

## Back to the state?: the public/ private mix in British old-age provision

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Projektleitung: Prof. Lutz Leisering PhD, Prof. Dr. Ulrike Davy

Christian Marschallek

**Back to the State?**

**The public/private mix in British old-age provision**

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Universität Bielefeld  
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Fakultät für Rechtswissenschaft

## Back to the State ?

### The public/private mix in British old-age provision

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<sup>1</sup> Christian Marschallek is a member of the research project “State regulation of private and occupational pensions in Europe” (REGINA) at the University of Bielefeld, Germany, funded by the German Research Foundation (DFG), coordinated by Lutz Leisering and Ulrike Davy ([www.uni-bielefeld.de/soz/regina](http://www.uni-bielefeld.de/soz/regina)). The author’s research is supported by a scholarship granted by the Research Network on Old Age Provision (FNA) of the Federation of German Pension Insurance Institutes (VDR) which is gratefully acknowledged.

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The author would like to thank the UK pension experts that took the time for an interview on that highly complex matter and his colleagues at the REGINA project as well as Carla Bethmann for their helpful comments on earlier versions of this paper and fruitful discussion. Remaining errors are those of the author.

**Postscript March 2009: I have corrected some factual errors, improved the English and, occasionally, clarified some points. The remaining errors are still my own. Also, this paper was never *updated* in any way since September 2005. Even then it only was a work in progress.**

## 1 Introduction

Compared to most other European welfare states the British pension system is characterized by low state pensions and a heavy reliance on (occupational and individual) private pension arrangements. The current UK government intends to shift the balance of state and private provision even further and to reverse today's 60:40 mix in the long run (DSS 1998). Despite two decades of pension reform that saw substantial cut-backs in contributory state pensions and an extensive promotion of private provision, the role of the state did not generally decline but even increased in some respect. The most significant example is probably the increasing state regulation of private arrangements for old-age provision. The once generous state incentives offered to make private provision more attractive have lost value. Both factors, among a number of others, are said to contribute to a so-called "savings gap":<sup>2</sup> The contributions paid towards (state or private) pension arrangements today are not sufficient to allow an appropriate standard of living for the bulk of tomorrow's pensioners. The savings gap is caused by both insufficient individual private savings and a trend towards less widespread and less favourable pension arrangements at the workplace, once the pride of the UK pension system. This causes many individuals once contracted out of the additional state pension in favour of private provision to return into the state scheme. While the UK government attempts to contain overall state expenditure for old-age, there is more money directed towards poorer pensioners, low earners and women by way of the new state second pension (S2P) and means-tested benefits. The latter are perceived by many observers to present a disincentive to private provision and thus to contribute to the savings gap. At the moment a lively debate surrounds the issue of higher state benefits as a prerequisite of a workable private pension regime helping to solve the current "pension crisis".

Thus, the challenges the British pension system is currently facing are finding an appropriate regulatory framework for private provision, coordinating the many

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<sup>2</sup> According to the ABI (2004) "7.4 million working people are still not saving at all for retirement and further 4.8 million are saving at too low a level to provide an adequate retirement income".

different pillars of pension provision, and reconsidering the role of the state as a pension provider.

What is the current role of the state concerning private pension provision in Britain? What are the issues surrounding the coordination of the complex public-private interface – meaning both the interaction between state and private benefits and the interference of public policy with private provision? Is more state – either as a provider or as a regulator – a prerequisite for more private provision? These are the questions I want to address in this paper. I will argue that, irrespective of significant steps towards pension privatisation, the role of the state is to a certain extent increasing.

Empirically my analysis draws partly on 31 expert interviews I conducted with decision makers, experts and influential actors in the field of old-age security in the UK in 2004/5. The interviewees were Members of Parliament (Conservatives, Labour) with a special interest in pensions, policy advisers to political parties, worked for government departments (DWP, Treasury, GAD), regulatory bodies (OPRA, OPB, FSA), for pension providers or in diverse organisations (NAPF, CBI, ABI, TUC, the Pensions Management Institute – PMI, the Society of Pension Consultants – SPC, the Investment Management Institute – IMA, the Association of Pension Lawyers – APL, Which? [formerly the Consumer's Association], PPI, The Association of Corporate Trustees – TACT, Age Concern, National Pensioners Convention - NPC, the Actuarial Profession, and the Association of Consulting Actuaries – ACA). Still, the views they expressed in the interviews did not necessarily represent those officially held by their organisations.

In the next part of this paper I will sketch out the UK pension landscape of the early 1980s (2), and illustrate the changes leading to the current arrangement (3). I will then discuss the role of the state in the UK pension system (4), before closing with some concluding remarks (5).

## 2 The British Pension Landscape of the early 1980s

“The United Kingdom pension system is complex – arguably the most complex of any industrialised economy” (HoL 2003: 45). Indeed, it has been suggested that it is in fact rather a patchwork than a system, with not all of its parts smoothly fitting (cf. Ward 2003: 268). Coupled with the long time period I am referring to, this necessitates a rather lengthy description of the UK pension arrangements. Its broad outlines are summarized in figure 1.

**Figure 1: The UK Pension Landscape After 1978**

1 <sup>st</sup> tier (state, mandatory)	2 <sup>nd</sup> tier (state or private, mandatory)	3 <sup>rd</sup> tier (private, voluntary)
<ul style="list-style-type: none"> <li>- <b>Basic State Pension (BSP)</b></li> <li>- <b>means-tested benefits</b> <ul style="list-style-type: none"> <li>- Income Support</li> <li>- Minimum Income Guarantee (since 1999)</li> <li>- Pension Credit (since 2003)</li> </ul> </li> <li>- other state benefits</li> </ul>	<ul style="list-style-type: none"> <li>- <b>state</b> <ul style="list-style-type: none"> <li>- SERPS (until 2002)</li> <li>- State Second Pension (S2P) (since 2002)</li> </ul> </li> <li>- <b>private (contracted-out)</b> <ul style="list-style-type: none"> <li>- occupational pension (salary-related = DB), or</li> <li>- occupational pension (money purchase = DC or mixed benefit, since 1988), or</li> <li>- personal pension (DC, since 1988), or</li> <li>- stakeholder pension (DC, CAT-standards, since 2001)</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>- <b>Additional Voluntary Contributions</b> to occupational pensions, personal pensions, or stakeholder pensions</li> <li>- other forms of savings and insurance</li> </ul>

The foundations of the post-war British pension system were laid in 1946 when the National Insurance Act introduced a Basic State Pension (BSP) which has since remained largely unchanged. It is financed by National Insurance contributions (NICs) paid by employees and their employers and by the self-employed. While NICs are earnings-related<sup>3</sup>, the BSP is flat-rate. The level of the Basic Pension is dependent on NICs only with respect to the length of the contribution period, but not on the amount of NICs paid. A full Basic Pension is available after contributing (or

<sup>3</sup> Only the self-employed pay flat-rate contributions.

being credited with NICs)<sup>4</sup> for 44 years (men) or 39 years (women).<sup>5</sup> For those with shorter contribution histories the Basic Pension is reduced accordingly, with the minimum of a quarter of the full amount available after 9 years of contribution (men: 14 years).

BSP was payable from State Pension Age, at the time age 60 for women and age 65 for men. Until 1980 a full BSP equalled roughly 20 per cent of average earnings and it was increased in line with average earnings or retail price inflation, whichever was the greater. From 1980 it was only raised in line with retail price inflation, thus losing value in relative terms, since wages grew faster than prices. The low level of benefits meant that even a full BSP was below the level of means-tested Income Support.

On top of the BSP the 1975 Social Security Pensions Act introduced the State Earnings-Related Pension Scheme (SERPS), again financed by NICs. Entitlements towards SERPS could only be built up by employees and only on band earnings between the Lower Earnings Limit (LEL) and the Upper Earnings Limit (UEL). These 'reckonable earnings' were revalued in line with the rise of average earnings in the whole economy until retirement. A full SERPS pension originally provided a quarter of an individual's average revalued reckonable earnings. In order to make SERPS mature more rapidly, benefits were based on the best 20 years of earnings since its introduction in 1978. After retirement SERPS was indexed to prices. SERPS benefits were available from State Pension Age.

