Notes and Brief Reports

Social Security Reform Proposals in the United Kingdom: The White Paper*

The Conservative government of the United Kingdom recently proposed changes for the British social security system designed to encourage greater private participation in providing retirement income and to provide better assistance to low-income families supporting children. On December 16, 1985, the government issued an official statement of policy in a White Paper, "Reform of Social Security: Programme for Action," proposing to (1) encourage the provision of an earnings-related pension through approved private pension schemes or portable, personal pension plans, and (2) replace the present system of assistance payments with one that is considered to be both easier to administer and more responsive to the needs of families. These proposals were sent to Parliament for legislative consideration on January 17, 1986.

Although the proposals leave intact the basic flat-rate benefit provided at retirement to all workers under social security, the government would modify, but not eliminate, a second, earnings-related pension, known as the State Earnings Related Pension Scheme (SERPS), and would revamp the assistance benefits currently provided under the social security system. The assistance programs would be replaced or modified by an income support program, a special fund for emergency situations, and benefits for special contingencies, as explained later.

Background to the Proposed Reforms

Recent discussions on the welfare state in the United Kingdom have centered on reforming the social security system, which provides a wide range of income-maintenance benefits, and, in particular, on addressing the problem of providing adequate retirement benefits in an era of economic constraints. The current debate over whether the provision of retirement income is handled best by the social security system or by the private sector through occupational pensions and personal arrangements dates back over a number of years.

The social security system, enacted in the late 1940's, was designed to provide flat-rate universal pensions to workers financed by flat-rate contributions, and means-tested assistance to those who fell through the holes of this safety net. Over the years, however, Labour governments have supported the provision of earnings-related retirement benefits through a state social security system and Conservatives have preferred coverage under occupational or private pension arrangements. [1]

The different approaches to earnings-related pensions are exemplified in the White Papers presented by two different governments in the late 1960's and early 1970's. [2] The Labour government in 1969 called for replacing the existing combined flat-rate and earnings-related pension with a universal, earnings-related state pension complemented by optional, private pension plans. In 1971, the Conservative government advocated retaining the basic, flat-rate benefit system while substituting a largely expanded private pension program for the earnings-related system under social security. Eventually, in 1973, the Conservatives enacted legislation eliminating the earnings-related layer and providing a system of private pensions. This legislation, however, was suspended when the Labour party came to power in 1974 and temporarily substituted a program of flat-rate, social security benefits as an interim measure. [3] In 1978, the Labour government implemented a program integrating a new flat-rate benefit with an earnings-related pension, called the State Earnings Related Pension Scheme (SERPS). Companies have the option to "contract out" of the earnings-related portion by providing a pension equivalent to the SERPS.

In the 1980's, the Conservative government has focused on encouraging private pension and personal retirement arrangements. The government would like

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[1] Max Horlick and Alfred M. Skolnik, **Mandating Private Pensions: A Study of European Experience** (Research Report No. 51), Office of Research and Statistics, Office of Policy, Social Security Administration, 1978, page 63.

[2] Martin B. Tracy, "Proposed Pension Reform in United Kingdom, 1972," **Social Security Bulletin**, August 1973, pages 45-49.

[3] Martin B. Tracy, "Social Security Revision in the United Kingdom," **Social Security Bulletin**, November 1975, pages 32-35.

Contracting-Out Provisions

The present structure of a coordinated state and private pension system was implemented in 1978. This system provides a basic flat-rate benefit and an earnings-related benefit known as the State Earnings Related Pension Scheme (SERPS). Employers may "contract out" of SERPS by providing a defined benefit at least equivalent to the state's Guaranteed Minimum Pension (GMP). Once the pension is paid by the employer, the state then provides pension adjustments to keep retirement income in line with changes in the Retail Price Index. As a result of the state guarantee, the eventual pension remains at least as good as the pension under SERPS.

In return for an employer contracting-out of the system, the government partially reduces the contributions paid by the employer and employee. In addition, employer contributions to approved private pension schemes are tax deductible, while contributions to the state earnings-related program are not.

In essence, under current contracting-out arrangements, employers take on future pension liabilities (an obligation to provide a GMP based on indexed earnings) in exchange for contribution reductions (lower contribution rates than under SERPS).

employees to set up their own portable, personal pension plans that would combine coverage under the earnings-related segment of the social security system and the employer's pension scheme. Such a plan was proposed by the Department of Health and Social Security in a consultative document in July 1983.

In November 1984, the government introduced a social security bill containing a package of private pension reform measures. The reform measures as enacted dealt with problems encountered by employees leaving a job before their pension benefits were vested ("early leavers") or losing the value of their vested benefits due to the lack of inflation protection.

