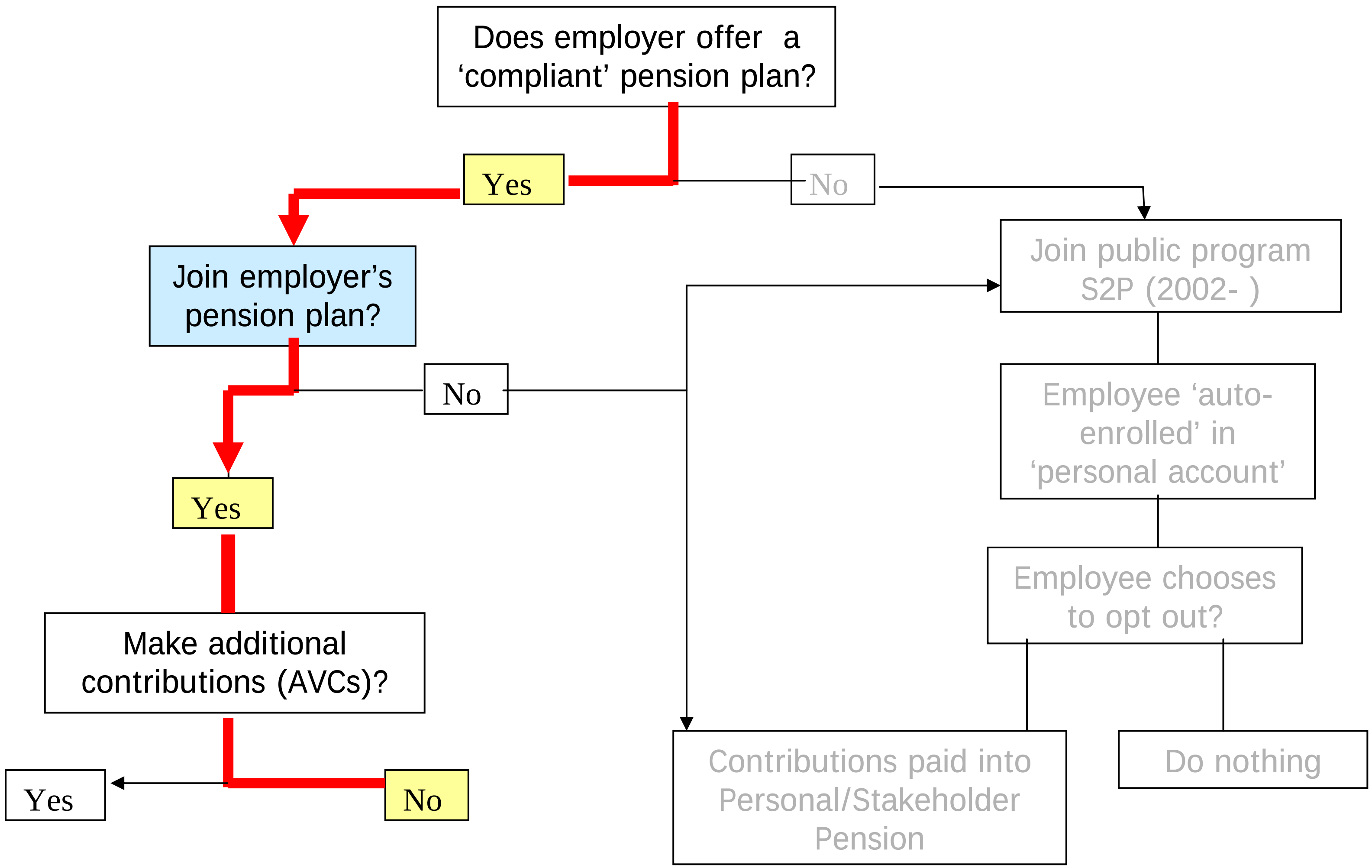
Second tier pension choice in UK 1988-2007
– if employer does not offer a pension plan – default option

