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Research Note 38

THE UK PENSIONS CRISIS

By Terry Arthur and Corin Taylor

The credit crunch and the recent collapse in share prices have rightly made people worried about their pension. Pension funds have lost up to 30 per cent of their value in the last year, threatening severe hardship for many people in their old age.

The objective for any pension scheme must be to fund the continuation of living standards (appropriately adjusted) available prior to retirement at an acceptable cost. While rising life expectancy places stresses on all pension arrangements, the UK's pension system, managed by politicians with short time horizons, has lamentably failed to achieve this.

The report reveals that:

- **Occupational pension schemes** have **lost between £150 and £225 billion** in growth, at least, as a result of the abolition of ACT relief on pension funds in the 1990s (see **Appendix 1**). This was before the recent financial turmoil.
- Partly as a result, the number of **active members of private sector occupational schemes has fallen by 41 per cent** in the past 12 years, with an even greater fall in defined benefit scheme members. **Were this trend to continue, there would be no active members of private sector occupational schemes in 12 years' time.**
- The **Basic State Pension** is **down 20 per cent or more** from its 1950 level relative to earnings.
- Public sector pensions have not suffered from the destructive political meddling and punitive tax rises that have bedevilled private sector schemes, and instead are being increasingly propped up by taxpayers. There are over **17,000 retired public sector employees with retirement benefits worth £1 million each,** while **unfunded public sector pension liabilities are estimated to exceed £1 trillion**, over 70 per cent of GDP.

Terry Arthur, author of the report and a Fellow of the Institute of Actuaries, said:

> *"Political management of the UK pensions system has failed to provide a decent retirement income for many people and has been a painful lesson in the limitations of government. The history of the state pension system has been littered with broken promises, while it is immediately apparent that the proposed NPSS could lead to lawsuits on a massive scale. The possibility that contributions may prove to have been worthless because they end up disqualifying the individual from pension credits or other benefits is just the tip of the iceberg."*

Corin Taylor, Research Director at the TaxPayers' Alliance, said:

> *"The infamous tax raid on pension funds has been a major factor in the collapse of occupational pension provision in the private sector, while gold-plated public sector pensions have remained immune from necessary changes. It is not right for taxpayers to be subsidising million pound retirement benefits for the public sector elite while seeing the value of their own pensions plummet, or in many cases not having a pension at all."*

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1. The objective for a pensions system

The objective of any financial policy concerning retirement income must be to fund the continuation of living standards (appropriately adjusted) available prior to retirement from work at an acceptable cost.

2. The performance of the UK pensions system

The performance of the three main branches of pensions – state pensions, private pensions and public sector pensions – will now be examined.

2.1 State pensions

In December 1942, at the request of the government, Sir William Beveridge produced his report proposing that all people of working age should pay weekly contributions; in return, benefits would be paid to those who were retired, sick, unemployed or widowed. He argued that this system would produce a minimum living standard "below which no-one should be allowed to fall".

Almost 70 years later, nobody would argue that anything remotely resembling Beveridge's claim has been achieved, although it would have been much nearer had his relatively limited recommendations been followed rather than escalated. Since then the state system has been reformed and reneged on many times.

At present there are two essentially unfunded state schemes, one providing a contribution-based Basic State Pension (BSP) and an additional scheme providing earnings-related pensions (formerly SERPS and now S2P). These two state schemes are highly insecure, being unfunded (PAYGO) and subject to retrospective as well as prospective cuts. The history of both is littered with broken promises:

- The Basic State Pension is at least 20 per cent down from its 1950 level relative to earnings.[1] The link with earnings was broken in 1980, for both past and future years of service.
- At the same time and partly as a result, 60 per cent of pensioners are now eligible for means-tested benefits, including housing-related benefits, with 45 per cent eligible for the Pension Credit alone.[2]

[1] Government Actuary's Department, 'Government Actuary's Quinquennial Review of the National Insurance Fund as at April 2000', October 2003, p.64
[2] Pensions Policy Institute projections of future eligibility for means-tested benefits, December 2007

- The state pension age is rising, again almost irrespective of the number of years of national insurance contributions already made.
- Several other reductions in accrued benefits have been made. In 1986 SERPS widows' benefits were reduced; in 1988 SERPS relevant earnings rules were changed and in 2001 the Basic State Pension death in service benefits were cut.

