

The UK Pension System: The Current System and the Reforms since 1980

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The Current System of Pension Provision in the UK

A flat-rate first-tier pension is provided by the state and is known as the Basic State Pension (BSP). Second-tier or supplementary pensions are provided by the state, employers and private sector financial institutions, the so-called three pillars of support in old age. The main supplementary pension choices are as follows. The state system offers a pension that is low relative to average earnings, although the pension is fully indexed to prices after retirement. Occupational pensions used to be of the defined benefit type, offering a relatively high level of pension related to final salary (which was partially indexed to prices after retirement up to a maximum of 5% p.a.), but, as a result of poor transfer values between schemes on changing jobs, only to workers who spend most of their working lives with the same company. Increasingly, however, companies are closing their final salary schemes to new members and replacing them with defined contribution schemes. Finally there are personal pension schemes that offer fully portable (and partially indexed) defined contribution pensions which are based on uncertain investment returns and are subject to very high set-up and administration charges, often inappropriate sales tactics, and very low paid-up values if contributions into the plans lapse prematurely; in 2001, stakeholder pension schemes with charges capped at 1% of fund value p.a. were introduced in an attempt to mitigate the consequences of the high charges extracted in personal pension schemes.

Employees in the UK in receipt of earnings subject to National Insurance Contributions (NICs) will build up entitlement¹ both to the BSP² and, on 'band earnings' between the Lower Earnings Limit (LEL) and the Upper Earnings Limit (UEL)³, to the pension provided by the State Second Pension Scheme (S2P); S2P was introduced in April 2002 and replaced the State-Earnings-Related Pension Scheme (SERPS) which started in 1978. These pensions are paid by the Department of Work and Pensions (DWP) (formerly the Department of Social Security (DSS))⁴ from State Pension Age which is 65 for men and 60 for women⁵. The self-employed are also entitled to a BSP, but not to a S2P pension. Employees with earnings in excess of the LEL will automatically be members of S2P, unless they belong to an employer's occupational pension

¹ NICs also build up entitlement to health service, sickness, disability and incapacity benefits and the job seeker's allowance.

² Worth £3,926 p.a. for a single person in 2002-2003, while national average earnings were £23,400 p.a., suggesting a replacement ratio of about 17%. The BSP is uprated annually in line with prices, subject to a minimum annual increase of 2.5%.

³ The LEL (equal to the annual BSP rounded to the nearest £100) was £3,900 p.a. and the UEL was £30,420 p.a. in 2002-2003. These are uprated annually in line with prices, with a minimum annual increase in the LEL of 2.5%.

⁴ The Department of Social Security (DSS) was renamed the Department of Work and Pensions in June 2001.

⁵ The State Pension Age for women is being progressively raised to 65 over the period 2010-20.

scheme or to a personal or stakeholder pension scheme that has been contracted-out of S2P. In such cases both the individual and the employer contracting-out receive a rebate on their NICs (1.6% of earnings for the employee and 3.5% for the employer, unless it operates a contracted-out money purchase scheme (COMPS) in which case the employer rebate is 1.0%⁶) and the individual foregoes the right to receive a S2P pension. However, there is no obligation on employers to operate their own pension scheme, nor, since 1988, is there any contractual requirement for an employee to join the employer's scheme if it has one.

There is a wide range of private sector pension schemes open to individuals. They can join their employer's occupational pension scheme (if it has one), which can be any one of the following:

- contracted-in salary-related scheme (CISRS)
- contracted-in money purchase scheme (CIMPS)
- contracted-out salary-related scheme (COSRS)
- contracted-out money-purchase scheme (COMPS)
- contracted-out mixed benefit scheme (COMBS)
- contracted-out hybrid scheme (COHS).