The UK has a strong tradition of occupational pension provision. The pension plans are usually set up by the employer as trusts. Hence, unlike the classical occupational pensions in Germany, the scheme's assets are independent of the sponsoring

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<sup>4</sup> "Credit will be given if, for instance, an individual is entitled to Statutory Sick Pay or Statutory Maternity Pay, or are aged 16, 17 or 18 and in fulltime education, or for men aged 60 or over" (PPI 2005: 13).

<sup>5</sup> The number of years can be reduced due to Home Responsibilities Protection (HRP). "[It] was introduced in 1978 and reduces the number of years of contribution required to secure a full BSP. Protection can be given for those complete tax years where an individual is caring for children, or an older or a disabled person. If a woman cares for a child until age 16 the requirement for a maximum BSP would reduce from 39 qualifying years to 24" (PPI 2005: 13).

When the pension age for women will be raised to 65 between 2010 and 2020, the number of years necessary for a full BSP will be increased accordingly.

company, which has to make up for possible deficits. Employers could make membership in their pension scheme a condition of employment. The schemes were overseen by the Occupational Pensions Board (OPB). The board members were representatives of employers and employees and of the actuarial profession. The OPB also served as an advisory body on pensions policy for the government (see Bonoli 2000: 61).

Occupational pension arrangements were tax privileged. Pension contributions up to a limit set by the Inland Revenue (IR) were tax exempt. Capital gains of pension funds were tax-free, too, provided the funding level did not exceed the IR limit of 105 per cent of the Projected Benefit Obligation.<sup>6</sup> Fund surpluses above these limits had to be reduced within five years by means of increased benefits or reduced contributions (often in the form of so-called contribution holidays) to sustain the tax approved status. Pension benefits were taxable but a part of them could be taken as a tax free lump sum. Additionally, pensioners enjoyed higher tax allowances and were likely to be in a lower tax band.

When the SERPS predecessor, the Graduate Pension,<sup>7</sup> was introduced, all occupational pension schemes fulfilling some fairly basic standards were given the right to contract-out of the additional state scheme in order to maintain strong occupational provision. But membership of these plans tended to be skewed towards male white-collar employees in larger enterprises and in the public sector. The state scheme was thought of as a fall-back option for those without access to occupational schemes.

Once established, the contracting-out option continued under SERPS, provided these schemes offered a so-called Guaranteed Minimum Pension (GMP), that is, roughly the same entitlement as under SERPS. Hence, only defined-benefit plans (so-called salary-related schemes) could contract-out. Contracting-out resulted in a National Insurance contribution rebate, representing the SERPS entitlements given up. The

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<sup>6</sup> The limits concerning the Projected Benefit Obligation set for tax purposes must not be confused with the much lower Minimum Funding Requirement (MFR) introduced by the 1995 Pensions Act (see below).

<sup>7</sup> The Graduated Pension was negligible and its value was eroded due to high inflation. There was no indexation of benefits before 1975 (O'Higgins 1986: 112).



function of SERPS in the British pension landscape was thus threefold. It provided an earnings-related pension for its members and it established a minimum standard for the contracted-out arrangements. Its third function was the most remarkable: SERPS served as a top-up for those with contracted-out occupational provision. Even though someone might have contracted-out, s/he would still be entitled to her/his SERPS pension less the GMP. “[T]he GMP refers to the occupational scheme’s obligation, but not to the employee’s entitlement. Whether contracted in or out, an employee is statutorily entitled to the amount that would have been payable under contracted-in provision” (O’Higgins 1986: 138). Unlike SERPS, the GMP did not have the best 20 years rule. The indexation of earnings during working life was less complete under GMP than under SERPS, particularly for those changing jobs frequently.<sup>8</sup> Survivor’s benefits were less generously calculated. Finally, there was no requirement for an indexation of the GMP after retirement. Since SERPS was inflation-proofed, the state scheme actually provided price indexation for contracted-out occupational schemes (O’Higgins 1986: 138). “This leads to the curious result that those who opt for private occupational provision by contracting out may still receive the majority of their second tier pension from the state” (O’Higgins 1986: 140).

Thus Whiteside (2003: 31) concludes: “The state not only permitted contracting out, but underwrote the viability of the schemes that chose to do so – a move that extended public liability in an unprecedented fashion.”

O’Higgins concludes in his analysis that “the label ‘private provision’ is a misnomer because it conceals a complex mix of public and private finance.” (O’Higgins 1986: 140f.). One could not possibly argue with that assessment. But still the regulatory framework of private occupational pensions was relatively weak, and there was a clear commitment by the state as to how much it was willing to provide. Over the next two decades both features of the arrangement were about to change. The state promise as well as the regulatory framework for private provision were to alter frequently. Whereas the former was to be frequently reduced the latter would tend to densify. The complexity of the public/private interaction was to become impenetrable. I will now turn to the changes that have occurred.

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<sup>8</sup> For details see O’Higgins (1986: 138) with further reference.

### 3 Two Decades of Pension Reform

#### 3.1 Increasing the scope of private provision, part I : The 1985/86 reforms

The Conservative Thatcher government was concerned about the future cost of SERPS introduced by its Labour predecessor. In a policy Green Paper entitled “Reform of Social Security” (DSS 1985 a, b) it proposed to abolish SERPS in favour of “a system in which everybody is able to contribute either to an occupational pension scheme or to a personal pension” (DSS 1985a: 24). The government made clear that they wanted more than *just* to cut back the state scheme: “The Government accept the need to tackle the open-ended commitments of SERPS. *But we do not believe it would be right to respond on a purely negative basis by simply ending or restricting SERPS without putting anything in its place.*” (DSS 1985b: 5; my italics).<sup>9</sup>

The original plans to put an end to SERPS faced opposition by some organisations such as Age Concern, the Trade Union Congress (TUC), the Labour Party and, perhaps more surprisingly, by the Confederation of British Industry (CBI), the National Association of Pension Funds (NAPF) and even the Treasury (Bonoli 2000: 71ff.). Consequently in its subsequent White Paper (DSS 1985c) the government aimed merely at containing the future costs of SERPS and at widening the scope of contracting-out, but it left the scheme in existence.

The changes to SERPS were to be phased in over a transitional period until 2010. The best 20 years rule was eradicated. SERPS was now to be calculated based on lifetime earnings. The level of SERPS was reduced from 25 per cent to 20 per cent of revalued reckonable earnings. SERPS rights inherited by surviving spouses were reduced from the full to the half amount of the member’s pension (just as under the GMP). Contracted-out occupational pension funds now had to inflation-proof GMPs up to 3 per cent, thus reducing the amount of SERPS benefits payable to those who contracted-out (see DSS 1985c: 4).

In order to expand the scope of private provision, contracting-out was extended to occupational plans working on a defined-contribution basis (so-called money

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<sup>9</sup> Interestingly, a similar argument was put forward in Germany in the wake of the 2001 pension reform.

purchase schemes). Since these schemes did not promise a defined level of benefits, the GMP was not applicable as a contracting-out criteria. Instead, a minimum contribution equal to the contracting-out rebate was prescribed as a condition for leaving the state scheme. The pension fund had to be used to buy an annuity at retirement. The part of the pension pot generated by the minimum contribution, called “protected rights”, had to be used to buy an unisex annuity<sup>10</sup>, indexed at least up to an inflation of 3 per cent and a 50 per cent reversion for a surviving spouse (Daykin 2001: 2) in order to match the provision under SERPS. While salary-related schemes meant an open-ended liability for the employers, money purchase schemes allowed them to know the cost of their promise in advance. It was expected that this would foster the set-up of industry-wide schemes and encourage smaller employers to offer occupational pensions.

Personal pensions, individually purchased from insurance companies, banks and other investment companies on a defined-contribution basis, were also established. They became a further way to contract-out of SERPS in order to allow them “to compete fairly with the state and occupational schemes” (DSS 1985c: 15). Again, at least the contracting-out rebate had to be paid in.<sup>11</sup> Pension scheme members were given the right to pay additional voluntary contributions (AVCs) above the prescribed minimum in order to boost their pension entitlements. But all too often members did not do so, resulting in large numbers of so-called rebate-only personal pension plans. Again, the aforementioned conditions applied to the protected rights part.

