Pension Reforms and Ageing Populations: Lessons from Australia and the United Kingdom

By

David O. Harris
Senior Consultant
1996 AMP Churchill Fellow
Watson Wyatt Worldwide

Testimony before the
US Senate - Special Committee on Ageing

May 18, 2004

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Mr Chairman, I am pleased to appear before the Senate Ageing Committee to discuss the social security reform experiences in Australia and the United Kingdom. For many countries, the need for social security reform is becoming more pressing as populations rapidly age. Moreover through generous promises linked with social security programs in many developed nations, chronic economic and social reforms will likely have to be implemented against the backdrop of either cutting benefits or increasing associated contributions via taxation. The ongoing relative success of the Australian and UK retirement models are clear proof that successful pension reforms can be achieved in developed nations that benefit the entire nation as a whole. Women, minority groups and 'blue collar' workers have seen significant benefits flow to them in having the ability to efficiently craft out their own retirement savings structures. This was especially seen in Australia.

For the US, great economic progress was nurtured through the ability of the economy to generate efficient forms of capital through individual saving in the last century. In the twenty first century the crucial dilemma confronting most Americans will be to generate sufficient retirement savings and what financial instruments will be best placed to satisfy this function. While Roosevelt in 1934 envisaged a strong and vibrant social security program for all Americans, nobody during this point in history could have anticipated the rapid aging of populations throughout the world. Simply put countries like Australia, and the UK have moved towards encouraging individuals to save on an individual retirement basis so offsetting the rapid ageing of each of their corresponding population.

An overview of Australian retirement system

When comparing globally the approach of many countries towards the reform of their mandated retirement provision; Australia and the UK stand out as countries that have grasp the 'thorny nettle' of considering and implementing significant retirement reforms. Although these two countries have signaled, through pension reforms their intentions to move towards a more fully funded, defined contribution system, distinctions exist between the two countries' approaches to reform in terms of the structure of political institutions, the role of organized labor and business. These three important factors or vested interests individually or combined can both encourage and discourage reform of retirement systems from occurring.

"Only three countries rely heavily on private mandatory saving policies for retirement, these include Australia, Switzerland and Chile."[1]

Australia's experience to date with the initial reforms of its retirement system in 1987 and subsequently in 1992 have generally been viewed as positive. In 1983 the Australian Labor Party (social democratic) led by Mr Bob Hawke MHR came to power. The ALP was determined to deregulate Australia's economy so as to compete more effectively on a world level. A vital ingredient in achieving this goal was seen to be significant reductions in wages growth. With this as a backdrop, the need for change in the retirement policy of Australia was also sharply defined by the Labor Government in 1983.

Like its counterpart in the United Kingdom, the Australian Labor Party is fundamentally a social democratic party based on largely collectivist principles. It had and still remains strongly linked with the trade union or organized labor movement, through its peak body, the Australian Council of Trade Unions (ACTU). Superannuation during this time was provided through traditional employer sponsored plans on a voluntary basis. Surprisingly for some in the United States, it was the Australian Labor Party, a social democratic political party who, with trade union (organized labor) support began to generate the momentum for change of Australia's retirement system. In the first instance the newly elected Federal Government began the process of ensuring the long-term viability of the Old Age Pension at its current level. Maximum payments per fortnight by the mid 1980s were now determined through the interaction of a comparatively stringent income and asset tests.

The Old Age Pension in Australia is seen by many as providing both a foundation and an important source of income for those retirees who have limited resources to sustain themselves in retirement. Its impact on Australia's GDP is seen in Appendix 1, Table 5. Many older Australians who are or have retired in the past often have not build up sufficient retirement savings. A common perception in the past by many workers was that they were entitled to an old age pension after paying taxes all their working life. Largely this view was encouraged by many governments but in the 1980s increasingly, the Commonwealth Treasury and the Federal Government expressed concerns over the direction of expenditure for providing the first pillar of Australia's retirement framework. Increasingly expenditures in providing the first pillar were also linked to a concern over the demographic position of Australia in the next century.

"For Australia the percentage of the population aged over 65 is expected to rise from 15% of the population, 2.9 million, to 23% by 2030, that is, 5 million people. The percentage aged over 85 is expected to more than double from around 2% to more than 5% amounting to 650,000 Australians over 85."[1]

The full pension payment under this pillar represents approximately 26% of male total average weekly earnings. Maximum payments per fortnight are calculated on a flat basis and are reduced accordingly, based on income and asset tests.