A CISRS is a defined benefit scheme that has not been contracted-out of S2P and so provides a salary-related pension in addition to the S2P pension. A CIMPS provides a defined contribution supplement to the S2P pension. A COSRS must satisfy a 'reference scheme test' in order to contract out of S2P, namely provide a pension for life from age 65 which is indexed to inflation up to a maximum of 5% p.a. where the starting pension is calculated by taking a minimum of 1/80th of the average salary over the three years prior to retirement for each year of service in the scheme up to a maximum of 40 years service. A COMPS must satisfy a 'protected rights test' in order to contract out of S2P, namely must have contributions no lower than the contracted-out rebate. A COMBS can use a mixture of the reference scheme test and the minimum contributions test to contract out of S2P, e.g., a salary-related scheme contracted-out on a protected rights basis is a COMBS. A COHS can provide pensions using a combination of salary-related and money purchase elements, e.g., some members could get the former, while others could get the latter; or the pension for a scheme member could be based on the larger of the two elements. Individuals can also top up their schemes with Additional Voluntary Contributions (AVCs) or Free-Standing Additional Voluntary Contributions (FSAVCs) up to limits permitted by the Inland Revenue.

As an alternative, individuals have the following individual pension choices that are independent of the employer's scheme:

- personal pension scheme (PPS)
- group personal pension scheme (GPPS)
- stakeholder pension scheme (SPS)

⁶ The non-contracted out National Insurance Contribution rate in 2002-2003 for employees was 10% of earnings between the Low Earnings Threshold (LET) of £89 per week and the UEL, while for employers it was 11.8% on all earnings above £89 per week.

A PPS is divided into two components. The first is an Appropriate Personal Pension Scheme (APPS) which is contracted out of S2P and provides protected rights benefits that stand in place of S2P benefits: they are also known as minimum contribution or rebate-only schemes since the only contributions permitted are the combined rebate on NICs with the employee's share of the rebate grossed up for basic rate tax relief.⁷ The second is an additional scheme, also contracted out, that receives any additional contributions up to Inland Revenue limits. A GPPS is a scheme that has been arranged by a small employer with only a few employees: it is essentially a collection of individual schemes, but with lower unit costs because of the savings on up-front marketing and administration costs. A SPS is a low-cost PPS with charges capped at 1% p.a. of the fund value and into which contributions of up to £3,600 p.a. can be made irrespective of whether the SPS member has made any net relevant earnings during the year⁸.

Pension Reforms since 1980

Thatcher-Major reforms to the pension system

The Thatcher Conservative government that came into power in 1979 became the first government in the developed world to confront head on the potential crisis in state pension provision that has arisen as a result of a demographic imbalance between the proportion of the population in retirement and the proportion in work. These reforms were continued by the succeeding Major Conservative government.

These governments introduced the following measures:

1. Linked the growth rate in state pensions to prices rather than national average earnings, thereby saving about 2% p.a. (Social Security Act 1980).
2. Raised the state pension age from 60 to 65 for women over a 10-year period beginning in 2010, thereby reducing the cost of state pensions by £3bn p.a. (Pensions Act 1995).
3. Reduced the benefits accruing under SERPS (which had only been set up in 1978) in a number of ways: (a) the pension was to be reduced (over a 10-year transitional period beginning in April 1999) from 25% of average revalued band earnings over the best 20 years to 20% of average revalued band earnings over the full career (Social Security Act 1986); (b) the spouse's pension was cut from 100% of the member's pension to 50% over an eight-year transitional period beginning in October 2002 (Social Security Act 1986); (c) the revaluation factor for band earnings was reduced by about 2% p.a. (Pensions Act 1995); the combined effect of all these changes was to reduce the value of SERPS benefits by around two-thirds.

⁷ 22% in 2002-03.

⁸ UK private pension schemes benefit from an EET system of tax breaks: the contributions into schemes are exempt from tax, the investment returns (with the exception, since 1997, of dividend income on UK equities) are exempt from tax, and the pension is taxed (with the exception of a tax-free lump sum equal to 1.5 times the final salary in the case of a defined benefit scheme and 25% of the accumulated pension fund in the case of a defined contribution scheme).

4. Provided a 'special bonus' in the form of an extra 2% NIC rebate for all PPSs contracting out of SERPS between April 1988 and April 1993 (Social Security Act 1986); provided an incentive between April 1993 and April 1997 in the form of a 1% age-related NIC rebate to members of contracted-out PPSs aged 30 or more to discourage them from recontracting back into SERPS; age-related NIC rebates continued in a revised form after April 1997 (Social Security Act 1993).

