# The uk pension system: overview of changes

The aim of this essay is to perform an analysis of the UK pension system, understanding its foundation and working. The core focus is to assess the statement “ the UK pension statement is fatally flawed and requires that we make fundamental changes in the way we save for old age”, by referring to the Pension Commission Reports, and the relative proposals that have been made recently.

The essay provides an introduction to the pension system, before tackling the issues that make the system troublesome and flawed. Detailed analysis of the reports, including the Pension Act 2007 and 2008, are used as evidence of various issues with the current setup, and the proposals are judged to see if they will provide the necessary changes to improve the system in the coming years.

The generic understanding of the term ‘ pension’ is the arrangement by which people who are no longer in employment are provided a form of income. It can also be considered as a form of savings, in which one accumulates funds without any taxes, to utilise later as retirement income (Blake, 2006). The chief difference between pension and a severance package is that the former is paid in regular instalments, while the latter is paid as lump sum at the time of departure from employment, or shortly thereafter.

Where pensions are granted at the time of retirement from the workforce, they are referred to as retirement plans or superannuation. The flexibility of the retirement plan is that it can be set up by employers, insurance companies, government or trade unions, to cater for the needs of the

workforce upon its exit from employment due to reaching the maturity age that is pre-decided as the point to move out. This is normally at 60 years, although recent changes have pushed it to 65 years (Blake, 2006).

Pension is referred by different names in different countries; the Americans call it a retirement plan, in Australia it is known as superannuation, and in the UK it is regarded as pension scheme (Blake, 1997).

Types of Pensions

In order to analyze the pension system objectively in light of the documents, it is important to understand the different types of pensions. There are three common types of pension in practice around the world (Blake, 2006). These are:

Employment-based pensions: Often regarded as a deferred form of compensation, this is primarily an arrangement between the employer and employee, aimed at providing a steady income to the employee once they are no longer in employment due to reaching maturity or retirement age. Both employer and employee make regular contributions to this fund during the period of employment.

Social / State pensions: These are funds created by national governments for the benefit of their citizens and residents. Contributions into these funds are made by the nationals of the country throughout their working life, and the benefits they end up receiving after retirement are based on the contribution history. Two known examples of this type of pension are National Insurance (NI) in the UK and Social Security in the United States (US).

Disability pensions: A more specialised form of pension that is designed to provide a regular payment if the member suffers a disability. In some cases, social pensions contain a disability clause which ensures a regular income to individuals should they have to retire earlier than normal, in the event of some disability.

Determination of Benefits

Pension or retirement plans can be classified into two main types, on the basis of the benefits that they provide: defined benefit plans and defined contribution plans.

The defined benefit plans follow a traditional set formula for calculating the benefits that a member will receive after retirement. It takes into account the individual's salary and years of employment (Blake, 2006). There are variances in the salary level taken; some plans take an average of the salary over the period of employment, others take the final salary as the determining value. The defined benefit plans also have a provision for early retirement; this allows employers to let go of workers who are close to the retirement age by offering supplemental benefits to the payout that will received. These benefits are paid till the time of actual retirement age being reached. The benefit for employers is that they can hire younger workers at lower pay to handle the workload.

Defined benefit plans are composed of unfunded and funded plans. In unfunded plans, there no assets set aside and the benefits are paid out through the workers' contributions and taxes. Funded plans use investment vehicles to place funds in, at the present time. Benefits are paid out of the

return on investment that is made in the future. However, since the return is not known, the level of benefits that will be given out is also unclear (Blake, 2006).

The defined contribution plans provide a payment at retirement based on the contribution made by the member during the time of employment. The contributions are maintained in an individual's account, with the amount being invested in a fund or the stock market. Returns made from the investment are credited back to the individual (Blake, 2006). The risks of the investment made are approved by the individual, with no responsibility held by either the employer or the sponsor. However, the administrators of the fund selecting the investment options are held responsible to a certain degree to ensure accountability. Additionally, defined contribution plans allow workers to decide the amount that they wish to regularly add to their retirement package, in addition to the contribution made by the employer.

Pensions in the UK

The UK Pension Provision can be divided into three main categories: state pensions, occupational pensions, and individual or personal pensions. The state's main aim is to ensure some form of basic pension provision as a preventative measure against poverty in old age. The retirement age currently stands at 60, but is under plans to be raised to 65, and be equalised for men and women (Blake, 2003; DWP, 2009).