Clearly to engineer or make such a significant shift in the overall retirement structure of any country requires a strong political resolve and vision for the future of a nation's citizens. In Australia's case, more through coincidence and luck a popular Federal Government, through trade union support was able to convey to the nation the impending problems Australia would confront, if it did nothing about addressing its aging population. This theme of the realization and admittance of a future retirement hurdle was best summarized in the *Better Incomes: Retirement into the Next Century* statement which expressed a commitment to:

'maintain the age pension as an adequate base level of income for older people' but went on to state that persons retiring in the future would require a standard of living consistent with that experienced whilst in the workforce."[2]

For trade unions, which had strongly supported the election of a Federal Labor government in 1983, increasing superannuation coverage was seen as a major priority. Before the introduction of mandated, second pillar, superannuation accounts, the extent of coverage of superannuation was limited to roughly 40 percent of the workforce. Typically employees who were covered by superannuation were employed in middle class, 'white collar' jobs where usually women and people from minority groups were under-represented. Brandishing this as a major bargaining tool, the trade union movement set about convincing the Federal Government that the level of superannuation coverage needed to be extended, via compulsory contributions into individual accounts. As early as the 1970s, the trade union movement in Australia had expressed reservations in how the retirement framework of Australia excluded certain workers based on income and profession. Many of the younger trade union officials argued for a more comprehensive system of retirement provision that in effect required all workers to be proactive in contributing and managing their own retirement needs. Some had noted the successes of the national provident funds, as seen in Malaysia and Singapore.

Significant dissatisfaction also existed amongst the labor movement over the extent and coverage of non-management or 'blue collar' workers. Moreover the union movement also realized that comprehensive wage increases were becoming increasingly difficult to successfully negotiate and that deferred savings benefits may be an alternative to simply striving for an increase in workers net pay. Initially the union movement's policies was effectively to increase employee coverage of superannuation

[1] Susan Ryan, "Quality of Life as It Relates to Australia's Aging Population or Living to 100 in a Civilized Society", Association of Superannuation Funds of Australia, Speech, 1997

[2] Senate Select Committee on Superannuation: 'Safeguarding Super', June 1992, p.7, Canberra, Australia

but by the mid 1980s the union movement had shifted its stance whereby it would play a more direct and active role in the day to day operations of superannuation, via industry funds. These industry funds, grouped around a particular economic sector of the Australian economy saw union and employer representatives come together as trustees to manage the administration and investment of many thousands of individual retirement accounts. The increasing involvement by the union movement in superannuation matters challenged some industry participant's views that effective administration and investment decisions would be distorted in favor of policies that stressed mutuality rather than economic reality.

Notwithstanding the active policy position taken by trade unions in Australia regarding superannuation for employees, a more pragmatic view of such support is linked with the steady decline in trade union membership. Between August 1986 and August 1996, the level of trade union membership reported by employees declined sharply from 46 percent in 1986 to 31 percent in 1996.[2] Such a significant decrease coupled with the decline in traditional union based industries such as heavy manufacturing further reinforced the union's enthusiasm to support such retirement reforms as they felt that they were in effect increasing their profile and relevance for existing and potential members.

By 1986 circumstances were ideal for the introduction of a widespread employment-based retirement incomes policy. The Federal Government argued that as the Australian economy was undergoing a period of significant economic readjustment from a largely primary producer to becoming more services orientated, the old age pension structure and its related drain on public finances could not be sustained. Effectively the government insisted that it was in the "public-interest" to have a national, compulsory, employment-related retirement income scheme in place.[3] This aspect of the Australian political environment and how the government of the day felt that it was acting in the best interests of all Australians would be later echoed in 1992 by then Hon. Treasurer Dawkins, when he commented that the retirement income scheme in place would provide "…a coherent and equitable framework in which retirement incomes objectives can be progressed …and [would] permit a higher standard of living in retirement than if we continued to rely on the age pension alone."[4]

Continuing wages pressure and demands by the union movement on the government for a comprehensive superannuation policy to be initiated saw the introduction of award superannuation, set at 3% of an individual's yearly income. This amount was paid by the employer in the form of a wage increase granted by the Conciliation and Arbitration Commission, a Federal government body. Newly created industry funds were effectively given a tremendous boost with this political decision. These funds are sponsored by employer and employee organizations in one or more industries and were established initially to receive the 3% award contributions. Ongoing debate about the aging population and growth in superannuation funds continued into the late 1980s.

