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Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

United Kingdom Pension Reform

The United Kingdom Government has recently published its White Paper on pension reform *Security in Retirement: Towards a New Pensions System*. It sets out a new structure for the UK pensions system and establishes the foundation for a new and lasting consensus on sustainable long-term provisions for pensions that include important reforms involving retirement age and mandatory savings arrangements. The UK reforms are of wide interest as there are many similarities between the UK, the United States and other countries in terms of the challenges faced by their respective pension systems.

Introducing the White Paper, John Hutton, Secretary of State for Work and Pensions stated: "We face the challenge of profound social and demographic change that demands a new kind of policy response. People today are not saving enough for their futures. Our pension system suffers from structural problems; it is unfair to many, particularly women. To meet these new challenges any reforms must meet five key tests; they must promote personal responsibility, be fair, and they must provide greater simplicity; they must be affordable, and must offer a sustainable solution that commands a national consensus."

Promoting personal responsibility involves addressing the problem of inadequate saving for retirement. The concept of fairness is intended to protect the poorest individuals and families, address the special situation of those who care for others, particularly women and others who are engaged in unpaid activities. It is also intended to provide equitable treatment for savers and fairness between generations. The current UK pension system is one of the most complex systems in the world; to achieve greater simplicity the proposed reforms will clarify the respective roles of the State (government), the employer and the individual. To be affordable, the reforms will maintain macroeconomic stability and set an appropriate balance for retirement provision between the State, the employer and the individual. The objective of achieving sustainability is to establish an enduring national consensus while being flexible with respect to future trends.

The first priority of the UK reforms is to facilitate personal saving for retirement. A new system of personal accounts will be introduced in 2012. There will be automatic enrollment for all employees into either a national personal accounts system or their employer's occupational system. Employees will contribute 4% on covered earnings and employers will make contributions of 3% on the same earnings. An additional 1% of earnings will be contributed into the personal accounts representing the value of tax relief for the employee's contributions. Although enrollment is automatic, employees will be able to opt out of the system and will forfeit the employer contributions that would otherwise be payable.

A second major reform involves a change to the method of indexing the basic State Pension. As from 2012, inflation adjustments will be based on changes in national average earnings rather than changes in consumer prices as at present. This reform is intended to ensure that pensioners share in rising national prosperity. It is estimated that by 2050, under the new adjustment method, the basic State Pension could be worth about twice as much as if it had been linked to prices.

Another major reform relates to the State Pension age that is currently 60 for women and 65 for men. The State Pension age is already scheduled to increase from 60 to 65 for women over the period between 2010 and 2020. The new reforms will further extend the State Pension age for both men and women to 66 over the period 2024-2025 and then to 67 over the period 2034-2035 and ultimately to 68 over the period 2044-2045.

Other reforms are intended to make the State Pension fairer and more widely available. These include a reduction in the number of years needed to qualify for pension to thirty and a new credit system for those caring for children and disabled people. Following these reforms, it is estimated that in 2010, 70% of women reaching State Pension age will be entitled to a full basic State Pension compared to 30% currently. It is also estimated by 2025, over 90% of women and men reaching State Pension age will be entitled to the full basic State Pension, compared to about 80% without the reforms. The total State Pension expenditure following the reforms is projected to remain level at 5.2% of GDP until 2020 and then increase to 5.9% in 2030, 6.5% in 2040 and 6.6% in 2050.

The UK is taking major steps regarding pension reform that represent an integrated approach involving the three basic pillars of Social Security, employer-provided arrangements and individual savings. While some aspects of the reforms are controversial, particularly the setting of the State Pension age at 68, it is conceivable that the UK approach may merit consideration as pension reform is debated in other countries.

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