Personal pensions were thought to improve individual choice and the portability of pension rights for job changers. It was no longer possible for employers to make membership in their occupational pension funds a condition of employment.

The conditions for job changers had already been improved by the Conservative government when it established that pension rights of early leavers had to be

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<sup>10</sup> Usually, annuity rates for men are more favourably than those for women due to the differences in life expectancy.

<sup>11</sup> Technically, both employee and employer continued to pay full NICs. The rebate was then transferred by the tax authorities to the personal pension plan. This procedure was chosen to reduce the administrative burden on the employer.

increased in line with prices (up to 5 per cent). Everyone leaving a scheme had now the right to receive a transfer value representing his deferred pension rights which s/he could put in a new scheme, a single premium annuity or a personal pension,<sup>12</sup> and schemes were required to disclose relevant information to their members (DSS 1985c: 5). In addition to the contracting-out rebate there was also tax relief on contributions towards a personal pension.

In its attempt to encourage private provision the UK government offered substantial financial incentives. Employers setting up new schemes and individuals taking out a personal pension for the first time were given an additional national insurance rebate, amounting 2 per cent over and above the standard rate, for a five year period. (DSS 1985c: 5).

The 1985 White Paper stressed the importance of investor protection for personal pensions to encourage more occupational and personal pensions. “People have a right to know that the savings on which their income in retirement will depend are properly safeguarded” (DSS 1985c: 17). Particularly, a new financial services legislation “should protect the public against overselling by the use of misleading projections of returns.” (DSS 1985c: 17). In order to safeguard the money locked away in personal pensions the schemes had to be approved by the OPB. “The Board’s main concern will be that people holding personal pensions will be properly protected, while ensuring that the rules are as simple and flexible as possible. They will be responsible for seeing that personal pensions comply with government regulations, meet appropriate investment standards and offer compensation in the event of negligence, fraud or theft” (DSS 1985c: 17).

### **3.2 Securing the pension promise: The 1995 Reforms**

The promotion of private pensions by the Thatcher government had – in some ways – been surprisingly successful. About ten years after the 1986 reforms roughly one half of the employees who had been members of SERPS in 1985 had left the scheme.

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<sup>12</sup> Before that it was estimated that only 5 per cent of job changers had their pension entitlements transferred to the new employer. 75 per cent only retrieved their own contributions (i.e. without the employers part or any interest). The remainder were entitled to a deferred pension. In this case future wage increases were not taken into account when calculating entitlements (Bonoli 2000: 64).

68 per cent of employees had contracted-out, and only 17 per cent remained in SERPS<sup>13</sup> (Budd and Campbell 1998: 100). Originally, the Department of Social Security (DSS) had assumed that about half a million people would take out personal pensions, but as early as by the end of April 1990 four million had been sold (Budd and Campbell 1998: 110). As Taylor-Gooby (2005: 122) remarks: “An advertising scheme for the new pension settlement (budgeted at £2 million) was deemed unnecessary.” Due to the incentives granted, the unexpected demand for personal pensions was quite costly for the government.

Unfortunately, the promised safeguards for investors proved to be much less successful. Tempted by the additional 2 per cent incentive and/or ill-advised by salespeople, some hundreds of thousands people who had better remained in the state scheme because of low income or discontinuous careers opted for a personal pension. Additionally, between 1988 and 1993 about half a million members of occupational schemes moved to personal pensions.<sup>14</sup> As many as 90 per cent of these were given inappropriate advice. Although often staying with the same employer, they moved to a personal pension to which the employer did not contribute and which took a significant part of the transfer value in commission and administrative charges<sup>15</sup> (Blake 2003: 334). These proceedings came to be known as the mis-selling of personal pensions.

The safeguards proposed in the 1985 White Paper proved to be insufficient in another incident, too, even though this one was not a result of the 1985/86 reforms. By the end of 1991 it turned out that Robert Maxwell, the glamorous media tycoon, had misappropriated money from the occupational pension funds of his companies, such as the Mirror Group, in an attempt to restore the solvency of other companies under his control, to boost share prices and to keep his diverse businesses running. As the investigation of the Department for Trade and Industry noted “Mr Robert

<sup>13</sup> The remainder were neither members of SERPS nor of a contracted out arrangement mainly due to an income below the Lower Earnings Limit (Budd and Campbell 1998: 100).

<sup>14</sup> The extra rebate was only available to former SERPS members in order not to encourage members of occupational schemes to leave their employers’ plans (Bonoli 2000: 79).

<sup>15</sup> Blake quotes the example of a miner who transferred to a personal pension in 1989, five years prior to his retirement. Instead of a lump sum of £5,125 and a pension of £1,791 from his former

Maxwell had always regarded the pension funds as his [... and ...] ran his companies and the pension funds as if they were one" (DTI 2001: Summary). After Maxwell's mysterious death the pension funds were found to be severely underfunded and their members were at risk of losing what had been promised to them.

This incident caused a public outcry and severe concerns about the governance of pension schemes and the security of pension money. In due course the Pension Law Review Committee, chaired by Roy Goode, was given the task of reviewing the legal framework of private pension provision. In its report it pointed out that the law should seek to protect the "pension promise", i.e. the scheme members' "reasonable expectations" that their accrued rights are protected and benefits will be provided according to the scheme's rules and legal requirements (Pension Law Review Committee 1993: 10). The Committee proposed the set-up of a pensions regulator, better protection of rights accrued in the past, member participation on the trustee board, better and clearer information to members, minimum solvency requirements and a compensation scheme to cover scheme deficits arising from fraud, theft or misappropriation. These proposals became part of the 1995 Pensions Act.

The Act set up the Occupational Pensions Regulatory Authority (OPRA) to replace the OPB and take over its responsibilities except for the advisory role. OPRA was given extensive powers, e.g. to remove and appoint pension scheme trustees under certain conditions, to wind-up or modify schemes under specific circumstances and to impose penalties for misconduct. OPRA also had far-reaching investigative powers, such as to require trustees, managers or professional advisers of a scheme or the sponsoring employer to produce any scheme-related document, to enter premises where scheme members are employed, scheme-related documents are kept or the scheme administration is carried out and to question any person on those premises (Blake 2003: 342).

For salary-related schemes the 1995 Pensions Act introduced a minimum funding requirement (MFR) as to make sure the assets of a scheme match its liabilities. If the scheme was running with an underprovision of up to 10 per cent the shortfall would

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occupational pension he received only £ 2,576 as a lump sum and a monthly pension of £734 from his

have to be restored within five years. A serious underprovision of more than 10 per cent would have to be reduced to no more than 10 per cent within three years time (Blake 2003: 345f.). Still, the MFR as it was calculated offered “only a 50 – 50 chance that an active member will obtain their full entitlement. Changes in the investment market mean that it is now even lower than intended” (Ward 2003: 274).

Scheme members were given the right to nominate one third of the trustees (at least one in small schemes and two in larger plans with more than 100 members) who cannot be removed by the employer without the consent of all other trustees (Blake 2003: 344).

A Pension Compensation Board was established to provide compensation if a scheme’s assets were reduced by an illegal act and the employer was insolvent. Payments were limited to 90 per cent of the loss or the amount necessary to restore the scheme to 90 per cent of the MFR.

The 1995 Pensions Act went beyond mere reactions to the Maxwell fraud. Again, measures were taken to reduce the cost and thus limit the generosity of SERPS, by changing the formula for the calculation of benefits. The method of revaluation of earnings under SERPS was modified, in order to prevent earnings below the LEL to generate entitlements as under the previous calculation rules (for details see Budd and Campbell 1998: 111). Additionally, following a ruling of the European Court of Justice, the pension age of men and women was equalised. Subsequently, the state retirement age for women was to be raised to 65, gradually phased in over a period between 2010 and 2020.

The GMP was abolished in favour of a reference scheme test.<sup>16</sup> This finally put an end to the (partial) inflation-proofing of salary-related occupational pension schemes by SERPS. At the same time occupational funds were now generally required to provide a limited price indexation of benefits up to 5 per cent per year.