With a delay to the 1990-1991 wage case occurring, where the ACTU and the Government supported a further 3% round of award superannuation the then government saw its opportunity to act in a decisive manner towards retirement saving. In August 1991 the then Treasurer foreshadowed the Government's intention of introducing a Superannuation Guarantee Levy which would commence on July 1 1992. In a statement *Security in Retirement, Planning for Tomorrow Today* given on 30 June 1992, the then Treasurer, the Hon John Dawkins MP, reaffirmed the government's position and direction on the aging of Australia's population and the need for compulsory savings for retirement:

"Australia-unlike most other developed countries meets its age pension from current revenues. Taxation paid by today's workers is thus not contributing to workers' future retirement security; the revenue is fully used to meet the annual cost borne by governments."[5]

The Superannuation Guarantee Charge Act 1992 requires all employees to contribute to a complying superannuation fund at a level that increased from 3% p.a. in 1992 to 9% per annum by July 1, 2002. Although support for the Federal Government's comprehensive superannuation reforms was quite pronounced, some opposition was expressed by then Australian Democrats (a minor 'left leaning' political party) leader Senator Kernot. She in contrast favored a single, government-controlled, national portable system, similar to that of a national provident fund. Although this approach gained some initial minor support the Federal Government's proposed legislation quickly generated wide acceptance through working in 'partnership' with organized labor, business interests and industry associations.

In effect by embracing traditional opposition groups linked with significant government reforms, criticism that may have hampered the passage of important legislation, relating to superannuation reforms was largely minimized. A further effective tactic used by the then Federal Government was to employ government inquiries or private sector research to highlight the inadequacies of Australia's level of retirement system provision at the beginning of the 1990s. With these inquiries being seen as delivering independent views or recommendations, the Federal Government via the media felt vindicated in implementing a mandated retirement system. Equally the Federal Government argued that all Australians would be better off if Australia's level of national savings were increased and thus superannuation in part was seen to be addressing this problem.

Another method by which the Federal Government was able to engineer significant change to the retirement system was through the use of an effective public education campaign in 1994-1995, that was co-ordinated by the Australian Taxation Office. Overall the total cost of the public education campaign amounted to some $AUS 11 million. Through the comprehensive use of the electronic and print media, the Federal Government displayed strong political savvy in being seen as introducing a retirement system that not only benefited the individual but the nation as a whole. These two themes of individualism and collectivism were to be stressed throughout the media campaign. Two further factors that allowed political institutions to achieve significant reforms in Australia was that the Westminster system of government that had been inherited from the United Kingdom, which allowed the relatively quick passage of debate and the implementation of the Federal Government's retirement reform agenda.

With a controlling majority in the Lower House (House of Representatives) and minority parties holding the balance of power in the Upper House (Senate), no real effective delays in the reforms were encountered. The Senate Select Committee on Superannuation, a parliamentary appointed committee was also used effectively by the government to hear, interpret or receive objections to the planned reforms. Such a process of feedback and exchanging views encouraged a spirit of 'consensus' to be generated amongst many stakeholders of differing political ideologies. Finally the very existence of well established, professional industry associations in the form of the Life Insurance Federation of Australia (LIFA) now the Investment & Financial Services Association (IFSA) and the Association of Superannuation Funds of Australia (ASFA) ensured that the affects and consequences of proposed reforms could be simulated and well understood by superannuation industry participants and bureaucrats alike. Unlike Chile where individual retirement account reforms created a totally new financial infrastructure, much of the superannuation infrastructure in Australia had already existed under the previous voluntary superannuation system. Thus important stakeholders and vested interests like life insurance companies supported the reforms based on self interest but also recognized how the existing financial infrastructure would be well placed to implement the government's retirement proposals. In effect the Federal Government had garnered support for their reforms from traditional stakeholders who had been strong critics of their previous economic policies. Such a shift in support in some ways overwhelmed any organized opposition to these reforms.

Similarly in Australia, business saw the advantages of reforms to retirement policy in terms of nurturing the capital market and overall level of national saving. Some concerns were raised over the active involvement of trade unions in the day to day operations of superannuation funds but these concerns were alleviated through adjustments in regulatory settings. A major concern for business after the broadening of compulsion in 1992 was the increased costs that would be levied on the employer as contributions lifted eventually to 9 percent by 2002. Larger business interests in many cases offered such contributions already on voluntary basis through their in-house corporate superannuation funds. Yet it was small business that strongly opposed the reforms arguing principally that the increased burden of cost linked with an expanded retirement provision would cause many business failures. In summary business played only a moderate role in supporting the government's reform agenda. This tacit support was co-ordinated in part by large financial providers who would develop or modify the financial infrastructure of such mandated retirement accounts. Some moderate opposition from business interests also centered on the political concept of individualism, in that the concept should not force individuals to save for their retirement using a particular financial product or mechanism.

