Pension Privatization in Britain: A Boon to the Finance Industry, a Boondoggle to Workers

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Proponents of Social Security privatization often claim that their motive is to help workers. Armed with sunny sales pitches and multi-million dollar marketing budgets, privatizers claim that individual accounts would give workers “better returns,” “freedom of choice,” and “improved efficiency.” Interestingly, though, these groups that are purportedly fighting for workers are not funded by workers, but by the finance industry. Given this potential conflict of interest, one might reasonably question whether privatization would really help working people or whether such reform would simply benefit Wall Street. Evidence from Britain, where the social security system was partially privatized more than a decade ago, suggests that the finance industry is the main beneficiary.

Background

The United Kingdom has a two-tier pension program. The first tier, called the basic state retirement pension (BSP) provides a modest flat-rate benefit. When it was originally implemented in 1908, the first tier did not require workers to pay in and only disbursed benefits to needy retirees. In 1925, the program was redesigned: the means testing requirement was dropped and contributions were mandated. Currently, the BSP provides a full benefit of approximately $105 in U.S. currency per week to all workers who contribute for the requisite number of years (44 years for men, 39 for women).

A second tier pension was added in 1961. Called “graduated pensions,” benefits for the program were based on earnings. Graduated pensions were designed to provide workers with modest benefits to supplement their basic state pensions.

The second tier was reformulated in 1978 when graduated pensions were replaced by the more generous State Earnings Related Pension System (SERPS). Similar to the U.S. Social Security system, SERPS is run on a pay-as-you-go basis (meaning that today’s contributions pay today’s retirees) and contributions and benefits are based on earnings. Workers earning less than the lower limit of $95 per week do not contribute to the system and are not eligible for benefits. Workers who earn more than the lower limit must contribute 2 percent of earnings up to $95 per week, plus 10 percent of earnings over $95 and below $719 per week. Employers also contribute between 3 and 10 percent of employees’ earnings. SERPS benefits replace approximately 25 percent of a worker’s pre-retirement wage, based on his or her 20 highest-earning years. Since the inception of the program, employers have been allowed to contract out of SERPS and substitute their own pension plans, provided they offered benefits at least as generous as the public program.

Individual Accounts
While limited opting out was permitted under the original SERPS legislation, the British government under the ideologically-driven Thatcher administration significantly expanded and encouraged this process.

In 1988, new legislation was implemented that allowed employees to opt out of SERPS (or occupational plans) and invest in individual retirement accounts called Appropriate Personal Pensions (APPs). The legislation also served to encourage opting out by cutting SERPS benefits. Under the legislation, the replacement rate of pre-retirement income will go from 25 percent in 1999 to 20 percent in 2009. In addition, benefits will be based on lifetime earnings, rather than a worker’s highest-earning 20 years (as was previously the case). To make opting out even more attractive, workers were offered generous incentives to contract out of SERPS and into APPs. [5]

This expansion of the opting-out process in Britain is notable in that it is the only example of pension privatization by a G-7 country. [6] All the other major industrialized democracies have chosen to maintain a single universal social insurance program for retired workers.

**Consequences of Privatization**

Britain’s experience with individual accounts has been troubling. None other than the business-oriented Wall Street Journal, in fact, headlined an article on the British experience: “Social Security Switch in U.K. is Disastrous; A Caution to the U.S.?” [7] While the Journal article mainly focused on a multi-billion dollar fraud scandal in which British pension sellers gave workers bad investment advice, others have critically noted the system’s unexpectedly high administrative costs and the growing income inequality among the nation’s workers. [8]

**The Mis-selling Scandal**

While proponents of privatization tout the freedom of choice that privatization would afford, they neglect to mention that a surfeit of options can be a double-edged sword. Workers who have the expertise or inclination may be able to pick out an appropriate plan. Workers who lack the know-how or desire to sort through the intricacies of pension policy, however, are left at the mercy of financial advisors.

