A Bloody Mess

From our February 2005 issue: How has Britain's privatization scheme worked out? Well, today, they're looking enviably upon Social Security.

By Norma Cohen
Web Exclusive: 01.11.05

Print Friendly | Email Article

A conservative government sweeps to power for a second term. It views its victory as a mandate to slash the role of the state. In its first term, this policy objective was met by cutting taxes for the wealthy. Its top priority for its second term is tackling what it views as an enduring vestige of socialism: its system of social insurance for the elderly. Declaring the current program unaffordable in 50 years' time, the administration proposes the privatization of a portion of old-age benefits. In exchange for giving up some future benefits, workers would get a tax rebate to put into an investment account to save for their own retirement.

George W. Bush's America in 2005? Think again. The year was 1984, the nation was Britain, the government was that of Margaret Thatcher -- and the results have been a disaster that America is about to emulate.

For all the fanfare that surrounds the Bush administration's efforts to present a bold new idea on pension reform, the truth is that it is not new at all. In fact, the proposal looks suspiciously like the plan set in train during Thatcher's first term in 1979 and which has since led Britain to the brink of a crisis. Since then, the nation's basic pension, which is paid for out of tax receipts, has shrunk dramatically. The United Kingdom has the stingiest state pension program of any G8 nation, and there is growing consensus -- even among British conservatives -- that reform is needed. And ironically enough, considering that America is on the verge of copying Britain's mistake, most experts seek reform in the direction of a more generous, and simpler, basic state pension -- one similar in design, in other words, to America's Social Security program.

David Willetts, the Conservative MP who is the opposition spokesman on pensions (and whose intellectual agility has earned him the sobriquet "Two Brains"), is one admirer of the U.S. system. "I like the way they distinguish between Social Security and means-tested welfare," he says. "They have higher Social Security benefits to keep elderly people off welfare." And last year, in a startling reversal of its decades-old policy, the Confederation of British Industry, the United Kingdom's premier business group and the functional equivalent of the U.S. Chamber of Commerce, called for a more generous state retirement benefit, saying -- remember, this is the nation's leading business lobby talking -- that it would even support raising taxes to help pay for it. (It also called for raising the retirement age.)

Britain's experiment with substituting private savings accounts for a portion of state benefits has been a failure. A shorthand explanation for what has gone wrong is that the costs and risks of running private investment accounts outweigh the value of the returns they are likely to earn. On average, fees and charges can reduce pension lump sums by up to 30 percent on retirement. The nation's savings industry, which sells those private accounts, has already acknowledged this. Which brings us to irony No. 2: Just as the United States prepares to funnel untold billions to its private sector for the management of private accounts, back in 2002, many U.K. insurance companies, mindful of tough new rules against giving bad advice, began to write to their customers urging them to consider abandoning their private savings and returning to the state pension system -- something hundreds of thousands of Britons have done already.

And this is the system that the United States is seeking to emulate?

* * *

How Britain's retirement system got to where it is today is a twisted tale that combines political ideology with fiscal expediency.

Britain has had pensions since medieval times; offering them to monks and abbesses was Henry VIII's simple formula for dissolving Catholic monasteries without a revolt by their occupants. They were given more widespread use in the late 19th century by some of the more enlightened entrepreneurs. But it was the aftermath of World War II that saw the widespread inclusion of pension benefits into workers' benefits packages. Britain's nationalization of its heavy industries such as coal, steel, and railroads made pensions as much an element of social policy as of employment policy. At the time, Britain was suffering a manpower shortage so acute that, for the first time, it encouraged citizens of its former West Indian colonies to settle there. For employers in certain industries such as retailing and banking, dependent on large numbers of relatively low-wage workers in a labor-restricted economy, pensions were a low-cost insurance policy against high staff turnover that could drive up wage bills. The system was, to be sure, complex and not without its inequities. But it was not in crisis.

Thatcher (now a baroness) came to power in May 1979 at a time when much of Britain was ready to hear her message. The now-infamous poster of workers on the dole queue, headlined “Labour Isn’t Working,” coupled with national disgust over a series of strikes during the 1979 “Winter of Discontent” that left bodies stacked at morgues in Liverpool and trash piled high in London’s Trafalgar Square, made Britons eager for change.