5. Relaxed the restriction on PPSs that an annuity had to be purchased on the retirement date, by introducing an income drawdown facility which enabled an income (of between 35 and 100% of a single life annuity) to be drawn from the pension fund (which otherwise remains invested in earning assets) and delaying the obligation to purchase an annuity until age 75 (Finance Act 1995).

6. Enabled members of occupational pension schemes to join personal pension schemes (Social Security Act 1986).

7. Simplified the arrangements for occupational schemes to contract out of SERPS by abolishing the requirement for occupational schemes to provide Guaranteed Minimum Pensions (GMPs): since April 1997, COSRSs had to demonstrate only that they satisfy the reference scheme test (Pensions Act 1995).

8. Ended its commitment to pay for part of the inflation indexation of occupational schemes (Pensions Act 1995). Until April 1997, COSRSs had to index the GMP up to an inflation level of 3% p.a. and any additional pension above the GMP up to an inflation level of 5% p.a. Since the GMP replaced the SERPS pension which was itself fully indexed to inflation, the government increased an individual's state pension to compensate for any inflation on the GMP above 3% p.a. But the 1995 Act abolished the GMP altogether and required COSRSs to index the whole of the pension that they pay up to a maximum of 5% p.a. (this is known as limited price indexation).

9. Improved the security of the assets in private sector schemes through the creation of the Occupational Pensions Regulatory Authority (OPRA), a compensation fund operated by the Pension Compensation Board (PCB), a Minimum Funding Requirement (MFR) and a Statement of Investment Principles (SIP) (Pensions Act 1995); OPRA, the PCB and the MFR are examined in more detail below.

Defects in the Thatcher-Major reforms

The main defects of the Thatcher-Major reforms are as follows:

1. Removing the requirement that membership of an occupational pension scheme could be made a condition of employment. Membership was made voluntary and new employees had to take the active decision of joining their employer's scheme: barely more than 50% of them did so.

2. No requirement to ensure that transferring from an occupational to a personal pension scheme was in the best interests of the employee, leading directly to the Personal Pensions Mis-selling Scandal that erupted in December 1993. Between 1988 and 1993, 500,000 members of

occupational pension schemes had transferred their assets to personal pension schemes following high pressure sales tactics by agents of PPS providers. As many as 90% of those who transferred had been given inappropriate advice. Miners, teachers, nurses and police officers were amongst the main targets of the sales agents. Many of these people remained working for the same employer, but they switched from a good occupational pension scheme offering an index-linked pension into a PPS towards which the employer did not contribute and which took up to 25% of the transfer value in commissions and administration charges. An example reported in the press concerned a miner who transferred to a PPS in 1989 and retired in 1994 aged 60. He received a lump sum of £2,576 and a pension of £734 by his new scheme. Had he remained in his occupational scheme, he would have received a lump sum of £5,125 and a pension of £1,791. As a result of a public outcry, PPS providers have had to compensate those who had been given inappropriate advice to the tune of £13.5bn.

3. No restriction on the charges that could be imposed in personal pension plans, hoping that market forces alone would ensure that PPSs were competitively provided.

4. Giving personal pension scheme members the right to recontract back into SERPS. This option has turned out to be extremely expensive for the government because of the back-loading of benefits in DB pension schemes such as SERPS: benefits accrue more heavily in the later years than the earlier years⁹. Despite the financial incentives given to contract out of SERPS into PPSs, it turned out to be advantageous for men over 42 and women over 34 to contract back into SERPS once the period of the special bonus had ended in 1993. To discourage this from happening the government has been forced to offer additional age-related rebates to PPS members since 1993. Far from saving the government money, the net cost of PPSs during the first 10 years was estimated by the National Audit Office to be about £10bn.