Also in 1984, the government began separate inquiries into a major social security reform. The findings of these separate inquiries were released in June 1985 in the form of a Green Paper, "Reform of Social Security," a working document designed to elicit comment and debate.[4] One of the Green Paper's proposals was the abolition of the earnings-related pension of the old-age, survivor, and disability insurance (OASDI) program. In addition, the government proposed to reform the Supplementary Benefit, the Housing Benefit, and the assistance benefit for families with low income.

In the White Paper proposals currently before Parliament, the government has dropped the provision to abolish SERPS as a result of public support for the program. Instead, the government proposes to cut back on the benefits provided under SERPS while advocating measures to encourage greater participation in private pensions, referred to as occupational pension plans. The White Paper proposals for the other social security benefits are similar to those in the Green Paper and will be discussed later.

Changes in the OASDI Program

Under the White Paper proposals submitted to Parliament, the provisions encouraging contracting out to private pensions or personal, portable pensions would take effect in April 1988. The cuts in benefits under SERPS, however, would be phased in gradually and not affect anyone retiring in this century.

As indicated in the proposals, the government would like to encourage wider participation in pension ownership in the private sector by simplifying contracting-out arrangements; setting up portable, personal pensions; and offering special incentives for newly contracted-out occupational and personal pensions. This would require significant changes in setting up new occupational pension schemes and the introduction of a new form of portable pension.

There are several key elements to the scheme being proposed:

- **Simplification of administration.** Under current contracting-out provisions, the employer may contract out the occupational pension plan from the state scheme only by providing defined benefits (pensions based on a percentage of earnings). The new proposals would allow the employer to offer defined contribution plans (pensions based on actual contributions and any interest accrued). This option would allow the employer to know in advance the size of pension commitments and show the employee how much is in a pension account at any given time. This proposed plan would also eliminate the requirements to index earnings and to keep extensive records on employee career earnings.
- **Creation of portable, personal pension plans.** To provide portability and eliminate the pension problems encountered by workers who change jobs frequently, the government is proposing a system of portable, personal pensions. Under this system, the employee could contract out of either SERPS or the employer's occupa-

[4] For a discussion of the Green Paper proposals, see Daniel Wartonick, "Proposals for Social Security Reform in the United Kingdom," **Social Security Bulletin**, August 1985, pages 45-48.

tional pension plan by providing a scheme based on a minimum level of contributions with an approved pension provider of the employee's choice. The employer would pay the full rate of combined contributions normally paid to SERPS, with a rebate on contributions going back into the employee's personal pension account. The Department of Health and Social Security would act as a clearinghouse for handling these contributions and rebates. The employer could choose to make additional contributions matched in whole or in part by the employee but would not be required to do so under the new proposals.

- **Incentives for occupational and personal pensions.** For occupational pensions or personal pensions contracted out of the state scheme between 1988 and 1993, the government would provide an additional rebate of 2 percent of earnings over the standard rebate on social security contributions normally paid into pension funds for contracting out. These rebates would go directly into either the employee's occupational plan or personal pension. A minimum rebate of £1 would be applied to the employee's plan if the rebate worked out to less than that amount per week to ensure that low earners also have some incentive for contracting out of SERPS. [5]

The government anticipates that many of the above proposals will encourage the growth of pensions in the private sector and lessen the financial burden on the social security program.

To trim expenditures under the OASDI program, the government has proposed the following changes, which modify but do not abolish SERPS:

- **Pension calculation.** The SERPS pension will no longer be calculated on the basis of the 20 best years of earnings but rather on lifetime earnings. This change reflects the view held by some that the "20 best years" rule was overly generous. In addition, benefits would amount to 20 percent of earnings, compared with the current 25 percent. Under present contracted-out arrangements, lifetime earnings are already used for the guaranteed minimum pension. Contracted-out pensions would no longer be based on 25 percent, however, but lowered to 20 percent of lifetime earnings under these proposals. These changes would not begin for retirees in this century but would be phased in over a 10-year period beginning in the year 2000. They would therefore not affect women currently aged 45 and men currently aged 50, since the retirement age for women is 60 and that for men is 65.
- **Occupational pensions responsible for indexing.** The government proposes that occupational schemes take up some of the financial burden of maintaining the value of pensions. Under the new scheme, employers would be required to adjust pensions after award in line with price increases up to a maximum of three percentage points per year. The state would continue to increase pensions but only for the annual increase in inflation exceeding three percentage points.
- **Cut in SERPS survivors benefits.** The SERPS survivors pension would become half of the deceased worker's pension, which is currently the case under contracted-out schemes. Currently, under SERPS, the spouse receives the full earnings-related pension of the worker. This provision would not take effect until the year 2000.