Thatcher’s vision was the dismantling of much of what Britain’s Conservative Party calls “the nanny state.” Individual choice and individual opportunity were to be the hallmarks of this dismantling. No longer would the state seek to shield people from the force of the markets; people would have to learn to stand on their own two feet. Britain was to be a nation of home-owning, share-owning entrepreneurs who did not want the state snooping into their business or asking more of them than good citizenship.

From the start, the new Tory government set out to make tax cutting the centerpiece of its fiscal policies. However, it was clear that this could not be accomplished without benefit cuts. As former Chancellor of the Exchequer Nigel Lawson notes in his memoirs, the single most important cut was directed at retirement benefits. So the Tories’ very first budget, passed by Parliament in 1979, included a fateful change in the formula for basic state pensions. For years before that, state pensions had risen in line with wages; but the 1979 budget decreed that in the future, they would rise in line with inflation. This is one key change that the Bush administration is contemplating today for Social Security.

In Britain, by most accounts, the change caused little political fanfare at the time. Ros Altmann, a Harvard-trained specialist in pension economics and a governor at the London School of Economics, says that neither the voting public nor most politicians understood the true implications of altering the link to wages. But those who pushed for the change knew what they were doing: They were slowing the rate of growth in pension increases, because in the United Kingdom, wages have historically risen by 1.5 percentage points to 2 percentage points ahead of inflation each year. (Wages rise ahead of inflation in America as well.) “Two percent doesn’t sound like much,” Altmann notes. “But with the effects of compound interest, that amounts to nearly a 50-percent reduction in the value of benefits over 30 to 40 years.” As a result, the basic state pension in the United Kingdom -- the equivalent of U.S. Social Security -- is today lower than that in all but four other European countries: Portugal, Greece, Belgium, and Ireland. It is also substantially below that of its U.S. counterpart.

The American observer may find it odd that Britain’s voting public was prepared to put up with so low a basic state pension. Why did voters never demand more generous old-age benefits? The answer lies in the fact that the United Kingdom has one of the most generous employer-backed pension systems in Europe. Aggregate assets in U.K. pension funds far outstrip the value of similar funds on the continent. Indeed, in a report issued last October, the Pensions Commission acknowledged this very point. “The UK pension system appeared in the past to work well because one of the least generous systems in the developed world was complemented by the most developed system of voluntary private funded pensions,” the commission wrote. “This rosy picture always hid multiple inadequacies relating to specific groups of people, but on average the system worked.”

Thus, with most Britons assured that their private pensions would protect them, the Tories faced little opposition as they kept at reducing state pensions. The Labour Party, then in opposition, was relatively acquiescent, in part because just a few years earlier, a bipartisan group had agreed on a new legislative centerpiece that was designed to ensure that old-age pensions retained their purchasing power. This legislation established a new and more generous second tier of the basic state pension, which was to be known as SERPS (State Earnings-Related Pension Scheme) and which promised to deliver every worker an additional pension, over and above the basic-level pension and equal to a percentage of the average of his or her best 25 years of wages.

* * *

That additional pension was known as the Guaranteed Minimum Pension (GMP) because, unlike the basic state pension, it set a floor under the smallest benefit a worker could expect in retirement. But it contained an interesting wrinkle: Employers who provided their own schemes for their workers could be allowed a reduction of roughly 60 percent of their payroll taxes if they guaranteed to provide a pension at least as good as the GMP.

Thus was established the principle of "contracting out," the British term for allowing citizens to divert money from state schemes and to invest instead in private plans -- the term of art, in other words, for privatization. The practice was finally put into place in force with a piece of legislation that passed in 1986.

The narrative of how this came to pass will sound familiar to those who have been following the current debate in America. At the start of 1984, then–Chancellor Nigel Lawson (now Sir Nigel; his daughter Nigella has more recently won great culinary fame on American television) had begun to express his alarm at projections for the cost of SERPS over the next 50 years. A colleague in the cabinet, Social Security Secretary Norman Fowler (also now a "Sir," albeit one lacking a daughter famous in the States), advocated abolishing it altogether. In his memoirs, Lawson describes SERPS as "a doomsday machine" and calls its provisions "irresponsible generosity." Both men were strong advocates of personal pensions. However, what Lawson does not say is that while the SERPS expenditure was likely to peak in the year 2030 (projections for that year appeared in all discussions about the need to curtail it), it was projected to fall off after that. But -- here's another wrinkle that should sound familiar to American ears -- by focusing on projections for 2030, the sense of impending crisis prevailed in the media.