The potential for confusion when confronted with the challenge of choosing an individual account is very real. According to James Shultz, professor of economics and aging policy at Brandeis University, a person selecting an APP in Britain must:

- select among “endowment,” “unit-linked,” and “deposit administration” schemes, each with a variety of variants. They can buy from life insurance companies, friendly societies, unit trusts (i.e. mutual funds), building societies, or banks. They must choose an “elected retirement date,” which, if different from the actual date, can result in a significant loss of benefits. They need to understand the key issues related to a pension’s “surrender value” and the large potential losses that might result from early termination. They need to be able to calculate and compare among competing products the widely varying administrative costs that are being charged. And they need to choose among the almost infinite kinds of “annuity” options offered at retirement. [9]

Given the complexity and tedious nature of the subject matter, workers are often tempted to forgo in-depth research and defer to the “experts.” Financial advisors, however, are not generally anxious to undertake pro bono work. Thus, the task of advising tends to fall to paid salespeople working for the various pension funds. These salespeople are not paid to give workers good
advice; they are paid to sell their company’s pension products. The reality of the situation, then, is that ill-informed workers are often left to deal with self-interested pension sellers. As one could well predict, fraud and exploitation are often the products of these unequal relationships.

According to the previously cited Wall Street Journal article, British regulators estimate that during the early 1990s more than two million workers (of the approximately 6 million workers enrolled in APPs) lost money due to bad financial advice in the so-called “misselling scandal.” Abuse in the system was rampant. A 1993 study commissioned by British regulators found, in a random audit, that 91 percent of 735 personal pension clients sampled received “unsatisfactory” or “suspect” advice. Service was so poor that in 35 percent of the cases, salespeople failed to even ask when the worker planned to retire before making a recommendation. According to the British newspaper The Guardian, total compensation due bilked workers may top $20 billion when all is said and done.

One might expect that in the wake of the tremendously bad publicity of the misselling scandal British workers would be given, at the least, a brief respite from predatory sales tactics. Unfortunately, this has not turned out to be the case. Coming right on the heels of the misselling scandal, pension industry regulators found that between 50,000 and 70,000 people were improperly advised to buy “free-standing additional voluntary contributions” (FSAVCs), also called “top-up” policies. Many workers bought into these private add-on accounts after being persuaded by salespeople that such plans provided the best mechanism for supplementing their company pensions. Regulators now say, however, that financial advisors misled workers and should have told them that they would have been much better off simply boosting contributions to their company plans. Defrauded workers are expected to share in compensation totaling $150 million.

While many workers fared dismally under the newly partially privatized system, pension brokerages enjoyed a windfall. These companies siphon off a significant portion of workers’ contributions in administrative costs and profits. Individual pension salespeople also did quite well under privatization. One salesman interviewed by the Wall Street Journal reported making $16,000 in commissions during his best week of sales.

High Administrative Costs

Advocates of individual accounts often infer that the administrative costs under a privatized system would be quite reasonable. The conservative Cato Institute, for example, asserts that administrative and money management expenses for private accounts would be approximately 1.17 percent to 1.83 percent of assets per year. Analysts in Britain, however, have found that these expenses average around 2.5 percent of assets—approximately double the proportion Cato projects. Over an average career and retirement, such fees reduce the value of an individual account by 25 percent.

Moreover, administrative and management costs represent only a fraction of the costs most workers bear under a privatized system. In Britain, a vast majority of workers also incur “alteration costs.” These expenses arise when a worker switches pension providers or temporarily stops making contributions to his or her account. The value of the typical British worker’s account is reduced by 15 percent due to these charges.

Retired workers also incur costs when purchasing annuities. In order to ensure that workers don’t outlive their savings, British law requires owners of APPs to purchase an annuity before they turn 75. The cost of purchasing these annuities reduces the value of an average account by approximately 10 percent. In discussing annuities, however, administrative costs are only part
of the story. It is also important to note that, depending on interest rates and life expectancy projections, the value of annuity benefits can vary widely. According to a recent article in The Guardian, Britons who retire in 2000 can expect to receive monthly annuity payments 42 percent less than those who retired in 1990 due to decreases in interest rates and increases in life expectancy projections.

Taken together, administrative/management costs, alteration costs, and annuity costs place a significant drain on workers’ savings. After accounting for interaction effects, Peter R. Orzag, a lecturer in economics at the University of California, Berkeley, estimates that these administrative fees and expenses cumulatively reduce the value of an average individual account in Britain by 43 percent. These considerable costs are made even more troubling by the fact that they disproportionately harm lower-income workers. A number of these costs are fixed, thus consuming an even larger percentage of low wage earner’s accounts. [17]

Income Inequality

Britain’s low-income workers and women are more likely to be enrolled in the public SERPS program than are higher-income workers or men. Currently, for example, 70 percent of those in SERPS earn half the average annual wage or less.[18] Under the partially privatized system, however, these workers face a conundrum.