New Income-Support Scheme

The proposed White Paper reforms would also reshape the present system of assistance benefits by eliminating certain benefits deemed inadequate, overly complex, and difficult to administer. The major social assistance programs under current law are the Supplementary Benefit, which provides payments to needy persons with little savings and income to assist with normal living expenses; the Housing Benefit, which provides help with the costs of rent and local government taxes; and the Family Income Supplement, which helps low-income working families meet the additional expenses incurred in the raising of children.

The government believes that the present system perpetuates problems known as "poverty or unemployment traps," in which people are better off out of work on welfare benefits than in work with an after-tax income lower than that received from benefits. To address this issue, the government proposes to replace the current assistance program with a simpler system of benefits based on net income. The new system would be designed to help meet the needs of families with children while keeping family members in work. If enacted by Parliament, these changes would take effect in 1988.

The following programs are being put forward to replace the present system:

- **Income support benefits.** The new proposals set forth a system of income-related benefits that eliminate the present Family Income Supplement and simplify the current Housing Benefit and Supplementary Benefit programs. In their place are substituted (1) a family credit scheme

[5] One British pound equals $1.48 in U.S. currency.

for low-income working families to ensure that income is better in work than out of work and (2) additional income-related benefits that are more closely related to the needs of families in various age groups. The family credit scheme would pay a credit for both adults and children to offset taxes and help increase net income. A newly revamped Housing Benefit would be included as income, however, for purposes of qualification. Under income support, allowances would be paid to individuals in various age groups, depending on their marital status and whether or not they are supporting children. Another premium would be paid for old-age and disability pensioners.

- **Social fund.** A special social fund would be established to provide assistance to individuals on the basis of specific needs or in emergency situations. The scheme would be administered at the local level, and decisions on eligibility would be geared to local conditions. Eligibility decisions could be appealed at the local level. This system would help such special needs as expenses associated with maternity, funeral costs, special interest-free loans, financial crises, and community care to help relocate people or help them avoid institutional care.
- **Special contingencies.** The government recognizes that certain contingencies require special attention and assistance. In this regard, the proposals focus on the disabled, widows, and pregnant women. Qualifying conditions would be eased for the long-term disabled so that they could receive a higher rate of assistance than presently payable and disabled children would receive an extra premium. Assistance to widows would be delivered immediately upon bereavement instead of after the current waiting period and would not affect qualification for benefits from the social fund. The qualifying age for the age-related widow's pension, however, would be increased from 40 to 45. The maternity allowance would be based on a recency-of-work test and would be paid directly through the employer. According to the government, the allowance would give women greater flexibility in deciding when they should stop working.

OASDI Savings in the Next Century

In the technical appendix to the White Paper proposals, the Government Actuary presents the cost implications to the OASDI program of continuing under the current system and of implementing the reform proposals. Assumptions underlying the cost estimates for both the current and proposed systems are (1) a real earnings growth of 1.5 percent per year, (2) an annual unemployment rate of 6 percent, (3) regular adjustments in the upper and lower limits for covered earnings to reflect earnings changes, and (4) the basic pension will continue to be increased in line with prices. Moreover, the current contributor-to-beneficiary ratio is 2.3:1 and is expected to drop to as low as 1.6:1 by 2035.

Under the proposed scheme, savings on OASDI benefits in constant November 1985 prices begin in the period 1993-94 at an estimated annual £300 million with total expenditures of £23,200 million and grow significantly over the next 40 years to an estimated annual savings of £13,500 million with total expenditures of £42,000 million. Corresponding expenditures for continuing under the present system are estimated at £23,500 million a year for 1993-94 and would grow to an estimated £55,500 million annually in 2033-34.

The estimates of savings under the proposed scheme assume that half a million additional persons in succeeding years choose to join an estimated 9.75 million workers contracted out of SERPS and that the proportion of contracted-out workers to the rest of the work force remains the same. If 5 million more persons elected to leave SERPS, making a total of 14.75 million persons contracted out of the program, an additional savings by 2033-34 of £2,000 million would accrue.

Estimated contribution rates necessary to balance expenditures gradually decline under both the existing scheme and the proposed scheme in the first 15 years, but gradually increase thereafter. However, combined employer/employee contribution rates rise from 14.2 percent in 2003-04 to 18.6 percent in 2033-34 under the present system and increase only slightly under the proposed scheme from 14 percent in 2003-04 to 14.6 percent by 2033-34. Significantly, the new system begins with a slighly higher contribution rate than the present system has in 1993-94 and does not dip below the existing scheme's rate until 2003-4. If 5 million more persons contract out of SERPS, making a total of 14.75 million persons, the cost of the new scheme would not drop below that for the existing program until 2013-14. This temporary cost increase in the new scheme is apparently the result of the additional rebates being paid.

Next Month

The June 1986 issue of the **Social Security Bulletin** will feature "Fast Facts and Figures About Social Security," a special report presenting basic program data in chart and tabular form.