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new scheme (Blake 2003: 334).

<sup>16</sup> The reference scheme, to which benefits have to be broadly equivalent, accrues 1/80<sup>th</sup> per year of service on 90 per cent of reckonable earnings averaged over the last three years of service (Davis 1997: 28).

The obligation for personal pension holders to buy an annuity at retirement was relaxed by the 1995 Finance Act. It was now possible to postpone annuitisation until the age of 75, without losing tax privileges. In the meantime part of the pension pot could be accessed by means of income drawdown.

### **3.3 Increasing the scope of private provision, part II: The New Labour reforms**

The Labour Party was strongly opposed to the Conservative pensions policy of the 1980s and 1990s, particularly to any attempt to abolish SERPS. However, when New Labour eventually came to power they followed the route of their predecessors in many respects. After the Blair government took office in 1997, their major reforms of the pension system were the replacement of SERPS by a State Second Pension (S2P), the introduction of Stakeholder Pensions (a kind of no-frills personal pension aimed at moderate earners) and the implementation of a means-tested Minimum Income Guarantee, soon to be replaced by the more sophisticated Pensions Credit. They also strengthened the regulation of pensions and other financial services by establishing a single Financial Services Authority (FSA).

The replacement of SERPS by the S2P in 2001 had two intentions: to improve benefits for low earners and – in the long run – to make S2P unattractive to anyone earning above a Lower Earnings Threshold (LET) set at roughly £9,000 annually<sup>17</sup>. The accruals were raised for everyone with earnings below the Upper Earnings Threshold (UET) of £18,500<sup>18</sup> in a way that benefited those on lowest earnings most. Unlike SERPS, which only had a single accrual rate, S2P had three different accrual rates on (future) band earnings.<sup>19</sup> Those earning between the LET and the UET were deemed as earning as much as the LET under S2P, which significantly improved their pension prospects.

S2P is particularly beneficial for those who take time off work to raise children or to care for disabled relatives. For the first time, these people, mostly women, may build

<sup>17</sup> 1998 figure.

<sup>18</sup> 1998 figure. The earnings thresholds (LET, UET) were to be raised in line with earnings. The UET roughly equals average earnings.

<sup>19</sup> The accrual rates were 40 per cent for reckonable earnings below the LET and 10 per cent between LET and UET. For earnings between the UET and the UEL the accrual rate of 20 per cent remained as under SERPS (accrual rates assume full working life).



up entitlements to the additional state pension. This applies for each full tax year (i.e. April to April) not working at all, or earning less than the LEL while looking after a child aged under six for which they receive Child Benefit, or looking after an ill or disabled person if certain conditions apply.

In the long run it is intended to turn S2P into a flat rate benefit at the level envisaged for people earning at the LET, while contributions are to remain earnings-related. Thus, it would no longer be reasonable for anyone earning above the LET to be a member of the state scheme. The then Secretary of State for Social Security, Alistair Darling, made clear that “it is my intention to ensure that we amend the system further, so that, if people stay in the state system, they will lose money, and they would be far better off in a funded scheme” (Darling 1998). But, up to now no measures have been taken to implement that last step. Still, the price indexation of the UEL entails a creeping tendency towards a flat rate benefit. After all, New Labour (almost) succeeded in doing what even the Conservatives did not dare: putting an end to state earnings-related pensions in Britain.

Those who were still members of the S2P but earned above the LET were expected to contract-out into a private pension. In line with the higher benefits of S2P they would give up, contracting-out rebates were to be increased for persons in the respective income band. Those contracted-out may still qualify for an top-up from the state scheme, reflecting its greater generosity.<sup>20</sup> To make contracting-out more attractive for low to moderate earners so called stakeholder pensions “designed to be simple, cheap and easy to understand” (Ring 2005: 355) were introduced in 2001. These are, basically, a form of personal pensions which have to fulfil some minimum standards in respect to cost, access, and transparency (hence called CAT standards). Charges are capped at 1 per cent<sup>21</sup> of the fund, there are no penalties for starting or stopping contribution or transfers to another scheme, the scheme has to accept contribution payments of as little as £20 and employers with more than five employees who do not offer an occupational scheme or contribute towards a (group) personal pension

<sup>20</sup> The calculations differ for occupational and personal (including stakeholder) schemes.

<sup>21</sup> Since April 2005 the price cap over the first 10 years is 1.5 per cent. As Wynn (2001) suggests there may well be additional charges that are not capped.

for their staff have to designate a stakeholder scheme and enable their employees to make contributions directly from their pay (Emmerson 2003: 174). Since stakeholder pensions have to comply to a given set of standards, they may be sold under a simplified advice regime since April 2005.

The introduction of S2P and stakeholder schemes did nothing to alleviate the situation of poorer pensioners entitled to means-tested Income Support. Instead of raising the BSP,<sup>22</sup> the New Labour government introduced a Minimum Income Guarantee (MIG) to improve the income for those on lowest means. The MIG was set at £75 per week for a single pensioner (£116.60 for a couple),<sup>23</sup> well above a single person's full BSP of £67.50 at that time. The MIG was to be increased in line with earnings while, on the other hand, BSP was only inflation indexed. Thus, the gap between the two is going to grow wider over the long term. The advantage was that the income of the poorest pensioners could be raised at a substantially lower cost than with an increased BSP which would have benefited better-off pensioners as well. MIG was means-tested and had to be claimed. Consequently, there was a gap between the number of pensioners entitled and of those actually claiming it (see Blake 2004: 29).

Introduced in 1999, MIG was reformed in October 2003 by the introduction of the Pensions Credit, consisting of two elements. The first, called Guarantee Credit, replaced the MIG while the second, called Savings Credit, was intended to ensure that people with modest savings are better off than those without. The MIG/Guarantee Credit is available from state pension age but the Savings Credit can only be claimed from age 65.

"For every £1 of income received that is above the level of the full BSP but below the level of the Guarantee Credit, the Savings Credit pays an additional benefit of 60p. The credit is then 'tapered down' for additional income above the Guaranteed Credit level" (PPI 2005: 3f.). Unlike the MIG, which in effect had a withdrawal rate of 100 per cent on savings in excess of the MIG, the Pension Credit's withdrawal rate is only

<sup>22</sup> Still, in 2001 and 2002 there have been increases to the BSP above inflation.

<sup>23</sup> Figures for 1999/2000.

40 per cent.<sup>24</sup> However, all pensioners without a full BSP, aged below 65 or in receipt of other means-tested benefits (e.g. housing benefit, council tax benefit) still face a withdrawal of up to 100 per cent of their savings.

The New Labour government also tightened the supervision of pension provision. In 1997 a Financial Services Authority (FSA) was created and given far-reaching responsibilities. Subsequently the FSA took over the tasks of a wide range of self-regulatory bodies set up by the financial services industry itself (see Foot 2004). The FSA's objectives are the maintenance of confidence in the financial system, the promotion of public understanding of the financial system, the securing of the appropriate degree of protection for consumers and the reduction of financial crime (FSA 2005). Still, the regulation of the governance of occupational pension schemes remained within the realm of OPRA. For stakeholder schemes there is a shared responsibility. Whereas OPRA is concerned with their governance, the FSA regulates the marketing of and advice on stakeholder pensions and authorises and supervises the fund managing firms.

### **3.4 Simplification and the protection of pension rights: The 2004 reforms**

In recent years there have been growing concerns about companies becoming insolvent and leaving behind an occupational pension scheme insufficiently funded to meet its liabilities. As the MFR was calculated on the assumption of an ongoing scheme even pension schemes funded by more than 100 percent of the MFR were affected. The consequences of underfunding became even more severe due to the statutory winding up priority order that gave pensioner's benefits, including future increases, priority over the entitlements of active members, so the remaining assets were unevenly distributed among the scheme members. Many employees close to retirement found that after decades of paying contributions the pension they had expected had virtually disappeared.