Table 1: Details of the Prescribed Superannuation Requirements Linked with the Mandated Second Pillar

	Employer's Prescribed Rate of Employee Support (%)
July 1 1997- June 30 1998	6
July 1 1998- June 30 1999	7
July 1 1999- June 30 2000	7
July 1 2000- June 30 2001	8
July 1 2001- June 30 2002	8
July 1 2002-03 and subsequent years	9

In March 1996, the then Labor Federal Government lost office and was replaced by a conservative, Liberal Coalition Government under Prime Minister John Howard. It had been the intention of the Australian Labor Party, with trade union blessing to further expand the compulsory nature of superannuation by gathering a 3 percent contribution from individual workers and providing an additional 3 percent to certain workers who met pre-defined income criteria. In total this would have meant that many workers' individual superannuation contribution accounts would have been receiving total contributions of 15 percent. Treasury estimates suggest that over a forty-year period these contributions would translate out to be approximately 60 percent of one's salary on retirement.

With regard to the taxation of superannuation, Australia has pursued a course which is quite unique and which on the whole I cannot agree with in terms of design and the overall rate of taxation applied. Based on Andrew Dilnot's model developed at the Institute of Fiscal Studies in London, Australia's taxation of superannuation can be described as TTT. Taxation of contributions at a rate of 15 percent, along with possible additional taxation of 15 percent for members' contributions earning over a certain threshold. A further tax of 15 percent is levied on the investment income of superannuation fund and finally the benefits can be subjected to varying tax treatment of between 0-30%, depending on timing of the contributions. The profile of the second pillar of Australia's retirement system depicts both a diversity and adequacy of return that reflects strong and vigorous competition among the financial services industry in Australia. Through a trustee structure, superannuation funds are managed in the most efficient and effective manner for members.

I would like to now turn briefly to the mechanics associated with selling, distribution and withdrawal of benefits from the superannuation account. One of the reasons why Australia has been so successful in keeping administrative costs low and also avoiding the problems associated with mis-selling is through effective and cost efficient regulation. Strict rules govern how superannuation policies are sold and switched. Moreover consumers are required to receive minimum levels of information about the superannuation products at the time of sale and also on a regular basis. Clearly it is felt that, as this is the largest financial transaction that a consumer will enter into in their life, effective disclosure should be provided to encourage transparency in the transaction. Increasingly superannuation account holders are being provided with greater investment choices. Some retail funds for example offer between 5-7 investment choices and proposed legislation by the Federal Government will force employers to offer choice of funds. Additionally specialized administration companies have developed services that allow superannuation fund trustees to outsource much of their investment and administrative functions. This intense competition has led to in part returns being maximized and administrative fees being minimized.

The success of consumer policy and integrated distribution platforms has meant that large scale consumer detriment has been minimized in Australia with its move towards a more fully funded system. Through sound regulatory transparency and significant improvements in the competency levels of distributors eg. financial advisers and financial planners public confidence in the overall retirement system has continued to increase significantly. This perception of security has nurtured a steady increase in the level of overall voluntary contributions made into superannuation accounts. In effect through sound regulation has come an acceptance by most Australians that saving for one's retirement is beneficial on both an individual and national basis.

By March 2001 the Australian superannuation system had combined assets of $A565.9 ($US253.00) billion. For just over 9 million workers this level of retirement savings is considered to be quite significant. It is important to note that 17.6% of these assets are invested internationally. Furthermore large levels of the superannuation assets are invested in equities and unit trusts. This investment category has grown steadily and is now estimated to be 46.1% of superannuation assets in Australia.

Table 2: Overview of the Australian Superannuation Industry – June 2001

Type of Fund	Total Assets ($billion)	Number of Funds (March 2001)	Members (000's)
Corporate	55	1582	990
Industry	63	105	7,738
Public Sector	116	65	2,979
Retail (including RSAs) – RSAs	192	245	13,340
Small Funds	128	523,000	523
Annuities, life office reserves etc.	13	na	na
Total Assets/Funds/ Members	566	283,842	25,570

Source: APRA Bulletin, Australian Government Publishing Service, December 2003

Administration costs continue to be a sensitive issue within the Australian political and financial services environment. These costs can vary widely between the types of superannuation funds found in Australia. Through an authoritative survey conducted by the Association of Superannuation Funds of Australia (ASFA), an average estimate of $1.28 ($US0.65) per member per week was made for overall administration costs in 1999-2000. It should be noted that this figure has declined from $1.66 ($US0.84) per week two years earlier. Expressed in another way, costs as a percentage of assets in June 2000 were calculated to be 1.29%. It is anticipated that this level of costs as a percentage of assets will decline as the system matures.

