History and the Pensions Crisis

In June 2005 a conference was held at the British Academy bringing together leading experts from a number of countries to discuss the current pensions crisis in the UK, and to consider the way forward. **Dr Hugh Pemberton**, *one of the convenors of the conference, reflects on the nature of the pensions crisis, setting it in its historical context.*

IN an address to the British Academy in December 2004 the governor of the Bank of England, Professor Mervyn King FBA, made a persuasive case for a more honest and open acknowledgement of the policy problems posed by future risks, using pensions to illustrate his point. Yet, as well as there being a strong case for more honesty about the future of pensions, one might equally argue that we need to be more honest about the past. For, whilst the present system is widely seen to be inadequate for present day needs, let alone up to the task of providing for the future, a significant problem for those seeking to reform the system is that policy makers must necessarily grapple with a considerable legacy, much of which constrains present policy options.

In this article, I discuss the nature of the pensions crisis and argue that an effective solution to that crisis cannot be built unless we better understand the history of how the crisis has arisen and acknowledge the constraints posed by past developments. In doing so, I draw on research conducted during a British Academy postdoctoral fellowship and on a conference at the British Academy in June 2005 the proceedings of which will be published in book form in September 2006 as a British Academy Occasional Paper (*Britain's Pensions Crisis: History and Policy*, edited by Hugh Pemberton, Pat Thane & Noel Whiteside).

The crisis

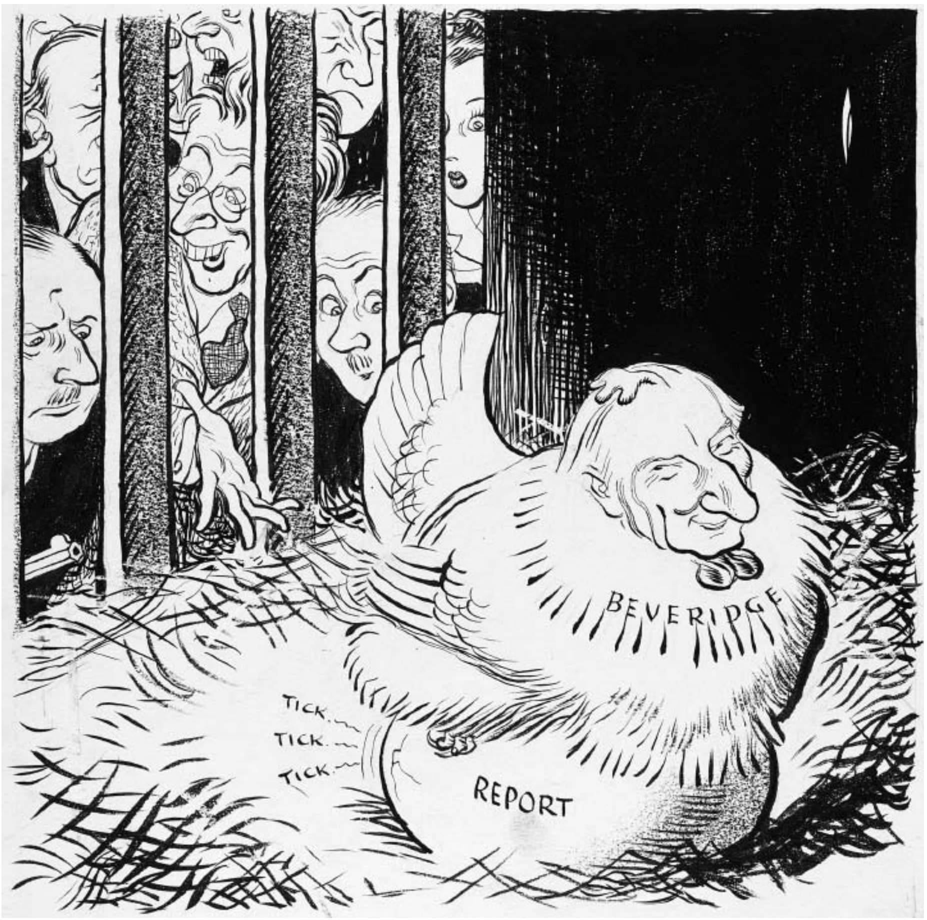
There seems now to be a widespread sense that Britain's pensions system, if not yet in crisis, will shortly be so. Perhaps the most often cited cause is the so-called 'demographic time-bomb'. This has two dimensions Firstly, a combination of the post-war baby boom and a subsequent deterioration of the birth rate, which has been below the level needed to sustain the population since the 1970s, means that we face not just a growing number of pensioners but a smaller number of working tax payers to support them. As Paul Johnson points out in our book, this has been clear for over 30 years and the failure to face up to reality for so long is notable. Secondly, pensioners are living longer as a consequence of rising living standards and medical advances. Whilst the rate of increase has lately been particularly fast this too is part of a welcome long-term trend – but one to which the actuarial profession has reacted far too slowly, as John Hills notes in his contribution to our volume.