And so, in 1985, the Conservatives pushed through what would become the landmark legislation of social-security privatization. The new law curtailed some SERPS benefits; allowed employees the choice of either joining SERPS or setting up a personal pension scheme; and, crucially, allowed those choosing a personal pension to contract out of SERPS altogether. It was these last two elements, when combined, that led to one of the greatest financial scandals in recent memory and that, together, have undermined confidence in long-term savings in Britain.

The new rules on personal pensions and contracting out did not take effect until 1988. But in the months leading up to their launch, the government spent substantial sums on advertising aimed at encouraging Britons to take them up. The Thatcherite government was so eager to pursue its ideological agenda that it spent taxpayers' money on it; the 1985 act had included a payment into the fund giving an additional 2-percent tax rebate to those taking out a new personal pension between 1988 and 1993.

When contracting out began, predictions from the Government Actuary's Department forecast that no more than 500,000 people would take up personal pensions. A former official told the *Financial Times* at the time, "We all told the secretary of state that personal pensions were really only good for the very young or for very high earners." But in the first five years, the number of private pensions sold would turn out to be 10 times those two segments of the population. The legislation, and the accompanying public-relations blitz, worked: The "take-up," as the British call it, of personal pensions was successful beyond the ministers' wildest dreams and was hailed as one of the triumphs of the Tory government. By the end of the 1988–89 tax year -- the first year in which they were available -- more than 1 million private pensions had been sold, twice the government projection. By the end of the following tax year they totaled 3.9 million, rising to 4.3 million at the end of the 1991 tax year.

It wasn't until a July 1992 gathering of ministers and civil servants at Chevening, the chancellor of the exchequer's country residence, that the government got its first official warning that all was not well. On the opening day of a strategy session called by then–Social Security Secretary Peter Lilley, ministers were alerted to the costs now associated with persuading people to opt out of occupational and state pension schemes into personal pension plans. The warning came from David Clark, then deputy secretary for pensions, in a paper to the assembled group. A minister recalled to me, "The paper said that, in some sense, personal pensions have been a tremendous success, but there are a few time bombs ticking away there."

A report written two years earlier by the National Audit Office confirmed what Clark had told the disbelieving ministers. The government had sent out £9 billion in rebates from 1988 to 1993 to people who had agreed to contract out; but at the same time, the massive shift to private pensions was going to cut SERPS costs by only £3.1 billion. In other words, the government was spending much more than it was saving by bribing people to leave SERPS. What had once been a £1.6-billion surplus in the National Insurance Fund vanished completely. Worst of all, many workers left good occupational plans and faced being worse off, not better off, in retirement by depending on the privatized schemes.

Finally, Britain's financial services regulator, the Securities and Investment Board, reacted. Over the objections of the insurance industry, it undertook random samples of paperwork from personal pension clients of most large providers and discovered that a staggering percentage of pensions had been sold to those who would be worse off in retirement as a result. The public outcry over the "mis-selling" scandal forced the government to act. It established a review panel and ordered that all those who had been made worse off by taking out a personal pension be compensated by the seller. Over the next eight years, roughly 1.7 million people sought and received compensation that ultimately cost the insurance industry £12 billion. In addition, hundreds of millions were paid out in fines and penalties. It was the biggest financial scandal in the United Kingdom to date.

In retrospect, it is no surprise that personal pensions became controversial; the insurance industry, which would benefit most from their creation, was also the most influential in crafting their design. For advice, Fowler relied heavily on a small group that included the highly influential insurance executive Sir Mark Weinberg, who had launched three insurance companies. According to Fowler's former aides, no one influenced Fowler more than Weinberg. "In the main, Weinberg was the only person in the industry who Fowler had direct contact with," one former staffer says.

* * *

Today, another financial scandal looms, and this one could be bigger. It involves the United Kingdom's occupational schemes, long the backbone of retirement provision (they are the British equivalent of traditional U.S. pension plans).