The new ‘personal accounts’ I

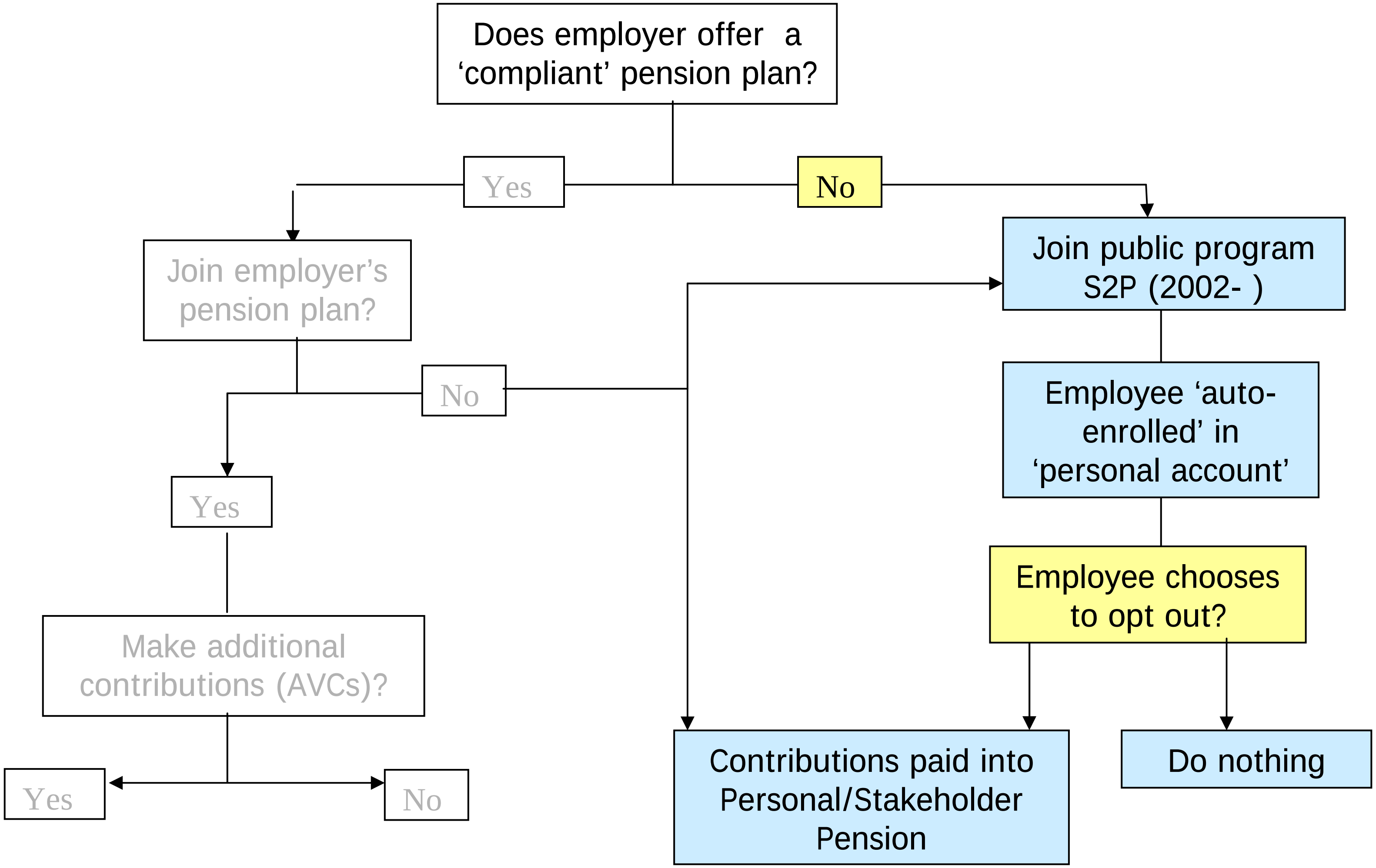
- New proposal enrols employees in ‘Personal Accounts’, from 2012.
- Individuals will be enrolled if they earn >£5000 per year, aged 22 to SPA.
- They pay 4% of earnings from £5000 pa to ceiling of £33500 pa (above minimum contribution).
- Also, employer contributes 3%, government 1% $\therefore$ total contribution = 8%.