These long-term demographic trends are exacerbated by important social changes relating to work. For the past 40 years or so, for example, governments have encouraged an increasing proportion of young people to enter further education, thus delaying their entry into paid work and postponing pension contributions. At the other end of people's working lives, however, we have seen a tendency to take early retirement – a trend particularly noticeable as firms restructured in the 1980s and 1990s. Taken together, these changes are stretching pensions in two directions since they have to last for longer but with fewer years of contributions. True, these pressures have been partly offset by the long-term increase in labour force participation by women and by immigration. But whilst both have produced additional contributions they brought with them future liabilities, thus postponing but not solving the crisis.

The demographic and social roots of the pensions crisis are therefore long-standing. One solution is for people to work for longer, and the Pensions Commission has recently suggested this. But whilst retiring later may go some way to addressing the inadequacy of future pensions it does nothing to address the existing inadequacy of the basic state pension. Again, this is a long-term issue. The Beveridge national insurance pension was never intended to be generous, as Jose Harris reminds us, but it was made less so by the Treasury, which saw the required expenditure as beyond the country's postwar means. Since 1946, therefore, the poorest pensioners have depended on means-tested supplementary benefits. So means-testing, for all the current concerns about its impact on incentives to save for retirement, is not a new problem. Nor is Treasury parsimony. Over more than half a century the Treasury has sought, with considerable success, to limit the growth in liabilities arising from the basic state pension.

State earnings-related pensions have also been subject to a long process of attrition. The Treasury fought hard in the 1950s and 1960s against a generous Continental-style system of earnings-relation in state pensions. Eventually, Labour managed to introduce a compromise system in 1978 – the state earnings-related pensions scheme (SERPS). Almost as soon as it was implemented, however, Conservative governments began to chip away at it, not least by encouraging workers to contract out of the scheme. Labour's replacement of SERPS by the state second pension (S2P) in 2002 continued this process.

In short, state pensions in Britain have consistently played a residual role and almost all postwar governments, whether Conservative or Labour, have turned to the private sector to fill the gap. This has had mixed, but generally disappointing, results. Initially, governments in the 1950s and 1960s looked to employers to provide earnings-related occupational pensions to their workers. As Noel Whiteside notes in our book, in the full-employment climate of those years employers were happy to oblige, supported by trade unions which saw attractive pension packages as a way round wage restraint policies. The problem with this approach was that it excluded the low-paid, the self-employed and those not in continuous paid work. Thus successive



Cartoon by Leslie Illingworth published in the Daily Mail *on 23 November 1942. (National Library of Wales, Aberystwyth; reproduced by courtesy of Solo Syndication/Associated Newspapers).*

governments, supported by the social partners, connived in a system that was bound to fail a large number if not the majority of British citizens.

Women were the most notable casualties of this approach, as is made clear by Pat Thane, Jay Ginn and Baroness Hollis in our volume, because they were disproportionately amongst those excluded, and when they did work in jobs with attached pensions they were generally low-paid. This was a double blow, for women were inevitably poorly served by a state pension system also based on entitlements built up through paid work since they tended, and tend still, to take time out of work to care for children and ageing parents.

Moreover, the expansion in occupational pensions coverage was not sustained, peaking in 1967 at just over half the workforce. Since then the proportion in such schemes has been declining. Recently, of course, we have seen a marked flight by employers from traditional 'defined benefit' schemes, typically paying pensions based on final salary, to 'defined contribution' schemes where the employee takes all the risk. There are short- to medium factors at work here such as the collapse of equity markets in 2000 and new accounting standards that make pension fund deficits all too visible in employers' balance sheets. Nonetheless, it is worth remembering that the decline of occupational pensions is a long-term phenomenon.

The inability of employer-provided pensions to fill the gap created by inadequate state provision led governments in the 1980s to encourage individuals to take out their own private pension plans. This was a disaster. The ensuing misselling of plans, the Maxwell fraud, and the Equitable Life saga, amongst other iniquities, served only to precipitate a catastrophic decline in consumers' trust in pension companies. This produced a marked expansion in regulation by government of those companies which inevitably served to make pensions more complex and expensive to administer. But regulation, it should be noted, is not a new phenomenon. Since 1973 state regulation of the private sector has increased: to protect pension rights, eliminate discrimination, outlaw dubious marketing practices, prevent misappropriation of company pension funds for other purposes, guarantee the solvency of funds and, most recently, protect scheme members when funds collapse.