Recently the Australian government announced that it will widen eligibility criteria for the Government's co-contribution scheme (whereby the Government matches an eligible member's after-tax superannuation contributions dollar for dollar, up to a prescribed annual maximum, and subject to an income test). In the recent May 2004 Budget the Australian government announced further measures whereby it would seek to encourage lower income families and workers to bolster their retirement savings via government co-contributions.

Overview of the British Retirement System

The United Kingdom's success in stabilizing its public expenditure on social security is notable in comparison with other European economies. Yet strong criticism has been leveled at the industry for its inability to remedy the mis-selling problems which occurred in the late 1980s and early 1990s. Widespread media comment on the issues related to this matter has progressively filtered into public policy developments, initiated by the bureaucracy and responsible Government ministers. A further concern expressed by some in industry is how the European Monetary Union (EMU) in the long term will impact on the United Kingdom's position, with regard to outstanding pension liabilities and contributions derived from the public. Compared with France and Germany, the United Kingdom is in a significantly healthier position. Yet a common fear expressed is that the United Kingdom will have to support directly, or indirectly, the maintenance of these two country's pension systems and possible overall reform in the long term.

Currently the United Kingdom's pension system is very fluid with a Pensions Bill before parliament looking at the modification of various aspects linked with the funding of second pillar retirement programmes and the creation of a compensation scheme – Pension Protection Fund (PPF) which in part is similar to the US PBGC. Occupational schemes are certainly an area where the Government is considering reform.

In summary, the political landscape of the United Kingdom has been clearly flattened by the large majority which the current government still commands in the House of Commons. Yet the issue of pensions still remains a controversial one with many vested interests calling for a major overhaul of the existing retirement framework.

The associated problems of old age and inadequate provision for retirement was debated for decades towards the end and beginning of the nineteenth and twentieth centuries in the UK. In 1908 the Old Age Pensions Act was introduced to provide a systematic, centrally organized provision for the elderly in retirement. This scheme, though the forerunner of the modern day basic pension was not a 'social-insurance' system. It was means-tested and non-contributory. Entitlement started at 70 and was restricted to the 'respectable' poor.

In 1925 the Widows, Orphans and Old Age Contributory Pensions Act introduced the notion of a contributory social insurance scheme for the over-65s, although means-tested non-contributory benefits continued to be paid to those over 70. The current unified compulsory social insurance scheme was instituted following the Beveridge Report of December 1942.

Currently the basic state pension entitlements equate to £79.60 per week (from 12 April 2004). This level is approximately 20% of average full-time male earnings. Such pension payments can be enhanced by the pensions credit that seeks to give further financial assistance to those people who meet related income and assets tests. The pension it should be noted is taxable. Increases in the state pension are in line with retail price inflation. Between 1975 and 1980 the policy was to uprate the pension in line with prices or average earnings, whichever was the greater. Before 1975 adhoc increases had maintained the level of the pension in line with earnings increases since 1948.

Table 3: Estimated Cost of Basic Pension with Price and Earnings Uprating

(£ billion in 1994-95 prices

Cost basic pension	1994-95	2000-01	2010-11	2020-21	2030-31	2040-41	2050-51
Price indexed	26.9	29.8	33.6	35.2	41.9	44.5	42.3
Earnings indexed	26.9	32.6	42.6	51.8	71.6	88.3	97.4

Note: 1.5% real earnings growth assumed
Source: Johnson P, Disney R and Stears G: The Retirement Income Inquiry - Pensions: 2000 and beyond Volume 2 - 1996, p.11, Retirement Income Inquiry, London, United Kingdom

Table 4: Target benefit pensions of selected developed nations

Country	Relative value of benefits
United States	43% of final salary
Australia	26% of Male Total Average Weekly Earnings
Germany	53% of average earnings
France	75% of average of 10 best years
Italy	68% of final salary (in 2013)
United Kingdom	20% of average income
Canada	25% of average wages
Belgium	60% of lifetime earnings

Source: Radaelli G & Shea R: 'Public Pension Systems: The Challenge Ahead', 1996 Lehman Brothers, London, United Kingdom, p.22

In 1948 the Beveridge Report had developed a compulsory pension system which consisted only of the first tier. In effect this was the basic state pension and means tested National Assistance. Yet increasingly, pressure on the Government to provide a more substantial second tier approach for all workers developed, partly as a result of the strong growth in occupational schemes. Between 1953 and its peak in 1967, occupational pension coverage expanded from 28 to 53% of employees. This coverage in recent years has declined which partly can be attributed to an overall trend in changing employment patterns.

In 1975 the Social Security Act introduced the State Earnings Related Pensions Scheme (SERPS). Its design allowed occupational schemes to contract out of SERPS to avoid the scheme substituting for private sector provision. Effectively the design of the second tier pension was for those people not in occupational schemes.