The new ‘personal accounts’ II

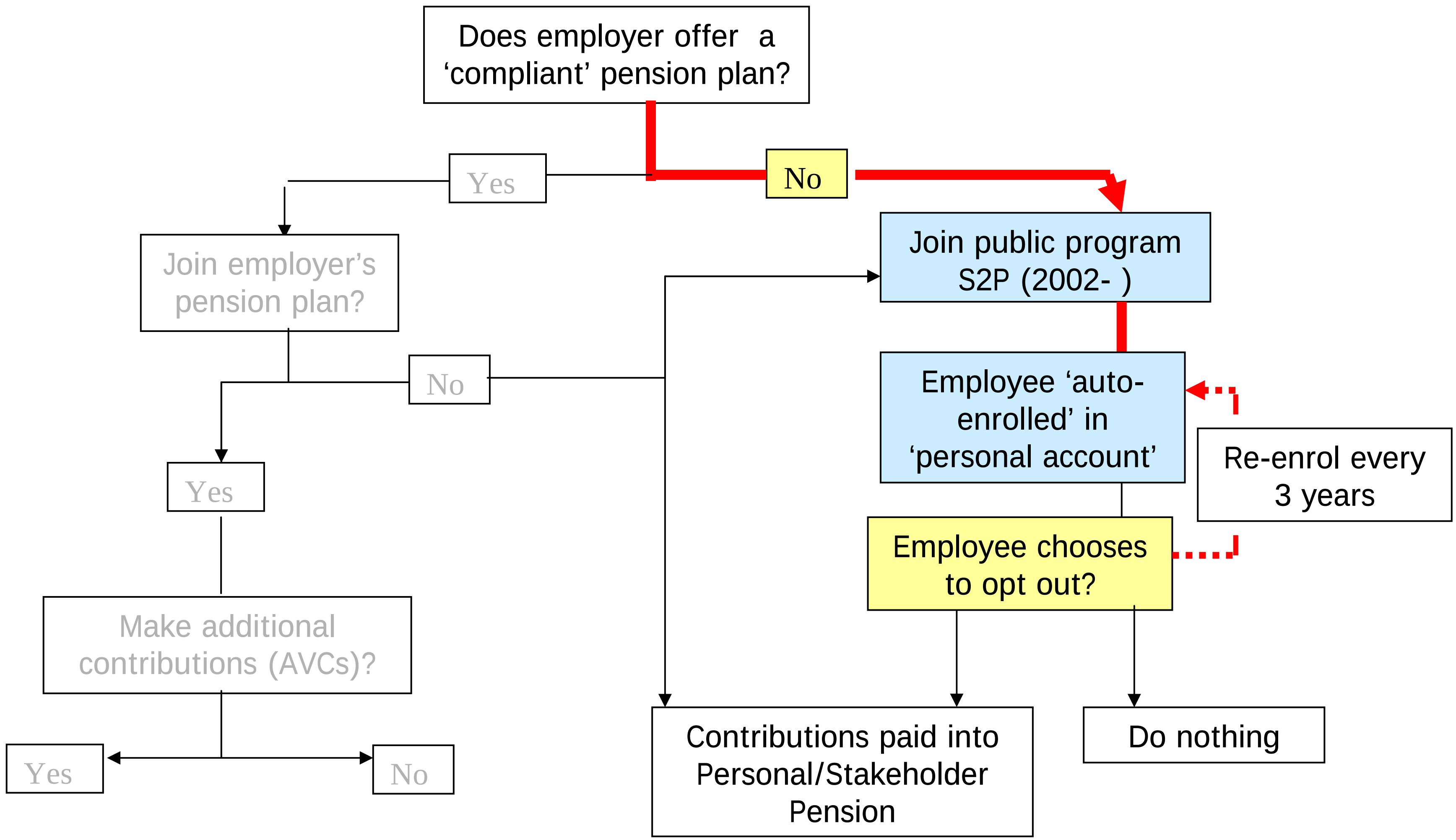
- If work for employer who is ‘compliant’, then exempt from new Personal Accounts. Exemption arises if:
  - Offers as a default a final salary DB plan of a certain minimum standard
  - Offers as a default a DC plan that contributes at least 8% (of which employer offers at least 3%) (and possibly a management charge test)
  - Other types of plans e.g. existing ‘group personal pensions’??
- If employer is ‘non-compliant’, employee is auto-enrolled into Personal Accounts (the ‘default option’) – he/she can choose to withdraw.
- Re-enrolled every 3 years unless another ‘compliant’ arrangement.
- Contracting-out limited to compliant employers.



Second tier pension choice in UK after 2007
– if employer offers an exempt (**'compliant'**) pension plan (DB or DC)



Second tier pension choice in UK after 2007
– if employer does not offer an 'exempt' pension plan



Second tier pension choice in UK after 2007
– if employer does not offer an 'exempt' pension plan

Evaluation of new proposals: I

- Many details have yet to be worked out (and not just ‘fine print’!) before start in 2012.
- DWP estimates ‘personal accounts could have between 6 and 10 million members with private pension saving of around £8 billion a year of which approx. 60% will be new saving’.
- NIESR calibration based on BHPS data of a ‘compulsory’ retirement saving model suggests big effect on retirement saving, but also substitution (e.g. of investment in equity markets)
- If 8% contribution becomes new ‘benchmark’ for saving, will more generous pension plans then reduce their contribution rates?
- Most tests of ‘default option’ are experiment-based – but this is a ‘noisy’ experiment with 3 changes:
  - Change in ‘default option’
  - 3% employer’ contribution for ‘non-compliant’ employers (previously often 0%?)
  - Associated changes to social security

Evaluation of new proposals: II

- Investment strategy for Personal Accounts also under review
- DWP acts as ‘clearing house’ for contributions, not as investor.
- Seems likely Personal Account holders given a (limited) choice of (private) plans and providers – some ‘niche’ plans (e.g. ‘green’ investments) & a generic plan.
- Experiments are being funded by DWP to determine ‘optimum’ number of plan types (fund allocations).

Conclusion: are there lessons from UK?

- UK programme has been successful in keeping public expenditure on pensions under control given demographic ageing.
- But saving adequacy an increasing concern
- Basic structure similar to Canada – 3 tiers of public provision + both DB and DC provision by private sector
- Too much tinkering in UK – bad for stable planning or proper evaluation – 2007 reform has more *ex ante* analysis than 2000/2003 reforms
- Integration of different parts of programme e.g. consistent indexation of benefit – Canada better in this respect (but indexation only to prices – what affect on relative incomes?)