Regulation was not the only factor contributing to the growing complexity of the overall system, as I shall describe below, but it was certainly important. And as the system has become more complex that complexity has itself become a barrier to the ability of the private sector to rise to the challenge set for it by government. Employers find the regulatory requirements of occupational pensions increasingly onerous and costly and this is a factor in their desire to withdraw from the market. Administration costs of private plans also rise, thus making them less attractive to consumers. As for the consumers themselves, they find themselves lost in a maze of such complexity that making rational decisions about pensions planning becomes all but impossible, thus discouraging them from making any decision at all and contributing to the poor take-up of private pensions by low to medium income earners unable to afford professional and disinterested advice.

In short, therefore, the private sector has not been able to fill the gap created by the inadequacy of state pensions in Britain. Indeed, far from expanding as the Treasury had hoped, Britain's system of privately-provided funded pensions is in serious long-term decline. It was this failure of the voluntary approach that led the government to set up the Pensions Commission in 2002.

The Pensions Commission's proposal

In the event, the Pensions Commission interpreted its brief rather more widely than the government had intended. It noted that 'Pension reform has too often in the past proceeded on the basis of analysis of specific isolated issues' and concluded that it was impossible to consider a part of the system without considering the whole. The Commission's first report was refreshingly blunt: there was an impending pensions crisis; and that crisis could only be solved if the country accepted the need to work for longer, to save more, and to pay higher taxes. In November 2005, the Pensions Commission published its second report putting forward its suggestions for a major reform of UK pensions to create 'a new settlement for the 21st century'.

The Commission's objectives were ambitious. It hoped to plug the gaping holes in the current state system for those (mainly women) with disrupted careers due to caring responsibilities. It aimed to overcome barriers to private provision in the form of consumer confusion and high costs. It hoped to keep employers involved in providing occupational pensions for their workers. It sought to craft a more sustainable state pension able to cope with rising longevity. It aimed to reverse the spread of means-testing produced by indexing the state basic pension to prices rather than earnings. But simultaneously it sought to maintain the improvements in the relative standards of living of the poorest pensioners that means-testing has delivered. Overall, it attempted to devise a system that was both less complex and more understandable.

The Commission proposed to achieve these objectives through a three-part reform. Firstly, the state pension age would rise to 67, or perhaps 69, by 2050. This would create the necessary conditions for its second recommendation: that state pensions be made more generous. The basic state pension (BSP) would continue but would rise in line with average earnings and would be paid to all UK residents, not just those who had paid contributions (thus dealing with the problem of those with interrupted careers and caring responsibilities, though not eliminating the future problems of those who have experienced such interruptions to contribution levels in the past). The earnings-related state second pension would be allowed gradually to evolve into a flat-rate top-up to the BSP paid to those who had made contributions. Thirdly the Commission proposed a new National Pensions Savings Scheme (NPSS) into which workers would be automatically enrolled. Employees would pay 4 per cent of their salary into this scheme, their employers would contribute a further 3 per cent, and the government would put in another 1 per cent. These contributions would be invested in stocks and bonds to build up a pension fund.

History and policy

In making its proposals, however, it may be that the Commission has failed to acknowledge the way in which history may both have created the crisis which it seeks to address and constrain options for the future. A key problem for any pension system is that the commitments made by pension providers to those contributing to pensions are very long term indeed. Clearly, an individual who purchases a personal pension from a pensions company enters into a long-term financial contract. In occupational pensions too, providing the scheme remains solvent, contributions made by employees, and matching employer contributions, carry long-term rights to a pension. Britain is unusual, however, in that the pensions contract in state pensions might also be seen as an individualised financial contract. This has important implications for policy.

Normally in a 'pay-as-you-go' pension system such as Britain's (i.e. a system in which pensions are paid from the contributions of today's workers) the pension 'contract' is essentially a collective agreement between generations. Because it is collective, it is amenable to political renegotiation. Britain, however, does not have this sort of state pensions contract, though many assume that it does. To understand why, we have to go back to the implementation of the Beveridge settlement in 1946.