The Blair reforms to the pension system

The Blair New Labour government came into power in 1997 with a radical agenda for reforming the welfare state. In the event, Frank Field, appointed the first Minister for Welfare Reform at the Department of Social Security (DSS) and charged with the objective of ‘thinking the unthinkable’, proved to be too radical for the traditional Old Labour wing of the Labour Party and was soon replaced. The eventual DSS Green Paper proposals ‘A new contract for welfare: Partnership in pensions’ (December 1998) turned out to be much less radical than initially anticipated, but nevertheless continued with the Thatcher government’s agenda of attempting to reduce the cost to the state of public pension provision and of transferring the burden of provision to the private sector through the introduction of Stakeholder Pension Schemes. Nevertheless, there was much greater emphasis on redistributing resources to poorer members of society than was the case with the Conservatives. Shortly after the publication of the Green Paper, the Treasury issued a consultation document on the type of investment vehicles in which stakeholder pension contributions might be invested. We will examine these proposals in turn.

⁹ Although the backloading effect is lower in average salary schemes (such as SERPS) than in final salary schemes (such as a typical occupational scheme).

The Department of Social Security proposals

The key objectives of the DSS Green Paper were to:

1. Reduce the complexity of the UK pension system, by abolishing SERPS.
2. Introduce a minimum income guarantee in retirement linked to increases in national average earnings on the grounds that people who work all their lives should not have to rely on means-tested benefits in retirement; the first-tier BSP will remain indexed to prices, however, and over time will become a relatively unimportant component of most people's pensions.
3. Provide more state help for those who cannot save for retirement, e.g., the low-paid (those on less than half median earnings), carers and the disabled, via the unfunded state system.
4. Encourage those who are able to save what they can for retirement, via affordable and secure second pillar pensions:
 - provided by the state for those on modest incomes (via a new unfunded state second pension), and
 - provided by the private sector for middle- and high-income earners, with the option of new low-cost defined contribution stakeholder pensions which are likely to replace high-cost personal pensions. But there will be no extra compulsion to save for retirement at the second pillar and no additional incentives over those already existing at the second pillar.

The Green Paper proposals formed the basis of the Welfare Reform and Pensions Act which received the Royal Assent in November 1999. The Act deals with following issues.

State pensions

1. A Minimum Income Guarantee (MIG) of £75 per week was introduced for pensioners in April 1999: it is means-tested on a weekly basis (and tapers off if the claimant's capital exceeds a specified limit) and is indexed to earnings. The MIG significantly increased the benefit income of the poorest pensioners, creating a new, higher income threshold below which pensioners with no or little savings should not fall.

2. In April 2003, the government introduced the Pension Credit (PC) the aim of which is not just to end the penalty on savings, but, for the first time, to reward savings. The PC, which is untaxed, is designed to make up the difference between the income a pensioner receives from *all* existing sources (including private pensions and savings) and the MIG. When it was first introduced, the pension credit meant extra cash for single pensioners with incomes up to £135 a week and for couples with incomes up to £201 a week. The guaranteed minimum income was £100 a week for individuals and £154 for couples. There was a maximum income entitlement under the pension credit of £135 a week for a single pensioner and £201 a week for a couple. The pension credit rewards saving by providing additional tax-free cash above the guaranteed minimum income at the rate of 60p for every pound of savings income, earnings or second pension up to the total income entitlement. The pension credit is the difference between the total income entitlement and the actual income received by the pensioner(s) from all sources. The

total income entitlement under the pension credit is therefore equal to the guaranteed minimum income (£100 in 2003-04) plus 60 per cent of the income received from any second pension, any savings or any part-time work up to the maximum income entitlement (£135 in 2003-04).

3. SERPS was replaced by a new State Second Pension (S2P) in April 2002: the S2P was initially earnings-related but from April 2007 becomes a flat-rate benefit, even though contributions are earnings-related (Child Support, Pensions and Social Security Act 2000).