During the initial period of this second tier pension scheme benefits, were comparatively generous with today's levels. SERPS guaranteed contributors to the scheme an additional pension of 25% of their earnings between lower and upper earnings limits. The scheme was compulsory. As indicated, employers and contributors could contract out of SERPS only into a salary-related occupational scheme if it offered benefits at least equal to those provided by SERPS.

Earnings in the best 20 years counted towards the pension at a rate of 1.25% of earnings between lower and upper limits. These limits were revalued in line with average earnings. Once payments commenced, the additional pension was uprated annually in line with consumer prices. The cost of uprating the basic pension (first tier) and SERPS was met by the National Insurance Fund.

Pensions under SERPS matured in 20 years and, as a result of the 20 best earning years formula, were especially advantageous to some groups. Employees earning more than the Lower Earnings Limit (LEL) for National Insurance Contributions (NICs) £57 per week for 1994-95 pay Class 1 NICs earn entitlement to SERPS as well as the basic pension unless they are contracted out. The Upper Earnings Limit (UEL) must by law lie between 6.5 and 7.5 times the basic state pension, and stood at £430 per week in 1994-95-around 120% of average male earnings.

An associated development that influenced the calculation of SERPS was that in 1980 the newly elected Conservative Government broke the earnings link for the annual uprating of the basic state pension and linked it instead to the Consumer Price Index. This factor is important as the LEL is itself tied to the flat-rate pension and the UEL is in turn increased in line with the LEL.

In June 1985 the Conservative Government published a Green Paper, *Reform of Social Security*. This document highlighted the implications of the basic state pension and SERPS over the following 50 years. The concerns raised by this paper in regard these two forms of pensions provisions can be summarized by Budd and Campbell:

“The Green Paper pointed out that the increased cost of the basic pension would benefit all pensioners equally. However the case was different for recipients of SERPS. Its earnings- related nature meant that the newly retired would benefit more than older pensioners would. Also half the extra cost would result from payments to members of contracted-out schemes (to provide indexation top-up to the Guaranteed Minimum Pension). The cost of SERPS (in 1985 prices) was expected to be about £24 billion in 2035, compared with a basic pension cost in 1985 of about £15 billion.”[6]

A significant change to SERPS took place in the second half of the 1980s when the Social Security Act 1986 provided that from 1999 onwards, SERPS additions to the basic state pension would be calculated not on the basis of the best 20 years rule but instead on lifetime average earnings. Now SERPS would provide 20% of average earnings over the whole working life of the individual.

As identified up to April 2002, the additional State Pension was called SERPS. SERPS was based on your record of National Insurance contributions and your level of earnings as an employee. On 6 April 2002, the State Second Pension reformed SERPS to provide a more generous additional State Pension for low and moderate earners, and certain carers and people with long-term illness or disability. The State Second Pension gives employees earning up to £26,600 (in 2004/05 terms) a better pension than SERPS, whether or not they are contracted out into a private pension, with most help going to those on the lowest earnings (up to around £11,600 in 2004/05 terms)

If an employee has annual earnings above a certain amount (£4,108 in 2004/05) you cannot leave the Basic State Pension. However, the employee can choose to leave the Second State Pension and join a private pension scheme instead. This is called contracting out. By contracting out and joining an employer’s contracted-out occupational pension scheme, the employee and employer benefits from lower, reduced rates of National Insurance contributions.

In 1988, the contracting out option was extended to a further range of products, principally personal pension products. The reason for this decision is subject to some conjecture. Some elements say it had an ideological basis spawned by the then Prime Minister, Margaret Thatcher who felt that Government should not be involved in pensions provisions linked with the former SERPS. More likely was that advice provided by the Treasury and Government Actuary’s Department indicated that through the affects of an ageing population, the UK’s economy would be crippled by overly generous welfare payments.

The condition for leaving SERPS is not, that a guaranteed minimum pension should be paid, but that a guaranteed minimum contribution should be made. This minimum level is the contracted-out rebate. Levels of rebate offered to people newly contracted out into personal pensions (or group defined contribution schemes) was set above the rebate for those in occupational pensions. Initially, an extra 2% ‘incentive’ rebate was offered with the aim of ‘kick-starting’ the personal pensions sector. In 1993-94, this declined to an incentive rebate of 1% restricted to the over 30s. The rationale for this policy was that a large number have already taken out personal pensions, and so a kick-start is no longer required. The following is an extract from the paper ‘The Roles of the Public and Private Sectors in the UK Pension System’ by Alan Budd and Nigel Campbell of HM Treasury that details the associated costs and problems encountered from the contracting-out of SERPS.