The drop in real interest rates and the accompanying disappearance in high returns on equities have left most British occupational pension schemes in deficit. Employers sponsoring some 70 percent of all defined-benefit plans -- in which the retirement pay is a percentage of the final salary -- have shut their doors to new members. Instead, as with American 401(k) plans, employers are offering defined-contribution plans in which company contributions, per worker, are very much lower than those of the schemes they replace. They're unlikely to ever deliver anything like the old-style retirement benefits. What has made this abandonment particularly acute is that the United Kingdom was so confident of the strength of its occupational plans that Tory and Labour governments alike insisted that no insurance scheme would be necessary.

But the crisis within the occupational pension system has laid bare just how inadequate Britain's public pension schemes have been. Now, some 65,000 British workers have lost all or part of their pensions as a wave of insolvent employers are discovered to have left their pension schemes severely underfunded. Some do not even have the cash to pay the GMPs that were promised in exchange for tax rebates. A 1995 attempt at reform fizzled. Those who have lost out have discovered that they have nothing to fall back on except the basic state pension, which is now so miserly because of changes put in place during the first year of the Thatcher reign that those relying solely upon it for their retirement income are defined as destitute. And that GMP, which was meant to supplement the basic state pension? "The Guaranteed Minimum Pension turned out to be neither guaranteed nor a minimum," says Ros Altmann of the London School of Economics. "These people would have been better off keeping their money under the mattress."

This, then, is the situation in Britain today:

- According to the Department for Work and Pensions, in 2004 alone, 500,000 people abandoned private pensions and moved back into the state system. Government actuaries expect another 250,000 to contract back in this year.

- In 2004, the Association of British Insurers, the trade association representing the companies that sell the private accounts, made a collective decision not to risk any more allegations of mis-selling. It urged all of its member firms to warn those who had taken tax rebates to open private accounts that they might have made a bad choice. The advice was particularly aimed at older workers with fewer years until retirement.

- Many insurance companies -- the sellers of the private accounts -- have been writing their customers urging them to contract back in to the state system.

- And, of course, even the U.K. version of the U.S. Chamber of Commerce has endorsed the idea of raising taxes to increase benefit levels.

* * *

Pension policy threatens to become a key issue in the British elections in May. To be fair, the United Kingdom is hardly alone in facing a pension crisis. With sharp increases in life expectancy among the elderly and plunging fertility rates, every nation in the world will face similar challenges. Moreover, the demographic patterns are similar even in less-developed nations; Mexico, for instance, is forecast to have old-age life expectancy similar to that of the United States in a few decades' time.

But whatever the solution to that challenge, there is little disagreement within the United Kingdom that the path chosen by successive governments over the past 25 years is not the right one. The Pensions Commission recently completed the most comprehensive review ever of the U.K. system and concluded that there are only four possible solutions for the difficulties ahead: cutting state retirement benefits, increasing taxes, increasing savings, or delaying retirement. While noting that there is no political support for the first choice, the commission concluded that each of the three other choices, on its own, is too painful. Only some combination of them is likely to help Britain's elderly obtain retirement with dignity. Adair Turner, chairman of the commission, a vice chairman of Merrill Lynch in London, and the former director general of the United Kingdom's biggest business lobbying group, says, "There are no other choices."

And so, at the exact moment that America contemplates replicating this disaster, many in Britain -- some conservatives included -- are looking more and more kindly on American Social Security as a model for reform. The National Association of Pension Funds, a group of employers who sponsor the nation's largest schemes, is urging government not to expect the private sector to shoulder the burden of keeping the nation's elderly from poverty. Chief executive Christine Farnish notes that it's "actually cheaper for the state to carry the risk," adding that in looking for a system that offers the best combination of modest guaranteed retirement benefits delivered at low cost, the U.S. Social Security program seems the best model. "It doesn't have to make a profit, and it delivers efficiencies of scale that most companies would die for," she says.

And that is how the British eye, wearied after beholding decades of privatization "reform," views the American system, which has served the United States so remarkably well for seven decades but which supposedly is now in dire crisis and must be overhauled by the time the forsythia bloom. It's a point of view Americans would do well to take in.

Norma Cohen is senior corporate reporter at the Financial Times and is currently responsible for coverage of pension issues. This article was made possible by a grant from the Center for American Progress. Members of the press interested in talking with Cohen should contact Alison Leff at pr@prospect.org.