The government reacted and introduced a Pension Protection Fund (PPF). The PPF is going to compensate for scheme underfunding in the event of employer insolvency,

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<sup>24</sup> This withdrawal is seen by many commentators as a form of tax on savings. In this perspective, 40 per cent equals the higher tax rate, reserved for rather well off people.

so each member will still receive the bulk of her/his entitlements. For those above the scheme's normal retirement age or already receiving benefits the compensation level will be 100 per cent, for the remaining scheme members it is set at 90 per cent subject to an overall benefit cap. The PPF will also take over the responsibilities of the Pensions Compensation Board. The PPF is funded by a mainly risk-based levy charged on all eligible schemes but is not underwritten by government (see PPF 2005, DWP n.d. b).

For schemes wound up due to employer insolvency before 6 April 2005 when the PPF became operational, the 2004 Pensions Act established a Financial Assistance Scheme (FAS) funded by £400 million of public money over 20 years. The benefits available under the FAS will be capped at £12,000 a year (DWP n.d. a), leaving many members without a full compensation for their losses.

The 2004 Pensions Act also intended a simplification of the regulatory framework. OPRA was replaced with a new Pensions Regulator (PR), following proposals of the Pickering Report on the simplification of private pension provision (Pickering 2002). The report pointed out, that OPRA had to focus on detailed compliance, but was limited in its ability to exercise judgement, to advice pension scheme professionals or to comment on the ambiguities within the regulatory framework (Pickering 2002: 8). The PR was therefore set up to work with a proactive, risk-based approach to impose lighter touch regulation on well run schemes.

The 2004 Finance Act saw a radical simplification of the tax arrangements for pensions. A plethora of eight different tax regimes on pensions savings was turned into a single one. Instead of age-related annual contribution limits a single lifetime limit of £1.5m and an annual limit were introduced on tax free pension contributions.

#### **4 The Role of the State in the UK Pension System**

As the previous discussion shows, the current state of the British pension system is characterised by high complexity and widespread confusion. To some extent this is caused by the interrelation of public and private elements. That means, firstly, private provision is to a large extent shaped by public policy and, secondly, changes

to one part of the system are very likely to cause intended or unintended consequences for the others as well.

For two decades successive UK governments – Conservatives as well as New Labour – attempted to shift the public/private mix in old-age security towards the private side. The level of contributory state pensions (BSP, SERPS) was eroded. This was accompanied by active measures to promote non-state pensions, namely the regulation of private provision, incentives and cost sharing offered by the state and attempts at consumer education. The pension reforms of the last 20 years eventually challenged the coordination of public and private provision. The state's role as a pension provider is likely to be extended again. To some degree this is the result of political intention, but it is also an (unintended) consequence of policy measures and changing circumstances.

#### **4.1 State benefits**

Many measures have been taken to contain the benefit level of the National Insurance pensions. Since 1980 the BSP is only linked to inflation and thus state pensions lose value in relation to earnings. SERPS has been cut back several times under Conservative governments; and since contribution limits were also price indexed, it was due to lose further value.

The overall aim of the New Labour pension policy was to provide state pensions primarily for those in greatest need and to expand private provision for all others: "Those who are able, should save what they can for their retirement. The Government should support those who cannot save and regulate the pension system effectively. The private sector should provide affordable and secure second pensions" (DSS 1998: 3). In the long run the government expected their measures to lead to a situation where about 60 per cent of pensioner income would be derived from private sources and only 40 per cent from the state, thus reversing the current public/private mix (DSS 1998: 8, 31f, 103).

For those defined as unable to save, the conditions of the state scheme have been improved substantially when SERPS was replaced with S2P by the New Labour government. The new rules benefiting parents and carers are likely to be particularly

advantageous for women. The proposed transformation of the State Second Pension into a flat rate benefit will, over the long term, reduce S2P entitlements for all but low earners.

While National Insurance pensions were generally declining – the S2P improvements will not be significant in the short-to-medium term – non-contributory means-tested benefits grew in importance for UK pensioners. The New Labour government introduced the MIG and the Pensions Credit, thus raising the pension income of those most in need but also the number of persons eligible. Following the introduction of the Pension Credit an estimated 58 per cent of all households with the oldest person aged 65 or over are entitled to at least one form of means-tested benefit Banks *et al.* (2002). The ratio is even higher (74.1 per cent) for families with the oldest member aged at least 75. Before the Pension Credit was implemented the figures amounted to 51.4 and 66.2 per cent respectively. The dependency on means-tested benefits is particularly high amongst women. For instance, three quarters of single women aged 60 or over are entitled (Banks *et al.* 2002: 14f.). “A total of 1.3 million families containing an individual aged 65 or over, or 36% of those eligible for the pension credit, were not previously entitled to the MIG.” (Brewer and Emmerson 2003: 5). The dependency on means-testing is expected to grow further in the future. Estimates for the ratio of pensioners entitled to income-assessed benefits in 2050 range from 65 to 80 per cent (HoL 2003: 47).

Hence, the growing dependence on means-tested benefits together with the (proposed) changes to S2P strengthened the elements of interpersonal redistribution within the system of state old-age benefits at the expense of the elements of mere inter-temporal redistribution. But there is a lack of coordination between state and non-state arrangements. The absence of an adequate non-means-tested minimum pension makes it difficult for an individual to judge whether additional private provision is worthwhile. As mentioned before, even with the Pensions Credit poorer pensioners face withdrawal rates of up to 100 per cent on their savings. Those who think themselves likely to receive the Pensions Credit later in life may conclude that saving today, they will not be much better off in the future. Often, people will not engage in detailed calculations. But if they consider buying a pension product the

salesperson will probably advise them not to do so because the adviser fears accusations of mis-selling later on.

One of the difficulties for the intermediaries trying to sell private pension provision is that at the moment we've got a government offering... , it seems to be moving towards means-tested benefits in retirement. So if you don't know what the level of those is going to be, the great fear of the financial advisors and the apprehensive individuals they advise is, for the relatively low paid, if you save during your career and end up simply earning a private pension and losing state means-tested benefit, what have you gained? (expert interview 1.3, pensions-related professional association)

Warner (2002) goes even further when he argues that "if stakeholder pensions had been a success among the people it was supposed to be targeting – the lower paid – the Government would be heading for the mother of all mis-selling scandals. The effect for the low paid saving small amounts of money through stakeholder would be only to deprive themselves in retirement of the equivalent in means-tested state benefit. There is no point in this group of people saving."

A further problem with the means-tested approach is the take-up level of these benefits. According to figures by the DWP, up to one third of those eligible for the MIG are not claiming the benefit (DWP 2005: 19), particularly if the entitlements are rather small and may not be regarded worth claiming by the entitled (DWP 2005: 22). The lack of adequate non-means-tested state pensions is partly detrimental to private provision and the British pension system will leave many pensioners with insufficient incomes from both state and non-state sources (see below 4.6).

## 4.2 Regulation

"To encourage the purchase of personal savings and pension products, government has extended official controls over marketing, sales, and customer relations, raising the administrative costs of an increasingly complex system and stimulating legal debates over whom (if anyone) should compensate for market failure." (Clark and Whiteside 2003: 13).

The increasing regulation of private pensions was motivated fiscally – aiming at the reduction of state spending on private pensions and the prevention of tax-avoidance – and triggered by publicly perceived unfairness (early leaver's rights, discrimination against women) and successive incidents of market failure (the Maxwell scandal, the mis-selling of personal pensions and the insolvency of companies with insufficiently

funded pension schemes, to name the most important). As described in the previous chapters, this resulted in a large amount of rules concerning scheme governance, funding, benefits, information and advice. The last ten years have seen the emergence of new regulatory bodies and the Pension Protection Fund. Today, the actions of those in charge of private pension funds – employers, trustees, fund managers, actuaries, auditors and financial advisers – are to a large extent determined by rules that were set by the state in order to achieve political goals and to react to perceived shortcomings of the system. “What has emerged is a public-private hybrid as officials attempt to adapt the market to secure political objectives with astoundingly restricted success” (Whiteside 2003: 32). The state interferes with the way private pensions are provided, trying to ensure that private provision is available, that it provides benefits in an appropriate way, and that people actually take advantage of private provision, in order to reduce future public liabilities. Thus, the state adapts the markets of private provision for old age to achieve welfare objectives. In other words, these markets are turned into regulated “welfare markets” (Taylor-Gooby 1999, Nullmeier 2003). British examples of welfare goals underlying the regulation of private pensions are minimum standards for either contributions or benefits, compulsory membership in either the S2P or a private equivalent, compulsory annuitisation of money purchase pensions in order to keep pensioners from spending their money too quickly, prescribed unisex-annuities and survivors benefits for the protected rights part of defined-contribution pensions to achieve more equality among men and women, and arrangements to compensate for market failures. The most important and most basic objective British governments pursue by regulating private pensions is to make sure that citizens actually do engage in private provision and that contributions are made at an appropriate level. This is supposed to give people a sufficient income in retirement without the need to fall back on the state. Unlike in Germany, for example, where regulated private pensions, intended to make up for cut-backs of state benefits, entail welfare state goals to a very large extent (Nullmeier 2001, Berner 2004), in the UK social objectives in the regulatory framework seem to be piecemeal and rather the result of short-term ad-hoc reactions.