2.2 Private sector pensions

The reduction and then abolition of advance corporation tax relief has helped to destroy Britain's private sector occupational pension system, which was once regarded as one of the best in the world.

This infamous retrospective tax raid has cost pension funds a cumulative £150-£225 billion, through lower-than-otherwise dividends and growth (see **Appendix 1**). This was before the recent financial turmoil.

The resulting collapse of occupational schemes in the private sector has been remarkable:

- Since 1995, there has been a 43 per cent fall in the number of active members of private sector defined benefit schemes, and a 41 per cent fall overall.[3] The rate of decline has accelerated sharply over this time frame.
- Since 2000, the annual average fall in the number of active members of all private sector occupational schemes has been 300,000. If this trend were to continue, there would be no active members of any occupational schemes in the private sector in just 12 years.
- Since 2000, the annual average fall in the number of open occupational schemes in the private sector has been almost 4,800, and this is unlikely to be solely due to schemes merging. If this rate of decline were to continue, there would be no open occupational private sector pension schemes in just seven years.

[3] Occupational pension scheme surveys, 1995, 2000, 2004 and 2005, Government Actuary's Department; Occupational pension scheme survey 2007, Office for National Statistics

Table 2.2.1: The collapse of private sector occupational scheme membership[4]

	Number of active members of private sector occupational schemes, millions			
Year	**Defined benefit**	**Defined contribution**	**Hybrid**	**Total**
1995	4.7	1.1	0.3	6.1
2000	4.6	0.9	0.1	5.7
2004	3.6	1.2	-	4.8
2005	3.7	1.0	-	4.7
2006	3.0	1.0	-	4.0
2007	2.7	0.9	-	3.6
Change 1995-2007	**-2.0**	**-0.2**	**-0.3**	**-2.5**
% change 1995-2007	**-43%**	**-18%**	**-100%**	**-41%**

NB: Figures rounded to nearest 100,000. Figures may not sum to totals due to rounding.

Table 2.2.2: The collapse of open private sector occupational pension schemes[5]

Year	**Number of open private sector occupational pension schemes**
1995	*Data not available*
2000	62,100
2004	54,000
2005	51,300
2006	32,600
2007	28,700
Change 2000-2007	**-33,400**
% change 2000-2007	**-54%**

NB: Figures rounded to nearest 100.

2.3 Public sector pensions

Unlike state and private pensions, public sector pension arrangements remain extremely generous. Most public sector schemes still have a pension age of 60, with generous early retirement provision, and the number of active members of these final salary schemes has actually increased, from 4.2 million in 1995 to 5.2 million in 2007.[6] Unfunded public sector pension liabilities are now estimated to exceed £1 trillion[7], over 70 per cent of GDP.

[4] Ibid.
[5] Ibid.
[6] Occupational pension scheme survey, 1995, Government Actuary's Department; Occupational pension scheme survey 2007, Office for National Statistics
[7] Neil Record, 'Sir Humphrey's Legacy: facing up to the cost of public sector pensions', Institute of Economic Affairs, 2006

New estimates using data obtained for this paper through the Freedom of Information Act reveal the full extent of the generosity of public sector pension arrangements. There are currently over 17,000 retired public sector employees in receipt of an annual pension (net of lump sum) of at least £33,000, which implies total retirement benefits of at least £1 million (see **Appendix 2**).