“The contracted-out rebate and the additional 2 per cent incentive made personal pensions a very good deal particularly for the young since the rebate was the same for all ages whereas the value of the SERPS benefit given up increases with age. The Department of Social Security’s working assumptions were that about 500,000 people would take out personal pensions and the number might ultimately reach 1 ¾ million. In the event take-up reached 4 million by the end of April 1990. By 1993-94 the take-up had risen to 5.7 million, of whom about 4 million had rebates paid into their APPs. The National Audit Office (1990) commissioned a survey of the cost to the NI Fund of the rebate and the additional incentive for the period to April 1993. It estimated that the gross cost could be £9.3 billion and that the present value of the savings in payments of pensions was about £3.4 billion. Hence there was a net present value cost of £5.9 billion (in 1988 prices). However, this does not take account of the step change in personal pension take-up, which will have reduced state pensions yet further in the next century even after the end of the continuation of the 2 per cent incentive."

The introduction of the Social Security Act 1986 provided a new avenue for employers to pursue in offering benefits to their employees in occupational pension schemes, this being in the form of contracted-out defined contribution schemes. Since 1988, the number in contracted-in defined contribution schemes has remained at about 500,000 but 430,000 is now in the new contracted-out schemes.

There is little support for the assertion that the shift to defined contribution schemes among employers reflects companies' changing views towards defined benefit schemes. Most recent data on the issue from the 'Government Actuary's Department suggests that 50000 members had seen their scheme change from DB to DC between 1987 and 1991, accounting for just 10% of the total increase in numbers'.[7]

Another significant change resulting from the introduction of the Social Security Act 1986 was that choice for the first time was provided to individuals on whether to join employer-provided pension schemes. Before 1988, most firms providing occupational schemes made membership compulsory for eligible employees. Just 8.5% of scheme members were in voluntary plans. This accounted for 17% of private sector members, with none in the public sector.

Overall since 1987, the total percentage not joining has increased from 18 to 23%, with a slightly more rapid increase among full-time women. More recent data from the National Association of Pension Funds (1994) annual survey suggests that the take-up among new employees for pension products was about 80% and has remained around this level since 1990.

Through allowing people to contract out of their SERPS entitlements and transfer from occupational schemes personal pensions in 1988 received a significant boost in sales growth and long term product development. The popularity of these products was quickly established and thus by 1992 % 23% of male and 19% of female employees had contracted out and was in personal pensions.
Concern in Treasury and other areas of Government was that these new retirement vehicles were only being used to receive the rebate provided through transferring out of SERPS. In 1991, 24% of employees had contracted-out into personal pensions yet about three-fifths of these personal pensions had been established simply to receive the associated rebate and incentives provided by the Government. Such a situation led or induced the mis-selling of pensions, which has continued to erode a recovery in the public confidence, within the industry.

Overall personal pensions today are 'manufactured' by a number of providers. These companies are mainly life insurance companies although building societies, unit trusts and other financial organizations are permitted to administer pensions (at least up to retirement). Restrictions on investments are relatively few and it is important to note that even supermarkets in the United Kingdom are offering such financial services products on an execution basis.

In general, the deposits from personal pension funds must be used to purchase annuity. Recent legislative amendments have increased the individual's freedom of choice between annuity suppliers. The Government has ensured that the same tax privileges extend to personal pensions, as which exist for occupational schemes.

A concise summary or assessment of personal pensions and the future role that they are likely to play in the British market is provided by Mr CD Daykin, the United Kingdom's Government Actuary in his report to the European Commission.

" Personal pensions at the minimum level for contracting-out are unlikely to provide a very inadequate income in retirement. A major challenge for education (and marketing) is, therefore, to persuade people that they must make additional voluntary contributions and that the responsibility for ensuring an adequate retirement is theirs. The State will not provide more than the basic flat-rate pension. Of course, there will still be the possibility of means-tested income support, but the whole thrust of encouraging private provision for a pension is to lessen the dependence on State Benefits.

Views differ as to the likely success of these objectives. Trade unions and staff associations in general remain very suspicious of personal pensions, which they see as putting too much of the risk (particularly of investment performance relative to inflation) on the individual and too much money (commission, profit, etc) into the hands of financial intermediaries, insurance companies and other financial institutions. The preferred option of organized labour is the final salary occupational pension scheme, if possible with full price indexation of pensions, both in payment and in deferment."[8]

With rapid transfers out of an existing Government pension tier and membership movement out of occupational schemes, principally through industrial and economic restructuring, the demands placed on existing distribution networks have been extreme. Coupled with an increased volume of business, commission restrictions were lifted in the late 1980s which allowed intermediaries to dramatically increase the up front commissions. Poor disclosure of product design and general information on pension policies was provided to the consumer under existing mandatory provisions.