In 1942, Beveridge proposed a system of 'national insurance' in which a worker's contributions would over time build up to provide a pension on retirement. In truth, Beveridge's scheme was never fully funded – though this was not clear to ordinary citizens at the time. But it was made even less so by Labour's decision to drop Beveridge's 20-year transition period to full pension rights (the 'golden staircase') when it implemented the Beveridge Plan in 1946. For those overseeing the implementation, the long delay envisaged by Beveridge to allow contributions to build up was simply not practical politics in the context of sacrifices made by workers during the depression and the Second World War. Instead, full pensions were paid immediately to those insured since 1925, and after only 10 years to those who had joined later. But abolishing the 'golden staircase' severely weakened the finances of the scheme. This in turn meant that the Treasury ruled out plans to pay a 'subsistence' pension (i.e. a pension that was enough to live on). And it meant that the scheme essentially became 'pay-as-you-go'. This shift in the funding basis of the scheme was concealed from contributors, however. Workers continued to view national insurance as a financial contract between the individual and the state in which their contributions purchased rights to a fully-funded future pension. Indeed, there must be some suspicion that this contract is legally enforceable under European law.

Thus in all its areas Britain's postwar pension system embodied individualised financial contracts. Such contracts are expensive to break. This does not mean that reform is impossible. There has been a major reform of British pensions about once a decade since Beveridge. It does mean, however, that those seeking to push through reforms consistently reached the conclusion that they would be best achieved not by abolishing or replacing an existing element in the system but by adding a new element. At best, pension rights were put into long-term 'cold storage' pending the retirement of contributors. The replacement of the 1961 state graduated pension by SERPS in 1978, is an example, as is its subsequent replacement by the state second pension in 2002. In both cases contributors' entitlements under these schemes continued, and will continue for many years to come. More often, however, the new element was simply added to the existing system (for example the introduction of personal pension plans in the 1980s). By 2002 Britain had nine distinct types of pension.

In all the present debate over the need for radical reform, however, the constraint of past contracts is rarely openly and honestly acknowledged. It is notable, for example, that the Pensions Commission's second report had only two pages discussing the ways in which history had limited its options even though past contracts implied such unacceptably large transition costs that the Commission was forced to rule out replacing the state basic and state second pensions and, instead, to build on them. If the state basic pension is to be paid to all, might the Commission perhaps have underestimated the potential opposition from workers who see 'their pension' being paid to people who have not made national insurance contributions? Did the Commission also underestimate the historic aversion of the Treasury to raising pensions spending?

One might also ask whether the Commission may have underestimated the potential scale of opposition to its proposal for a new National Pensions Savings Scheme even though there is a clear historical precedent in the reaction to a similar scheme proposed by Labour in 1957. The Treasury, for example, was then and is now averse to such a scheme because of fears that the government would be expected to stand as guarantor in the event of a collapse in asset values. Likewise, the industry was then and is now opposed to a scheme whose low costs threaten its existing business. Even in the 1950s the pensions industry wielded considerable market and political power that it used to strangle National Superannuation at birth. Given the subsequent increase in that power it seems almost inconceivable that pension companies can be reduced to mere sub-contractors of the state responsible for managing investments.

Conclusion

As the Pensions Commission noted in its first report, 'The problems of the British pension system today reflect the cumulative impact of decisions and commitments made, and of policies rejected, often with unintended consequences, by governments over several decades'. These commitments matter because they give rise to a set of financial contracts that are politically and financially expensive to break. They matter too because in both the public and private sectors they create substantial institutional impediments to radical change.

That said, developments over the past half-century indicate that further change is possible. But history also points to there being limits to its scope. It also suggests that change will not be retrospective and that the price of reform will be more complexity. Finally, history tells us that it is very hard to unpick decisions on pensions because of the very long-term commitments they involve. Decisions made now will potentially shape policy until today's adults are all dead. This puts a considerable onus on policy makers today to eschew the quick fix so beloved of their predecessors and to build a solution that will not just endure but that will be flexible enough to settle the question for some time to come.

The one-day conference 'Why has it all gone wrong? The past, present and future of British pensions' was convened by Dr Hugh Pemberton (University of Bristol), Professor Pat Thane FBA (Institute of Historical Research) and Professor Noel Whiteside (Institute of Governance and Public Management, Warwick). A volume arising from the conference, *British Pensions Crisis: History and Policy* will be published in October 2006 (*British Academy Occasional Paper 7*) .

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The eighth annual British Academy Lecture, 'What Fates Impose: Facing Up to Uncertainty' was delivered by Professor Mervyn King FBA, Governor of the Bank of England, in December 2004. The text, published in *Proceedings of the British Academy* volume 131, may be found via www.proc.britac.ac.uk

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