Between 2002 and 2007, the S2P:

- ensures that everyone with a complete work record receives combined pensions above the MIG
- treats low-paid workers earning between the LEL¹⁰ and the Low Earnings Threshold (LET)¹¹ for S2P purposes (Band 1 earnings) as if they had earnings equal to the LET. The accrual rate on the S2P is 40 per cent of the difference between the LET and the LEL (this difference is known as the ‘surplus’), twice that of SERPS
- gives workers earning between the LET and the Second Earnings Threshold (SET)¹² an accrual rate of 10 per cent of Band 2 earnings, half that of SERPS
- leaves those earning over the SET and below the UEL¹³ (Band 3 earnings) unaffected (with an accrual rate of 20%)
- updates the LET, the SET and the surpluses in the three bands in line with national average earnings
- calculates the pension by taking the revalued surpluses in each band, applying the relevant accrual rates, adding together the resulting three values and dividing this sum by the number of tax years of membership of the scheme up to state pension age
- provides credits for carers (including parents with children under 5) and the disabled.

From 2007, S2P becomes a flat-rate pension scheme, although it will still be based on earnings-related contributions. This is intended to provide a strong incentive for workers on moderate and higher earnings to make their own private pension provision, while state provision in retirement is concentrated on workers on lower earnings. From 2007, everyone contracted-in to the state scheme will be treated as if they had earnings equal to the LET, regardless of the level of their actual earnings. Qualifying carers and long-term disabled people with broken work records will continue to be treated as if they had such an earnings factor. The S2P will be calculated for everyone by reference to the surplus in an earnings factor equal to the LET with an accrual rate of 40%. NIC rebates to those in contracted-out pension schemes remains earnings-related.

Stakeholder pensions

1. New Stakeholder Pension Schemes (SPSs) were introduced in April 2001, but are principally intended for middle-income earners (between the LET and the SET) with no existing private pension provision. They can be used to contract out of S2P.

¹⁰ £3,900 p.a. in 2002-03

¹¹ £10,800 p.a. in 2002-03

¹² £24,600 p.a. in 2002-03, calculated as 3 x LET – 2 x LEL rounded to the nearest £100

¹³ £30,420 in 2003-03

2. They are collective arrangements, provided by:

- an employer
- a representative or membership or affinity organisation, or
- a financial services company.

3. They are defined contribution schemes, with the same restrictions as for personal pensions, namely that on the retirement date up to 25% of the accumulated fund may be taken as a tax-free lump sum, the remaining fund may be used to buy an annuity or to provide a pension income by way of a drawdown facility until age 75 when an annuity must be purchased with the remaining assets.

4. They have to meet minimum standards, known as CAT marks (for charges-access-terms) concerning:

- the charging structure and level of charges (a maximum of 1% of fund value)
- levels of contractual minimum contributions (£20)
- contribution flexibility and transferability (no penalties if contributions cease temporarily (up to 5 years) or if the fund is transferred to another provider).

5. The main provisions of the Pensions Act 1995 apply to SPS, covering the annual report and accounts, the appointment of professional advisers and the Statement of Investment Principles.

6. They are regulated principally by OPRA, although the selling of schemes and the supervision of their investment managers is regulated by the Financial Services Authority (FSA), with the Pensions Ombudsman for redress.

7. Employers without an occupational scheme and with at least five staff must offer access to one 'nominated' SPS and to provide a payroll deduction facility.

8. There is a new integrated tax regime for all defined contribution pension schemes. SPS, personal pension plans and occupational DC schemes will attract tax relief on contributions up to a maximum of 17.5% of earnings (below age 36), rising to 40% (above age 61). But contributions up to £3,600 pa can be made into any DC plan regardless of the size of net relevant earnings. Contributions in excess of £3,600 pa may continue for up to 5 years after relevant earnings have ceased. Thereafter, contributions may not exceed £3,600 pa. All contributions into DC plans will be made net of basic rate tax, with providers recovering the tax from the Inland Revenue and with higher rate tax, if any, being recovered in the self-assessment tax return.

Occupational pensions

1. Occupational schemes can contract out of the S2P.

2. Employers can again make membership of an occupational scheme a condition of employment, and employees are only allowed to opt out if they have signed a statement of rights

being given up, certified that they have adequate alternative provision, and have taken advice that confirms that the alternative is at least as good as the S2P.