Regardless of all efforts by the state, welfare market outcomes are to a large extent outside the realm of political control and not fully calculable (Nullmeier 2003: 966). Attempts to influence the behaviour of market actors by means of regulation or incentives might still have unintended effects. Regulatory measures may not be sufficient to create a pension system that is likely to be understood and trusted by those expected to provide for their old-age and to generate an adequate income for their future retirement.

Commonly the term regulation is used in a rather narrow sense, referring to prescriptions and red tape. I would like to use the term in a wider sense (cf. Leisering 2005: 5), that is, including state subsidies (4.3) and measures aimed at making citizens fit for the markets they are to rely on (4.4). I will now turn to these instruments.

### 4.3 Subsidies

Generally, state spending on pension provision may proceed along different lines. What comes to mind first is the direct provision of pensions by the state, financed by contributions or taxes. This element of the UK pension system has been described earlier (4.1). But there may also be *public* expenditures on *private* pension provision. Often, these have the form of financial incentives by way of tax deferrals or the payment of direct subsidies. But the state may also underwrite part of the private obligations. Generally, this second form of public spending is part of “fiscal welfare” (Titmuss 1987).

In the UK the actual cost of private pension provision has always been shared with the state since SERPS had been introduced by the 1975 Social Security Pensions Act. “The 1975 settlement of the shape of the British pension package can [...] be characterized as a structure of subsidized competition: the state created a structure within which private provision could compete with state provision on more-than-equal terms. [...] The state [...] undertook to pay for guarantees which the private sector (because of factors like uncertainty, timescale, etc.) felt unable to provide for” (O’Higgins 1986: 139). Successive reforms shifted the cost of price indexation from the state to the private providers. A first step was made in 1986 when contracted-out schemes were for the first time compelled to provide a limited price indexation (LPI).

After the GMP had been eventually abolished in 1997, the state was no longer providing the price indexing of private pensions. The inflation risk is now shared between the provider and the individual. The LPI might be sufficient to sustain the value of benefits at the current low level of inflation but is likely to result in a decreasing purchasing power of pension benefits should inflation rise again.

With the introduction of S2P in 2001 members of private pension schemes on low earnings will have their pensions topped up by S2P, which provides higher benefits on earnings up to the UET. The top-ups differ for occupational schemes on the one hand and personal (including stakeholder) pensions on the other hand.

Still, there is a significant element of cost sharing between public and private in private pension provision by means of tax incentives and the contracting-out rebate. In order to make it attractive for SERPS members to switch to private provision (and to prevent them from switching back) the contracting-out rebate has been quite generous after 1987. The unforeseen success of personal pensions lead to considerable costs for the Exchequer. The extra 2 per cent rebate – some have called it a “bribe” – made it particularly advantageous for young people to contract-out of SERPS and to contract back in at a later date. This was due to an effect called back-loading of benefits: Compared to the defined-contribution personal pensions, contributions towards the end of working life accrue more heavily under SERPS.<sup>25</sup> Since there was no rule to prevent contracting back in, special age-related rebates have been offered since 1993 to discourage these tendencies. All in all, it was estimated that instead of saving money the net costs for government in the first ten years of the existence of personal pensions were about £10 billion (Blake 2003: 335). Meanwhile, due to falling investment returns and less favourable annuity rates, the rebate might be too low to make contracting-out worthwhile under current conditions. The level of the rebate is only reviewed every five years (next due for 2007), but investment returns might oscillate much quicker. In the future the rebate may well be set at a higher level again.

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<sup>25</sup> Due to the compounded interest, defined-contribution schemes accrue most heavily over the first years of contribution while the effect of later payments is less significant. Under a defined-benefit scheme such as SERPS the accruals are the same over the entire contribution period, irrespective of the proximity to retirement.

Since the administration costs per member are higher for (small) private schemes than for the (large) state scheme, parts of the contracting-out rebate (actuarially calculated to generate broadly the same amount of pension as the state scheme for those contracted-out) are consumed by administrative charges and do not generate any future benefits. Even with the higher rebates of the past, many of those who contracted-out into a personal pension are likely to receive less (from their NIC rebate) than they would from SERPS/S2P (Which? 2005, OAC 2005). Higher rebates in turn mean higher contributions for those remaining in the state scheme (see Ward 2003: 273).

The advantageous tax regime for private pensions is also a form of state subsidy. Even though tax free contributions are actually just a form of deferred taxation since pension benefits are taxable (except for the tax-free lump sum), they are particularly beneficial for individuals who are higher rate tax payers during working life but pay only the standard tax rate afterwards due to a lower income in retirement. Not only the contributions but also the accumulation of private pensions is subsidised by the state. Pension funds are tax-favoured, there is no tax on interest, income or capital gains. However, since 1997 they are no longer able to recover Advanced Corporation Tax on UK dividends (PPI 2005: 57), which is estimated to reduce the schemes' dividend income by 7 per cent (Davis 1997: 23).

Despite the substantial state subsidies towards private pensions and considerable amounts of cost sharing their extent appears to be declining. Additionally, tax advantages are more beneficial for the better-off, that is, those who are most likely to save anyway. Thus, this form of fiscal welfare contradicts the government's claim to target state spending on those who need it most (DSS 1998).<sup>26</sup>

#### **4.4 Financial literacy and "Informed Choice"**

As mentioned in part 3 it has always been a goal of UK pension policy to improve the amount of information available to (prospective) pension scheme members. The growing range of pension products eligible for contracting-out of SERPS/S2P has

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<sup>26</sup> Note that in Germany tax subsidies towards private pensions are particularly generous for low earners and families because these groups are assumed to need extra support for their saving efforts.

widened the choice of individuals regarding old-age provision. But the New Labour government is assuming that the availability of various options and many sources of information may not be enough for many people to make the “right” choice, resulting in under-provision for retirement. It thus launched an “Informed Choice” campaign to make citizens fit for the markets they are to rely on. “Informed Choice” comprises of three elements: activation, education and information (DWP 2004: v).

The first aspect, *activation*, refers to a wider range of options, such as stakeholder pensions or new forms of annuities, and proposals for flexible retirement. It also includes measures to increase membership of occupational pension schemes, particularly for those earning over £10,000 a year<sup>27</sup>. In order to do so, employees may be forced to make choices about their membership and contribution. The government considers three options to overcome people’s inertia: active decisions by new employees whether or not to join their company’s scheme, commitments to save more in the future, or automatic enrolment in the pension plan with the opportunity to opt-out (DWP 2004: 13-17).

The second part of the Informed Choice campaign, *education*, builds on the FSA’s strategy for increasing “Financial Capability” (see FSA 2003 for details), including financial education as part of the school curriculum and active labour market programmes. It also encompasses an integrated retirement planning service offered by the DWP, best practice guidance for employers on how to communicate the value of their pension schemes, and steps to improve the ability of employers and Citizens Advice Bureaux as well as other voluntary organisations to give information on pension provision (DWP 2004: 19-23).