Table 2.3.1: The number of retired public sector employees with retirement benefits worth £1 million

Public sector pension scheme	Number in receipt of annual pension (net of lump sum) of at least £33,000	Source
Civil service	3,680	FoI response, Cabinet Office, 15/11/2007
NHS – England and Wales	8,449	FoI response, NHS Pensions Division, 08/02/2008
NHS – Scotland	2,035	FoI response, Scottish Public Pensions Agency, 01/05/2008
Teachers – England and Wales	1,824	FoI response, Department for Children, Schools and Families, 16/05/2008
Teachers – Scotland	155	FoI response, Scottish Public Pensions Agency, 01/05/2008
Judges	815	FoI response, Ministry of Justice, 01/05/2008
Royal Mail	167	FoI response, Royal Mail, 20/05/2008
Overseas pensions scheme	23	FoI response, Department for International Development, 27/02/2008
MSPs (Scotland)	2	FoI response, Scottish Parliament, 29/05/2008
Total	**17,150**	

2.4 Future changes

The Second Report (2005) of Lord Turner's Pensions Commission described the UK pension system as "the most complex in the world". The Department for Work and Pensions has fully acknowledged this.[8] Unfortunately, the subsequent Pensions Act 2007 (and indeed the Pension Commission's own proposals) made sure it would remain that way.

In 2012, the default National Pensions Savings Scheme (NPSS) will be introduced. The NPSS is a highly regulated defined contribution scheme with

[8] Department for Work and Pensions, 'Overview and Summary of Costs and Benefits of the Pensions Bill', 2007

auto-enrolment of employees (albeit with an opt-out facility), compulsory minimum contributions and personal accounts.

It is immediately apparent that the proposed NPSS could lead to lawsuits on a massive scale.[9] The possibility that contributions may prove to have been worthless because they end up disqualifying the individual from pension credits or other benefits is just the tip of the iceberg. For many young people and their families, it is simply not sensible nor, indeed, feasible to devote scarce resources to future retirement.

Much of private sector saving, such as ISA saving, is flexible in terms of duration – for a rainy day which cannot be predicted. Often there are many more pressing items than inflexible savings for retirement. For example, the fast repayment of a mortgage is saving which could easily be better value than pension savings. Nor is it necessarily sensible to save at all until much later than one's early twenties; this depends on family situations, the rearing of children, the likelihood and extent of a rising earnings stream, and so on.

3. Causes of failure

There are four important reasons for the failure of British pension arrangements to ensure a decent income for those in retirement at an acceptable cost.

- Firstly, the general causes of government failure are common over a wide range of activities: control by politicians with little or no managerial experience, poor alignment of incentives, and poor feedback (no price mechanism or profit-loss signals), not least with regard to changes in behaviour of welfare benefit recipients.
- Secondly, there is a huge difference in time-horizons – measured in decades for those affected, alongside a few years or even months for ministers. Politicians are thinking about how to get re-elected, but a world-class pensions system requires tough choices now, while the benefits for people in their 20s will only be felt in their 60s, 70s and 80s. The familiar feature of short-term political decisions is deadly in planning retirement policy. It is highly unfair, though unfortunately not surprising, that occupational schemes for MPs and others in the public sector have been largely free of the hugely damaging meddling suffered by their counterparts in the private sector.
- Thirdly, government changes have continually offended the cardinal principle of accrual, in which a year of work becomes a year of eventual

[9] There is an uncanny resemblance here to the mis-selling episode following the Social Security Act 1986, a travesty which rumbled on throughout the 1990s and featured compensation payments of at least £15 billion, with additional legal and administration costs of over £5 billion.

pension benefits *according to rules in the year in question*. Gordon Brown's 1997 tax-grab from pension schemes via abolition of ACT relief on *then existing* assets (a process started by the previous Conservative government) was a straightforward theft which left accrued liabilities uncovered – when people were saving in the 1980s, they were assuming that there would be no tax raid on their pension funds. If ever one needs proof of the time-horizon gap, here it is.

- Fourthly, whilst unanticipated rising life expectancy in retirement places stresses on any form of pension arrangements, a rising dependency ratio is only a problem for schemes with funding shortfalls.[10] Unfortunately, the state pension schemes and public sector occupational pensions remain largely unfunded, which means they will increasingly have to be bailed out by taxpayers in the future.

4. Conclusion

There is no easy solution to the pensions crisis. Reform will be difficult and unpopular. Other countries have, however, undertaken sustainable reforms to their pension arrangements. The reforms in Australia and Chile point to a more practical solution in the UK, along NPSS lines. The kernel could be private pension pots (PPPs) alongside a new system of means-tested benefits paid according to circumstances and irrespective of age. PPPs could be modelled on ISAs, with larger tax-free contribution limits and a light regulatory touch.