The UK state pension dates back to the early 1900s, when it was introduced as " Old Age Pension". The qualifying age at the time for receiving this

benefit was 70, and there was means test that needed to be cleared prior to any payments being released (Blake, 2003).

The state pension is made up of three elements: basic state pension (BSP), additional pensions and pension credit. BSP is also known as state retirement pension (SRP), and is a contribution based plan. The benefit that an individual receives is based on their NI contribution history (Budd & Campbell, 2000). Additional pension relates to schemes that the government introduced to provide extra provision to the nationals, in addition to BSP. This includes the graduated retirement benefit, state earnings-related pension scheme (SERPS) and state second pension (S2P). The graduated retirement benefit ended in 1975 and the SERPS was ceased in 2002. The current S2P follows the basic principles introduced by SERPS, by taking into account the individual's NI contributions and providing benefits where earnings are below the low level identified by the state. The additional pension schemes are voluntary and individuals can opt out of making contributions to it. Pension credit was introduced in 2003 and is a means tested benefit that aims to lift a majority of retired people out of poverty. The benefit is paid after the individual reaches the age of 60, and their income from savings is below a certain level. Those with some form of savings doubly benefit when they reach the age of 65, with a second provision of the scheme kicking in, known as " Savings Credit" (Blake, 2003).

The occupational pensions are administered by employers to provide benefits to their employees after they retire. These can be defined benefit or defined contribution schemes run by the employers, or an arranged third-party. Typically, the UK occupational schemes are jointly funded by both

employer and employee, where employees contribute around 6% of their gross salary into funds that invest into equity, and provide a return of that investment to the individual’s account for the future (Budd & Campbell, 2000).

The third category of UK Pension Provision is personal pensions. This is when individuals make arrangement with a provider like an insurance company, to make regular contributions in a scheme, similar to occupational pensions (Blake, 2003). Like the other plans, the contributions are made by the individual throughout their working life, with benefits of pension being released after retirement. The process of these benefits being released can vary; in some cases, the provider purchases a pension plan prior or at retirement for the individual.

Challenges to Pensions

The most important challenge faced by most nations, including the UK, is the aging of the population. With birth-rates slowing down and life expectancy increasing, a larger percentage of the population is elderly. This means that the ratio of workers to retirees is growing, meaning there are less individuals each year earning and contributing to the pension system, while there are more beneficiaries being registered each year. The current system is normally referred to as “ pay as you go (PAYG)”, in view of how it is funded and utilised (Blake, 2003). This challenge is harder to address with individuals seeking to look for alternatives to ensure a better lifestyle after retirement for themselves, than the bigger picture of a nation with a large portion of retirees falling below the poverty level.

Another challenge faced is the reduction in investment into private pensions. Employers have cut the contributions they had been making as a response to the current business climate (Budd & Campbell, 2000). This means that the amount available or due to be available for retirees in the future will be lesser than initially forecasted, ending up with further disparity between the need and provision of the benefits at that stage.

The complexity of the UK pension system has made it harder for changes to be implemented effectively, resulting in more patch-up than complete reforms. This complexity has given rise to a sense of despair among the workforce on the ability of the state to cater to the demands of the citizens, and offer solutions that are viable and feasible in the long-run.

Pensions Commission

Formed in 2002, the Pensions Commission was a public body in the UK that did not come under any governmental department, but reported to the Secretary of State for Works and Pension (Pensions Commission, 2007). Its sole aim was to review the system of private pensions and savings in the nation, and make recommendations as it saw necessary on whether changes needed to be made for the future. The changes were primarily linked to the voluntary contributions made by individuals and organizations.

The Commission published two reports, in 2004 and 2005. The reports provided a detailed analysis of the UK pension system at the time, its evolution over time should it remain unchanged, and recommendations on steps that were needed to formulate a new policy that was more in line with the future demand (Pensions Commission, 2007).

The UK compared to the rest of Europe

With limited accessibility to data from current years for the pension schemes in Europe, an analysis of a survey conducted during the late 90s shows some interesting information, highlighting the plight of the UK pension system, and the drastic need of reform in the present age (Blake, 2006).