If low-income workers or women opt out of SERPS and into individual accounts, they typically face proportionately higher administrative expenses due to their lower average account balances and more intermittent work histories. Women opting out, moreover, can expect to receive lower annuity benefits due to their longer life expectancies. If these same workers remain enrolled in SERPS, however, they must accept declining benefits as scheduled cuts in the public program (put into place to encourage opting out) take effect.

Under the British system as currently constructed, then, low-income workers generally (but women in particular) are damned if they do, damned if they don’t. Although most cuts in the public program have not yet been phased in, income inequality has increased over the past two decades and a number of analysts suggest that such inequality will rise dramatically as SERPS cuts are implemented.[19] In fact, British economists now predict that 33 percent of the nation’s elderly will be living in poverty by 2050 (in the U.S., by way of contrast, 10 percent of elderly currently live in poverty).[20]

Lessons for the U.S.

The Social Security privatization effort in the U.S. is being funded by a number of financial, investment, and insurance interests. The insurance company American International Group Inc., the State Street Boston Corp., American Express Corp., and the discount brokerage Quick & Reilly Group Inc., for example, have given $2 million to the Cato Institute to support the organization’s pro-privatization agenda. Dupont Co., Morgan Stanley & Co., and others have contributed nearly $1 million to Economic Security 2000, a group formed to try to develop grassroots support for privatization.[21] And these examples are just the tip of the iceberg: special interests have given millions more to dozens of other groups and candidates who support their privatization agenda.[22]

Although the finance industry would stand to make over $1 billion per year if even one-sixth of the U.S. Social Security system were privatized, their promotional material focuses on privatization’s purported benefits to workers. [23] In Britain, however, while pension fund profits have been strong, workers and retirees have fared poorly.
Owners of individual accounts in Britain have faced a number of problems that workers covered by the U.S. Social Security system have not had to contend with. Such problems include:

- **Fraud.** Since 1988, over 2 million APP holders in Britain have been defrauded in separate scandals. The U.S. Social Security program, in contrast, has not had a financing scandal during its 65 years of operation.

- **Exorbitant administrative costs.** Administrative costs and money management expenses on APPs average around 2.5 percent of assets per year. In the U.S., Social Security’s administrative costs are nearly two-thirds lower, averaging just 0.9 percent of net contributions. Workers purchasing APPs in Britain, moreover, incur alteration and annuity costs. Together, administrative, alteration, and annuity costs reduce the value of an individual account by 43 percent over a typical career and retirement. The U.S. Social Security program, which operates under a unified pay-as-you-go system, does not charge alteration fees and provides inflation-adjusted monthly benefits for life at no cost.

- **Increasing income inequality.** Due to cuts in public pension benefits and regressive administrative costs, economic inequality among the Britain’s workers is increasing. The U.S. Social Security system, on the other hand, has a progressive benefit structure that replaces a larger proportion of low- and middle-income workers’ wages. Social Security’s progressive payout formula helps to reduce the economic divide among U.S. retirees.

Given the problems Britain has had with individual accounts, privatizers’ extravagant claims should be viewed with skepticism. In evaluating arguments for privatization, we would do well to ask two questions: “Who is making the arguments?” and “Who stands to benefit?” In the U.S., the finance industry is funding the pro-privatization effort. Not surprisingly, evidence from Britain also suggests that the finance industry would be the primary beneficiary of privatization.

**Endnotes**


[5] The pension reform legislation was passed in 1986 to be implemented in 1988. Ibid.


i.e. see Peter R. Orzag, “Administrative Costs in Individual Accounts in the United Kingdom” and John B. Williamson, “Social Security Privatization in Other Nations.”


The Guardian, 12/18/99

The Guardian, 10/20/99


Peter R. Orzag, “Administrative Costs in Individual Accounts in the United Kingdom.”

Ibid.

Ibid.


Robert Dreyfuss, “The Real Threat to Social Security.”