There is a pressing need for major and immediate reforms to cut the shameful and unsustainable costs of public sector schemes, often supported by taxpayers who have watched their own schemes disappear or decline, usually at the hands of government. Despite regular government abuse of the accrual system we do not recommend that accrued rights should be reduced. But future service benefits in public sector schemes must be sharply reduced.

For more detail, readers might be interested in the forthcoming paper for the Templeton Foundation, led and edited by Philip Booth, Editorial & Programme Director of the Institute of Economic Affairs, which is particularly

[10] In contrast, advance funding means that retired people own capital, which is operated by workers in a mutually beneficial arrangement in which both parties gain. Those owning the capital are no more dependent on those operating it than the reverse. Indeed, given free trade, whole countries could predominantly be retirement havens. A dependency ratio has relevance only on a world-wide scale and even then only insofar as there are too few people to operate the capital equipment saved by the previous generations. But the blame for the UK's current pensions plight lies almost entirely with transient politicians rather than changing populations.

exciting because it covers in depth some aspects of retirement benefits which rarely see the light of day.[11]

Authors

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[11] Booth et al, forthcoming, 'Pension Provision: Government Failure Around The World', The Templeton Foundation

APPENDIX 1

Effects of the removal of ACT relief on pension fund values

(Original as at August 2005. The Supplement at the end of this Appendix updates to August 2008.)

Conclusion of Terry Arthur's paper submitted to the Pensions Board of the Actuarial Profession in August 2005, following a Briefing Paper by the Pensions Policy Institute:[12]

1. The most solid starting point for an estimate of the effects of the removal of ACT relief seems to be to assume that in the absence of selling all returns come from dividends – dividends whose growth is enhanced by retentions. This means a simple pro-rata (20 per cent) reduction in the present value of pension funds' UK equities in 1997 (see paragraph B1 of supplement overleaf). Together with the normal actuarial practice of using present values, direct comparison with scheme deficits is easily available – and can easily be updated via compound interest as time goes by.

2. Any assessments via the discounting of cash flows lost need to ensure that those cash flows are calculated as accurately and independently as possible, with correct allowance for their movement over time, in particular the automatic growth of dividends created by profit retentions. Again the results should be in terms of present values, updated to the present and compared with scheme deficiencies.

3. These results would provide an authoritative and *actuarial* assessment, perhaps subject to amendment (again actuarial but less clear) for the inherent assumption of perpetuity in the unadjusted figures.

4. Any further adjustments, in particular speculative ones such as those in the PPI Briefing Note which looks like an attempt to reduce the damage done by Gordon Brown and HMG, should be left to the speculators and politicians, to whom it appears that our profession has been especially sympathetic to date. It would be very hard to justify a (current) present value of anything less than £100 billion, and £150 billion may still be a conservative estimate.

5. This situation is crying out for a remedy – by the profession which, after all, calculates the deficits – which today are almost certainly of the same order as, and probably less than, the effects of the removal of ACT relief. The time for such action is ripe, not simply because of current publicity

[12] Pensions Policy Institute, Briefing Note 22
http://www.pensionspolicyinstitute.org.uk/news.asp?p=130&s=6&a=0

but also because the removal of ACT relief has been responsible for much of the position in which private schemes find themselves. (Indeed such removal in respect of accrued assets at the time is a theft of part of those assets and has parallels with the Railtrack situation.) Yet the position of schemes in the public sector (which has received the fruits of the removal of ACT relief) is a stark contrast, with huge benefits and huge liabilities which do not have to be capitalised at all.

Supplement to Appendix 1, updating to August 2008

A. Paragraph 1 of the original Appendix above suggested that future updates should be made via compound interest (only). The reason for this is that tax changes applying *only to prospective benefit accruals thereafter* could be viewed as "fair game" for the Treasury. On this basis compound interest at say 5 per cent p.a. for the three years since August 2005 means that the current value of the loss referred to above would be at least £115 billion and more likely £175 billion.