It was discovered that on the whole, 57% of the workforce in the UK who were in paid employment contributed towards a pension. This is the voluntary contribution that occupation pensions allow. The data of European Union (EU) workers showed that 79% of the contributed to a pension plan. This disparity shows the resulting imbalance in benefit payments and contributions for the UK, as well as a defining reason for a high percentage of pensioners falling below the poverty line (Blake, 2003).

When the comparison was done for self-employed individuals, it was discovered that 59% of men and 47% of women in the UK contributed to a pension scheme. However, this pales in comparison to the 73% and 72% of men and women, respectively, in the EU who contributed to a pension plan (Blake, 2003). This is an addition to the point stated earlier, that signifies the growing income equality setting into the social system in the UK, and is a reflection of the divergence of income among workers.

On the organization front, more employers have changed their schemes in the UK, requiring individuals to fend for themselves, and be more responsible for the provision of pension. The state has taken a backseat, to become more of an enabler and regulator (Blake, 2006). However, with increasing concerns from the citizens, the UK government in the last few years has

started to investigate changes to the current system, in hope of bring improved benefits in the long run.

The Turner Report

In 2005, the Pensions Commission published the Turner Report, after its exhaustive research of the prevalent pension system in the UK. The report was aimed at providing the government a course of action with recommendations on steps that needed to be taken to bring a radical shift in the contributory habits, as well as the structure in place for the pension system (Pensions Commission, 2007).

One of the recommendations from the report as linked to combating the population ageing challenge faced by the system. It was of the view that the retirement age be increased so that the contributory workforce numbers are improved to supplement the needs of the pensioners (Pensions Commission, 2007). Also, the age for receiving maximum benefits should be changed so that these are only available to older nationals, with others needed to invest into private pensions as a means of supplementing their retirement income.

Another recommendation was for the formation of a National Pension Savings Scheme (NPSS), a semi-compulsory contribution scheme that offered individuals a set choice of investments within a constrained range of investment options (Pensions Commission, 2007). The creation of such a scheme would allow UK workers to enjoy supplementary retirement benefits without any reliance on employers to act as sponsors. However, sceptics have argued recently on the viability of such a scheme to be cost-effective or

the governance policies for it to remain efficient and reactive to the changing financial conditions domestically and internationally.

The National Pensions Debate

The work of the Pensions Commission and the resulting Turner Report gave the UK government a wake-up call on the needs for change in the pension system. The first steps towards reform were taken in the step of opening the debate to the public. The focus of such a step was to involve the citizens into the process of deciding what was needed, as they were the chief beneficiaries of the system.

The National Pensions Day, organised on 18 March 2006, brought together thousands of UK nationals on a uniform platform, to share their views and offer alternatives, in terms of the reforms needed to be auctioned by the government to have a lasting effect on the pensions system (DWP, 2009). As well as a coordinated public event through internet link-up, the UK government used an online survey to grasp a broader understanding of the mindset held within the nation on the delicate nature of the current pensions system.

From the input gained due to the debate and the report produced by the independent Pension Commission, the UK government took two initiatives; it published two white papers to cover the proposals that it believed were compulsory to implement for positive change to come into the system (DWP, 2009).

The first white paper, titled “ Security in Retirement: towards a new Pension System”, outlined the government’s proposals that were designed to revamp the pensions system provided they met with the requirements set within personal responsibility, fairness, simplicity, affordability and sustainability (DWP, 2009). After having formulated and published this white paper, the government brought together key business leaders and organization figureheads to offer consultative advice on the reforms that were being proposed. This collective arrangement was a means of ensuring minimum barriers to the process of change for the long term.

The second white paper was titled “ Personal Accounts: a new way to save”, was published by the government proposing the setup of a new national system of low cost personal accounts. The ideology here was to introduce a habit of saving among the UK nationals and residents, which would help in providing income after retirement. This time, the government proposed a period of public consultation on the matter, wanting to address any queries and reservations from the audience that would most be affected by it (DWP, 2008).

Having gained a major consensus towards the auctioning of these reforms, the Government moved ahead with the implementation process. The process however was long-term oriented and phased, in order to allow the change to be effected positively and have long term benefits for the nation.

The Pensions Act 2007

The reforms proposed to the state pensions system in the first white paper were transformed into law by this act. The changes proposed covered three

key areas: the Basic State Pension (BSP), the State Second Pension (S2P) and the qualifying conditions set out for both (DWP, 2009).