Concerning *information*, the third part of the initiative, the UK government intends to add so-called ‘What if’ forecasts to the individual state pension forecasts issued on request to illustrate the consequences of certain individual decisions. It also plans to issue automatic state pension forecasts at regular intervals. Furthermore, combined pension forecasts were initiated, delivered by the employer or pension provider, in order to depict both the state and private pension entitlements of the individual . For

the time being combined forecasts are voluntary, but in the future pension schemes might be compelled to provide them. The government develops an internet-based retirement planer, available from spring 2006, comprising all pension information from state and private sources to help people estimating their desired retirement income, take other long-term savings into account and trace 'lost' pensions, e.g. those resulting from past employment (DWP 2004: 25-29).

Both the Informed Choice and the Financial Capability initiative indicate how much the state is involved in creating the prerequisites of a voluntary welfare market. Although the UK government, unlike its German counterpart, "does not have a target income for future pensioners" (DWP 2004: 5) many of the proposals indicate it is perceiving state and private pensions as part of *one* income package for retirement. While the state is not prepared to provide public retirement benefits above a given (low) level, it is urging those defined as able to save to do so. Thus, "Informed Choice" appears to be a strategy aimed at steering people to the welfare market for retirement products, *to make them choose private provision* (Mann 2005: 5). The focus on choice makes it possible, to blame individuals' income deprivation in retirement on *their own choices* in working life (Hyde and Dixon 2004: 277, Leisering 2005: 3; Mann 2005: 5).

But a policy that encourages people "to take advantage" of market opportunities may put the state under severe pressure if markets do not deliver. When it became apparent that there was no member protection when companies went bust with insufficiently funded pension schemes, protesters took to the streets, demanding government compensation. One sign read "We've tried to provide for our old age, now all we've got is pension rage. No fund, no hope, no future" (see Pestridge, 2003). The protesters pointed out that they were just doing what they were asked to do, and held the government liable for their misfortune. According to some of the victims and even a number of experts, the state may well have a legal liability because regulators and government departments have provided false information about the safety of occupational final salary schemes (see Altmann 2004 and Webb 2004).

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<sup>27</sup> For those earning below this level more generous state pensions are considered likely to be sufficient to maintain a similar standard of living in retirement as in work (DWP 2004: 7).

Likewise, after the Equitable Life Insurance found itself forced to withdraw Guaranteed Annuity Rates it had promised to its policy holders, the latter set up the Equitable Member Action Group that finally sued government for compensation on the grounds of an inadequate regulatory system (Mann 2005: 12). Hence, government policies to encourage people to join private pension schemes contributes to the politicisation of welfare markets (Nullmeier 2003: 968; Leisering 2005; Mann 2005).

Undoubtedly, many measures proposed by the “Informed Choice” and “Financial Capability” campaigns would help to make the voluntary welfare market approach work. But these campaigns face great obstacles, namely poor numeracy and the sheer complexity of the British pension system. Some suggest the UK has both the most complicated pension arrangements and the least financially astute individuals in the world. “For example, 25% of adults have ‘very low’ numeracy, meaning they are unlikely to be able to perform even the simplest calculation” (FSA 2003: 7). “Forty per cent of adults [...] do not know what a percentage is. How are they supposed to choose between types of personal pension [...]?” (Foot 2004: 203).

Even if numeracy could be improved in the long run, many individuals might feel unable to save for retirement. With UK consumer debts amounting to more than £1 trillion (BBC 2004), many Britons are preoccupied with their credit card bills, loans and mortgages and may be well advised to pay them off before starting a pension. More generally, the ability to save for retirement and the amount of actual savings are closely related to people’s income and the availability of employer contributions (Hyde and Dixon 2004 with further references). People with unstable employment patterns and frequent spells of unemployment are often unable to lock money away in a pension. They are likely to prefer a more flexible savings product. (Emmerson 2003: 184).

Pensions have been bad news over the last two decades. Incidents such as the Maxwell pension fraud, the mis-selling of personal pensions, insufficiently funded occupational pension plans of insolvent companies or the failure of the renowned life-insurer Equitable Life resulted in a drop of consumer confidence. Fuelled by media exaggeration these things had contagious effects on pension provision overall

(see Casey 2003). Measures to restore confidence like the PPF require some time. As an unintended consequence, these measures might accelerate the closure of defined-benefit plans as they impose further costs on those schemes.

But the most important impediment to the success of the Informed Choice strategy is the complexity of the entire pension system. The huge amount of options is likely to result in information overload and the prospect of means-testing complicates matters even further. The House of Lords Select Committee on Economic Affairs consider it “very difficult to provide unambiguous financial advice for that half to three-quarter of the population who are likely to be eligible for the Pension Credit during their retirement. FSA rules require that individual financial advice should be thorough and appropriate, but it is extremely difficult to provide such advice given the uncertainty of the way in which private savings may interact with the Pension Credit” (HoL 2003: 47f.). If a task is deemed “very difficult” for financial advisers with their expertise, it is probably unfeasible even for the most astute, educated and informed consumer.

#### **4.5 Decline of workplace pensions, savings gap, and contracting back**

Occupational pensions have for a long time been the pride of the UK pension system. They have been described as “one of the great welfare success stories” of the (last) century (DSS 1998: 18). Since occupational pension funds in the UK invested large parts of their money in equities, the stock market boom of the 1990s allowed employers to maintain rather generous pension schemes at virtually no cost, while many of them were able to take extensive contribution holidays. After the stock market crash in 2000 there have been growing concerns about the funding of occupational pensions. Furthermore, increasing longevity, the growing regulatory burden and the obligation to improve benefits as a condition for contracting-out made the provision of defined-benefit occupational pensions increasingly expensive for the employer.

The actual cost of providing contracted-out salary-related pensions became suddenly obvious when the Accounting Standards Board announced a new accounting standard called Financial Reporting Standard 17 (FRS 17) in November 2000,

scheduled to be implemented within three years. FRS 17 was designed to reveal the costs of an occupational pension fund so that any underfunding would be reflected in the company's balance sheet. Apparently the sheer size of the liabilities of their pension funds came as a surprise to many sponsoring companies.

[T]he sort of pensions that have been built up are very, very expensive and the cost and the volatility of that cost is now appearing in their company accounts in a way it never used to. The new accounting standards are making all of that transparent and finance directors have had some nasty shocks. They had no idea what all this would cost! They certainly know now and they're thinking: "Why are we? Why, you know, as part of our strategic planning and our workforce planning, why are we putting 25 per cent of payroll costs into pensions?" (expert interview 1.2, provider association)

So FRS 17 eventually marked the end of the "fool's paradise" (Pensions Commission 2004) of occupational pension provision. Due to the maturity of their pension funds a number of British businesses may be aptly described as "a huge pension fund with a small company attached". By no means could the sponsoring employer make up for any significant underfunding of their schemes (cf. Blackburn 2002: 44f.).

Thus the end of the stock market boom, rising longevity, the increasing regulatory burden and the FRS 17 accounting standard led to the acceleration of a long-term trend of employers closing down defined-benefit schemes or replacing them with defined-contribution (or mixed-benefit) arrangements and reducing contributions. As a result, occupational pension arrangements became less generous and more risky for the employee (see Pensions Commission 2004: 85-125). The Pensions Commission (2004: 85), for instance, estimates "that active membership of private sector [defined-benefit] schemes has so far fallen by 60% since 1995".

This situation was further aggravated by the collapse of a number of companies with insufficiently funded pension schemes. The government found itself forced to offer some compensation to affected members via the Financial Assistance Scheme but refused to underwrite the PPF. One can only speculate whether or not the British government would rethink this position if claims on the PPF should increase dramatically.

Not only pension providers, but also the individuals are their backs on the welfare market for pensions. They are put off by the complexity of the arrangements, by their lack of confidence in the market, or because they assume they will find a better deal



elsewhere. This might be a state scheme, the prospect of a means-tested benefit in old-age or an investment in property. At the same time as there is a lively debate about a “pension crisis” and a “savings gap”, the UK property market is quite dynamic.

There is a widespread perception that a house is a good investment and a pension is a bad investment (expert interview 3.9, policy adviser of an opposition party).