3. The compensation scheme established by the 1995 Pensions Act was extended to cover 100% of the liabilities of pensioners and those within 10 years of normal pension age (NPA).

4. The 1997 Finance Act changed the tax rules applying to UK dividend payments. Advance corporation tax paid by companies at the time dividends are paid at the rate of 20% could no longer be reclaimed by pension funds and other tax-exempt organisations. This has been estimated to reduce the income of pension funds by £5bn p.a.

Personal pensions

1. PPS can contract out of the S2P.

2. They receive protection in cases of the bankruptcy of the member.

HM Treasury proposals

The Treasury proposals were contained in 'Helping to Deliver Stakeholder Pensions: Flexibility in Pension Investment' (February 1999). They called for the introduction of more flexible investment vehicles for managing pension contributions, not only those in the new stakeholder pension schemes, but also those in occupational and personal pension schemes. These investment vehicles were given the name Individual Pension Accounts (IPAs). The main IPAs are authorised unit trusts (AUTs or open-ended mutual funds), investment trust companies (ITCs or closed-ended mutual funds), and open-ended investment companies (OEICs).

In comparison with the individual arrangements of existing personal pension schemes and the poor transferability of occupational pension schemes, IPAs offer:

- lower charges: since collective investment vehicles have much lower overheads than individual investments;
- greater flexibility: since IPAs are easy to value and transfer between different stakeholder, personal and occupational pension schemes, allowing employees to move jobs without having to change pension schemes, thereby encouraging greater labour market flexibility.

Assessment of the Blair reforms

The Welfare Reform and Pensions Act, while containing some significant improvements on the existing system, does not fully meet the Green Paper's own objectives.

Reforms to state pensions

While the abolition of SERPS helped to simplify the UK's extremely complex pension system, the proposal to have a MIG (of £75 per week) that differed from the BSP (£67.50 per week at the time) reintroduced substantial complexity at the starting point for state pension provision,

especially when the difference between the two amounts (£7.50 per week) was initially so small. It would have been far simpler to set the MIG equal to the BSP and to link the latter to earnings. Now the government explicitly rejected this on the grounds of both cost¹⁴ and the fact that it would benefit the high paid as well as the low paid, whereas the government's emphasis was on helping the low paid. But the problem with keeping the BSP linked to prices rather than to earnings is that it will continue to fall relentlessly as a proportion of national average earnings (NAE): it is currently just 17% of NAE and will fall to well below 10% by 2025. While the government admits that this will save substantial sums of money, it implies the government is effectively abandoning the first pillar of support in old age and obliging everyone to rely on the second and third pillars. The Green Paper talked about building on the BSP, but this implies building on a sinking ship.

If the government is genuinely concerned about security at the minimum level for all, it should consider funding the first pillar appropriately by establishing an explicit fund (like the Social Security Trust Fund in the US) into which it places the NICs of those who are in work, while the government itself funds the contributions of the low-paid, carers and the disabled¹⁵. The contribution rate could be actuarially set to deliver the MIG for all when they retire. It could be a hypothecated part of NICs. In other words, the contributions would accrue 'interest' equal to the growth rate in NAE. The state could explicitly issue NAE-indexed bonds which the SSTF would buy. This is the only honest way both of preserving the value of and honouring the promises under the first pillar. The second and third pillars could then be formally integrated with the first pillar, i.e., the second pillar is used to deliver the tranche of pension between the MIG and the Inland Revenue limits, while the third pillar is used for voluntary arrangements above the IR limits. If the first pillar remains unfunded, there is nothing to prevent future generations renegeing on an agreement which they are expected to keep but did not voluntarily enter into.

The fact that membership of pension schemes at the second pillar remains voluntary, is highly worrying for reasons of myopia and moral hazard. Compulsory contributions are seen as one way of dealing with individual myopia and the problem of moral hazard. Myopia arises because individuals do not recognise the need to make adequate provision for retirement when they are young, but regret this when they are old, by which time it is too late to do anything about it. Moral hazard arises when individuals deliberately avoid saving for retirement when they are young because they calculate that the state will feel obliged not to let them live in dire poverty in retirement. Inevitably, this will lead to substantial means testing in retirement.