B. Several other factors referred to in the note would serve to increase these numbers further:

1. The tax raid via loss of ACT relief was actually started by the Conservative chancellor Norman Lamont in 1993, which is estimated to add about 30 per cent to the numbers above, bringing them to £150 billion and £225 billion – the amounts used in the body of this paper.
2. The "fair game" argument for future accrual assumes that future service benefits could be adjusted downwards without pain. The unreality of such an assumption is there for all to see in the annihilation of occupational schemes since 1997. Most of this can be attributed to government, with the losses from the Brown raid alone exceeding subsequently revealed deficiencies by a large margin.
3. Due to the time-lags in information gathering, it is too soon to make a realistic assessment of the changes in benefit accrual due to scheme closures and benefit reductions. The carnage itself as illustrated earlier in the report is sufficient testimony to a now incalculable figure.
4. A rough and ready rule for the future is, to the extent it is invested in UK equities, any contribution to a pension scheme since 1997 must be some 20 per cent larger than was previously the case, in order to create the same retirement benefit as before.

APPENDIX 2

£1 million retirement benefits in the public sector

The number of public sector employees in England and Wales with retirement benefits worth £1 million has been calculated using data on the retired members of the various public sector pension schemes supplied to the TaxPayers' Alliance through the Freedom of Information Act. (Copies of the various FoI requests and responses are available from the TPA.) The responses from the pension scheme administrators confirmed the number of retired members of each scheme who are currently receiving an annual pension, net of lump sum, of at least £33,000. These are detailed below in Table A3 (note that it has not been possible, as yet, to obtain data for the Local Government, Police and Fire Fighters' Pension Schemes, nor, unsurprisingly, for MPs). There are currently over 17,000 such retired public sector employees.

Table A2: The number of retired public sector employees with retirement benefits worth £1 million

Public sector pension scheme	Number in receipt of annual pension (net of lump sum) of at least £33,000	Source
Civil service	3,680	FoI response, Cabinet Office, 15/11/2007
NHS – England and Wales	8,449	FoI response, NHS Pensions Division, 08/02/2008
NHS – Scotland	2,035	FoI response, Scottish Public Pensions Agency, 01/05/2008
Teachers – England and Wales	1,824	FoI response, Department for Children, Schools and Families, 16/05/2008
Teachers – Scotland	155	FoI response, Scottish Public Pensions Agency, 01/05/2008
Judges	815	FoI response, Ministry of Justice, 01/05/2008
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Overseas pensions scheme	23	FoI response, Department for International Development, 27/02/2008
MSPs (Scotland)	2	FoI response, Scottish Parliament, 29/05/2008
Total	**17,150**	

An annual public sector pension of £33,000 net of lump sum is equivalent to a pension pot, from which an equivalent annuity could be purchased, of around £1 million:

1. At the age of 60 (the standard retirement age for existing public sector employees) current annuity rates show that the value of an annuity of £1 pa, increasing according to the Retail Prices Index and with continuation at a rate of 50 per cent to a surviving spouse, is approximately £26 (note 1).
2. We understand that currently there are some 17,150 retired public sector employees in England and Wales receiving a pension of £33,000 or more. In the overwhelming majority of such cases there would have been an additional tax-free lump sum of three times the initial pension.
3. Clearly, if all these pensioners had retired today on £33,000 pa plus a lump sum of £99,000, each would be worth £1 million.
4. In fact some would have retired many years ago; the value of their pensions at the starting time would have been smaller than £1 million. On the other hand £33,000 pa is the minimum under consideration here; many pensioners will be receiving appreciably more. Furthermore, many hundreds of public sector employees will be retiring each year on pensions far greater than £33,000 pa.
5. Given the above situation, in our opinion it is perfectly reasonable to say that "there are 17,150 retired public sector employees in England and Wales with retirement benefits worth £1 million".

Notes

1. This ratio is entirely consistent with Neil Record's authoritative publication, "Sir Humphrey's Legacy", published last year by The Institute of Economic Affairs in association with Profile Books Limited. http://www.iea.org.uk/record.jsp?type=book&ID=390