‘Pensions’ has become a negative term for many consumers in this country and people don’t have the confidence any more in pension savings. And instead they’re putting their wealth into property which is probably not a good idea because the property market in this country is quite volatile and it’s quite easy to be seduced by thinking ‘Oh well, my house is worth a hundred thousand Pounds, I don’t need to worry!’ People have no idea about how much money they’ll actually need to have a decent income in retirement! (expert interview 1.2, provider association)

Some people might not even enter the welfare market for old-age provision in the first place. The ability of people to plan ahead is affected by their (in)ability to envision the future, by the amounts of resources they command and by the views and actions of others around them which influence their own behaviour. So those with insecure lives face difficulties in planning ahead (Rowlingson 2002). For them a policy approach focusing primarily on voluntary provision via regulated and subsidised welfare markets is unlikely to result in an adequate pension income.

The current retreat of providers and consumers from the welfare market for old-age provision becomes most obvious in the recent trend to contract back from private pensions into the additional state scheme. According to estimates by the consulting company Watson Wyatt, in the tax year 2002/2003, 522,000 individuals were contracted back from private pension arrangements into S2P. Among these, 319,000 individuals contracted back from occupational pension plans, either because their employer altered his pension promise (most likely a scheme closure or a transformation of a final salary plan into an money purchase scheme), or because they changed jobs and the new employer did not offer an (contracted-out) occupational pension plan. The remaining 203,000 individuals chose to switch back from having their contracted-out rebate paid into a personal pension to membership in S2P. Against the background of low investment returns and rising life expectancy, the contracting-out rebate is currently set at a level too low to make contracting-out worthwhile. Therefore some providers tell their customers to consider contracting back in (cf. Knight 2004).

Even if employers maintain to offer some form of occupational pension plan contracting back marks a step towards a new mode of risk sharing between employers and government concerning future pension liabilities.<sup>28</sup> In some respects this represents a new “partnership in pensions”, but it is clearly not the kind of partnership the government had in mind when drafting the 1998 Green Paper (DSS 1998).

It thus becomes obvious, that the British approach to old-age security, which draws heavily on voluntary engagement in regulated and subsidised welfare markets is currently facing its limits: As private provision remains voluntary for providers and individuals, both sides of the welfare market may voluntarily turn away from it.

#### **4.6 The current debate**

The current public debate on pensions policy in Britain focusses on measures to revive the voluntary approach. Many experts assume that a higher (basic) state pension without means-testing (possibly combined with the abolition of contracting-out) would make informed choices much easier for individuals and thus improve the level of private provision. This argument contradicts the common notion that state benefits crowd out private savings for old-age. Still, the majority of interested parties proposes higher state pensions for the following reasons: any presumed disincentives of means-testing would cease to exist, the overall pension system would be much simpler and easier to understand, thus making savings decisions more straightforward and financial advice easier to give. “[V]irtually all people in the industry would like to see the state bedrock pension taking people clear of means-testing, so that the advisory process can be simple” (Peter Tompkins, PricewaterhouseCoopers, quoted in HoL 2003: 48).

Over time, both due to this government and other governments - let’s not single out this government for criticism - the interface between state provision and private provision has become disjointed. And I think that’s one of the key reasons why we are calling for a reform of the state pension system. Because private provision should be able to build upon a solid state platform where people saving privately are not dis-incentivised by the current regime (expert interview 1.7, provider association).

And so I’m not sure that more information and expecting consumers to behave like rational economic creatures is necessarily going to solve our problems in this country, and that’s why I come back to an

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<sup>28</sup> This is exemplified in the case of the brewer Scottish & Newcastle plc (CBI 2004: 52-55).

universal subsistence pension that people can live on, that lifts them out of poverty. And then people will understand that if they want any more luxuries than that, they're on their own and they've got to do something for themselves. And that is such a simple thing to understand, I think people could get their heads around that (expert interview 1.2, provider association).

Many experts also believe that a higher state pension would result in a lighter touch regulation of private pensions. This would make private pensions more attractive for providers. The greater transparency would appeal to customers as well. Both aspects would raise pension savings.

Ideas of a higher state pension are put forward by a diverse range of organisations, such as the ABI, Age Concern, the CBI, the NAPF and "Which?" (formerly the Consumer's Association). Still, there are differences between the proposals by different actors concerning the entitlement conditions, the state pension age, the level of benefits and the implications for S2P and contracting-out.

There seems to be some agreement, that the level of a minimum state pension should be roughly at the level of the Guarantee Credit. Some actors would like to retain the contributory principle within the state pension schemes, others suggest a residency test as the criterion for entitlement. The latter position is most prominently represented by the proposals of a Citizens' Pension worked out by the NAPF and the PPI (NAPF 2004). Many contributors argue for a higher pension age in order to contain the costs of more generous benefits (e.g. Consumer's Association 2003, CBI 2005).

The numerous proposals have been generally accepted by the House of Lords Select Committee on Economic Affairs, which stated "We therefore recommend that as a top priority the Government should consider introducing a non-means-tested state pension paid on the basis of citizenship to all persons of pension age" (HoL 2003: 48).

There is less agreement on whether or not the State Second Pension should be continued. The CBI, for instance, wishes to retain S2P (CBI 2005), the ABI proposes a flat rate second pension with the contracting-out option reserved only for those earning more than £15,000 annually (ABI 2005). "Which?" suggests a pre-funded second pension administered by a National Pension Scheme and would like to see contracting-out limited (to occupational schemes with demonstrably better benefits

than the state scheme) if not abolished completely (Consumers' Association 2003). The Citizens' Pension proposal developed by the PPI and the NAPF suggests to end to S2P and the associated contracting-out, assuming that the new simplicity of the pension system together with still moderate state benefits will be enough to induce voluntary savings (NAPF 2004). This idea is also endorsed by the House of Lords Select Committee on Economic Affairs: "We believe that the provision of this baseline state pension is a necessary element for the development of a more extensive system of voluntary pension saving in the United Kingdom. In addition to providing an adequate, simple and comprehensible pension for retirees, a non means-tested universal pension would enable the extremely complex system of "contracting-out" to be abolished, thereby enormously simplifying the administration and regulation of occupational pension schemes." (HoL 2003: 48)

Still, the government has been reluctant to endorse plans for higher state pensions, citing high costs and the lack of improvements for those who currently receive the Pensions Credit.

## **5 Conclusion**

Is the British pension system heading back to the state? Despite its success in containing public spending on (state) pensions and widening the scope of private provision, I would argue, that the state is indeed becoming more important in UK pensions policy. This "nationalization" is a two-fold process, featuring the state as a regulator, and the state as a provider. Often, these two functions are seen as mutually exclusive, because the former implies "privatisation" and thus less scope for the latter.

I have argued that the scope of state regulation of private pensions has increased substantially. Using "regulation" in a broad sense, this has also entailed significant (though currently decreasing) state subsidies and measures to improve citizens' financial literacy. Still, the regulatory framework is yet unable to make private pensions attractive for providers and at the same time comprehensible and secure for savers.

State regulation of private pension in fact encompasses the regulation of the entire public/private pension mix. I have argued in this paper that regulating private provision without taking into account its interaction with state benefits is likely to result in the unintended failure of private pensions and, in fact, the entire pension system.

At the same time the role of the British state as a pension provider is increasing. This was – to some extent – intended when New Labour decided to target public resources on those who need them most. Thus, the growing importance of the regulatory welfare state is paralleled a more redistributive welfare state. However, the increased *interpersonal* redistribution is accompanied by reduced *intertemporal* redistribution.

But the state's role as a provider has also increased "by the backdoor". When providers and individuals retreat from the regulated welfare markets for old-age provision they shift the responsibility back to the state. Thus the mechanism of contracting-out, thought to offload public liabilities to the market, now returns like a boomerang in the form of contracting back into the state pension.

While there is a providing state returning by the backdoor, many commentators argue it is high time to open up the front doors as well, proposing higher state pensions and the abolition of means-testing. Almost paradoxical, this is seen as a prerequisite to make private provision work. Thus, this proposed future state would still have an important role as a (lighter touch) regulator. Still, one might doubt whether we will ever see these proposals realised. The Pensions Commission (2004) is pointing to other reform options, such as compulsory private provision. If the path dependency theory is anything to go by, the muddle-through option (Pensions Commission 2004: 13, 155) is the most likely, even though the least desirable.

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