Minimum competency standards for intermediaries were also a major concern. Without any minimum set standards of advice and training, intermediaries often provided inaccurate and in the most extreme cases misleading advice. Such features of the life insurance and pensions industry, the 'seeds were clearly sown' for problems to occur in the future. Improved disclosure standards that are anticipated along with the introduction of a de-polarized distribution environment are anticipated to improve the distribution standards for individually based retirement products.

A major shift in retirement thinking took place in April 2001 when the current Government initiated a low margin, high volume retirement product called the stakeholder pension. Such a product places a mandatory price cap of 1% on all fees, charges and commissions linked with its manufacture and distribution. The product can be distributed on a group as well as an individual level and is available to consumers who are outside the employment nexus. In some cases spouses and children purchase such products in response to related taxation incentives. Unfortunately such a product has not widely extended pension coverage and related contributions as was anticipated by the government. While employers are compelled by law to offer facilities for its employees to make contributions into stakeholder pension products, only 8% of stakeholder pension products receive regular contributions.

One of the major issues British policy makers have been grappling with has been the sharp decline in pension coverage by defined benefit schemes. Through revised accounting standards and a general economic downturn many leading Footsie 100 companies have either closed their defined benefit schemes for new members or have required their plan participants to increase their contributions. This shift from defined benefit to defined contributions will likely continue if significant regulatory and social policy issues are not addressed via related legislation or regulations.

As identified the Government over the last 15 months has moved to address some of these regulatory and legislative concerns via pension taxation simplification and social policy refinements. It is intended by April 2006 that the existing eight pension taxation treatments will be simplified down to one. This will allow an individual 'pension pot' to accrue ₤1.5 million over an individual's lifetime along with being able to receive maximum annual contributions of ₤200,000. Equally in respect of social policy, planned pension reforms will see importantly an increased consideration for planned financial education and communication. While the detail of this policy initiative is still to be finalised it remains clear that the likely direction will draw heavily on the enhanced communication and education experiences of US 401(k) model. Moreover the related research conducted by US academics into behavioral finance further reinforces the likely attractiveness of such a planned policy direction.

To conclude, the most startling pension reform approach adopted by the UK during the recent raft of reforms was announced by the Secretary of State for Work and Pensions, Andrew Smith on February 12th 2004 with the creation of the Pension Protection Fund (PPF). Like the PBGC in the US which the PPF is modeled on in part, this planned regulatory body will seek to develop a compensation mechanism for defined benefit plan members whereby if the scheme fails, premiums, initially flat but eventually risk based will ideally cover the shortfall for plan members. While such a legislative approach offers some practical policy benefits, wider cost and pension policy considerations need to be carefully understood if such a policy is to succeed in the long term.

Conclusions

For the United States the challenges of social security reform may seem immense if not impossible from initial observations. Yet what countries like Australia and the UK demonstrate is the ability for a nation to give its people a greater ability to craft out a sufficient and appropriate level of retirement wealth to meet expected future needs and demands. Certainly no one country's experiences with regard to social security reform can be easily translated to another. Yet what countries like Australia and UK can demonstrate to public policy planners in the United States is the strong propensity that the individual is ideally placed to determine his or her own retirement needs. Give people certainty with regard to a retirement or social security model and they then can best prepare for their own retirement. This harnessing of the individual's need to maintain retirement security in retirement will increasingly become a major political and social issue in the Australia, UK and the United States during this century. Ideally social security reform should encompass all perspectives of country’s society. Failure to act or to simply adopt a myopic position by law makers is no answer in the long term for the citizens of a nation.

Appendix 1

Table 5: Projected future state spending on pensions as a percentage of GDP

	1995	2000	2010	2020	2030	2040	2050
Australia	2.6	2.3	2.3	2.9	3.8	4.3	4.5
Canada	5.2	5.0	5.3	6.9	9.0	9.1	8.7
France	10.6	9.8	9.7	11.6	13.5	14.3	14.4
Germany	11.1	11.5	11.8	12.3	16.5	18.4	17.5
Italy	13.3	12.6	13.2	15.3	20.3	21.4	20.3
Japan	6.6	7.5	9.6	12.4	13.4	14.9	16.5
Netherlands	6.0	5.7	6.1	8.4	11.2	12.1	11.4
New Zealand	5.9	4.8	5.2	6.7	8.3	9.4	9.8
United Kingdom	4.5	4.5	5.2	5.1	5.5	4.0	4.1
United States	4.1	4.2	4.5	5.2	6.6	7.1	7.0

Source: OECD, cited in Johnson (1999)

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