Some of the key changes are:

The qualifying years for receiving full BSP was 39 for women and 44 for men. Effective 2010, this would be reduced to 30 for both.

The annual cost of living component in BSP was linked to prices in terms of increases. This would be changed to link with earnings from 2012, provided the fiscal position allowed affordability.

Easing the conditions for contribution to BSP, so that everyone can build up some entitlement, instead of those meeting the tough qualification process.

From 2010, introducing national insurance credits in relation to S2P, essentially for those individuals who suffer from long term disabilities and those who have caring responsibilities, allowing them to build up some additional pension entitlement.

However, one major change that was proposed linked with the issue of the ageing workforce. For long term affordability of the state pension system, it was decided necessary to implement a gradual increase in the state pension age for both men and women. The important part of this change would be the pace at which the increase has been proposed. The period for this increase was between 2024 and 2046; with the age being increased to 68 by the end of this term (DWP, 2009).

The Pensions Act 2008

In continuation to the proposed reforms that were deemed necessary after the commission investigation and public debate, this act put into law most of the actions advised in the second white paper. The aim here was to encourage greater private pension saving, so that individuals were not solely reliant on the state to meet their living costs after retirement (DWP, 2009).

Some of the key changes of this act are:

Automatic enrolment of eligible workers into a qualifying workplace pension scheme, with effect from 2012. What this means is that workers would have to take a decision not to be part of the pension scheme provided by the employer. If any such decisions have not been made actively by the worker, he or she would be enrolled automatically to the workplace pension scheme.

A minimum of 3 per cent contribution by the employer to the employee’s pension account, based on the earning band. This was as a supplement to the 4 per cent contribution that would be made by the employee, and the almost 1 per cent in tax relief provided by the government.

2012 would see the introduction of a new low cost savings vehicle, named as the National Employment Savings Trust (NEST). This scheme is aimed at the medium and low earners, with low charges and simplicity.

The Process of Reform

When analysed against the pension systems in the developed world, the prevailing UK system has shown serious flaws that have increased over time. The key factor to consider here is the ageing population. While this factor is

prevalent in other developed nations running state pension systems, the problem seems less influencing for a few reasons.

Canada and Australia have a lower population and a higher percentage in the active workforce. The US being the largest economy in the world has a significant pensioner population, but its higher rate of immigration has allowed it to have a workforce that contributes heavily to the pension system. The UK, however, seems in neither of these areas. It has a significant portion of its workforce nearing the retirement age in the coming decade. With immigration being tightened, the number of foreign workers entering to contribute to the pension system is not as high as required (Butler, 1997).

The above point, however, points a serious flaw in the PAYG system, where the current working individuals contribute in the present day, to pay the benefits of those already retired, expecting the same for themselves when they move out of the employment age bracket. The example can be referred to as a bucket of water with a hold in the bottom. There is little accumulation, as water flows out, and the inflow is a slow stream.

The need for an understanding to be developed in the public for being more responsible towards their individual needs in retirement is important. Taking personal responsibility during the working age will in turn help avoid a large number of pensioners falling below the poverty line later.

Additionally, a supporting but steady role of the employer in terms of contribution to pension schemes for the employee is a step forward. Superannuation schemes in Australia have been following this model for a

number of years, with new changes allowing more flexibility to the employee to choose their investment vehicle, but restricting access to the funds till retirement age (Blake, 1997).

The recent financial crisis too has impacted the pension system in the UK, as most schemes had invested in several schemes and stocks that have since fallen in value or collapsed. This has resulted in a write-down for many pensioners, furthering emphasizing the failings of the government to provide better protection to pension plans. The state of economy and its stability, therefore, becomes an important factor in the overall effectiveness of the pension system in the United Kingdom.

The underlying message in the reform is an acceptance of the drawbacks existing in the pension system of UK, and taking steps to rectify it. Its main aim is to introduce the concept of savings among the public, by offering simplified processes to include more of the working population in the contribution to the state plans, as well as to individual and organizational plans, thereby diversifying the sources of income after retirement.

With the reform commencing in 2010, the outlook remains positive. With public involvement in the decision-making process, it is likely that the changes under implementation will be accepted without much resistance. However, critics still argue over whether there is going to be a lasting effect once all variations are completed. One of the most important factors in this would continue to be the economic condition and the sustainability of stability shown.