In short, while the Welfare Reform and Pensions Act has some good points, it fails three tests set by Frank Field for a good state pension system: it is not mandatory, it is not funded and it

¹⁴ An additional £3bn per year (*Daily Telegraph*, 31 July 1999).

¹⁵ In fact, the Conservative government in the UK announced in March 1997 plans to privatise the entire state pension system from the turn of the century and to end its unfunded nature. All individuals in work would receive rebates on their NICs which would be invested in a personalised pension account. The initial costs in terms of additional taxation were estimated to be £160m in the first year, rising to a peak of £7bn a year in 2040. However, the long term savings to the taxpayer from the end of state pension provision were estimated to be £40bn per year (all in 1997 prices). The proposals were put on hold as a result of the Conservative government's defeat in the May 1997 General Election (see *Basic Pension Plus*, Conservative Central Office, 5 March 1997).

remains means-tested.¹⁶ Field argued that means-testing turns honest, thrifty citizens into dishonest citizens, since they have a strong incentive to conceal the true extent of their savings from the authorities in order to avoid having their state benefits cut. The spendthrift tend to end up with higher state benefits than the thrifty, to the annoyance of the latter. However, the Pension Credit was specifically designed to overcome this problem, by rewarding rather than penalising retirement savings.

Reforms to private pensions

The government's proposal to have a maximum charge of 1% of fund value on SPSs will have two dramatic effects on private sector pension provision, especially PPSs.

The first is that it will help to force economies of scale in DC pension provision. This is because stakeholder pensions will be a retail product with wholesale charges. To deliver this product effectively providers will need to exploit massive economies of scale. Charges for personal pension schemes which prior to the introduction of stakeholder pension schemes averaged 1.4% p.a. and rose to as much as 2.2% p.a. of fund value for 25-year policies¹⁷ are much higher than the 1% p.a. CAT-marked limit on SPSs. There may be a range of providers of SPS to begin with, but the only way for a provider to survive in the long run will be if it operates at low unit cost on a large scale. This will inevitably lead to mergers amongst providers and a final equilibrium with a small number of very large providers.

Existing personal pension providers and distribution channels face these challenges:

- APPSs face massive competition from SPSs for future NIC rebates;
- SPSs could be better than PPSs for middle-income groups, leaving PPSs as a choice only for those on high incomes who require and are willing to pay for a bespoke product; those people who wish to manage the investments in their scheme themselves would choose a self-invested personal pension scheme (SIPPS);
- new affinity-based SPSs with gateway organisations linking up with pension providers (e.g. Amalgamated Engineering & Electrical Union with 720,000 members and Friends Provident);
- the Treasury's proposed PPIs provide a low-cost alternative investment vehicle to the high-cost managed funds of most PPSs;
- Individual Savings Accounts (ISAs), introduced by the Treasury in April 1999 to encourage greater personal sector savings, also provide an important alternative to PPSs. Contributions into ISAs of up to £7,000 per annum are permitted and the investment returns are free from income and capital gains tax. While not intended as pension savings vehicles (they do not attract tax relief on contributions, for example, unlike standard pension savings products), ISAs can be used in retirement income planning, since they

¹⁶ Field, F. (1996), *Stakeholder Welfare*. Choice in Welfare Series No. 32, Institute of Economic Affairs, London; Field, F. (1996), *How to Pay for the Future: Building a Stakeholders' Welfare*, Institute of Community Studies, London.

¹⁷ *Money Management*, October 1998.

enjoy the big advantage that they can be cashed in tax free at any time, thereby avoiding the need to purchase a pension annuity on the retirement date.

The second benefit is that it will effectively force stakeholder pension funds to be passively managed, since active management would result in a charge higher than 1%. In the past, active fund managers have not demonstrated that they can systematically deliver the superior investment performance that justifies their higher charges. Further passively-managed mutual funds in the US, such as Vanguard (which are similar investment vehicles to IPAs), have charges below 0.3%.