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Individual Accounts for Social Security Reform:

Lessons From the United Kingdom

by David Blake and John Turner

To consider a Social Security reform approach that creates substantially new structures such as voluntary carve-out accounts, it is important to apply what we already know about the functioning of pension systems and their effects on workers rather than analyzing an idealized form of the proposed system. This article describes the United Kingdom's experience with voluntary carve-out accounts, including the system's numerous difficulties. Among the many problems are "mis-selling," high administrative costs and fundamental difficulty determining the appropriate offset between the reduction in the worker's payment to Social Security and the reduction in that person's Social Security benefits.

INTRODUCTION

Individual account plans have received considerable attention as part of Social Security reform proposals. They are defined contribution plans and can be:

- Mandatory or voluntary
- "Add ons" to or "carve outs" from Social Security.

Carve outs are financed with Social Security taxes and substitute for part of Social Security benefits.

Although policy analysts have written extensively about individual account plans, of the four basic types determined by the combinations of these characteristics, the least attention has been paid to voluntary carve-out (VCO) accounts. In recent years, however, there has been increased interest in them (see, for example, Blake 2003; Turner and Rajnes 1995; Kotlikoff, Smetters and Walliser 1998; Disney, Palacios and Whitehouse 1999; Orszag and Greenstein 2001; Williamson 2000; National Academy of Social Insurance 2005, Turner 2006). VCOs can be the most complex type of individual account.

With a VCO individual account, the worker has a choice. The worker can remain in the traditional Social Security system or withdraw from it—either partially or fully, depending on the structure of the VCO. VCOs in the United Kingdom can involve either a defined benefit[1] or a defined contribution plan[2] as the alternative to Social Security. We focus on defined contribution plans because they have been the subject of recent proposals in the United States. The United Kingdom is the only high-income country that allows VCOs with the worker establishing an individual account defined contribution plan.

A worker choosing a VCO pays the same amount in payroll taxes[3] as a worker not taking a VCO, but the disposition of the funds differs. With a VCO, part of the worker's payroll taxes (the contracting-out rebate) is diverted to an individual account from which he or she would receive future benefits, and future Social Security benefits are in turn reduced.

In considering Social Security reform, especially a reform approach that creates substantially new structures such as VCOs, it is important to apply what we already know about the functioning of pension systems and their effects on workers to assess the strengths and weaknesses of the proposed reform, rather than analyzing an idealized form of the proposed system. This article draws on the United Kingdom's experience with VCOs.

CONTRACTING OUT WITH INDIVIDUAL ACCOUNTS IN THE UNITED KINGDOM

In the United Kingdom, workers can "contract out" of Social Security, replacing part of their Social Security benefits with private pensions, either through a defined benefit plan or, since 1988, an individual account defined contribution plan. The United Kingdom was quite late in establishing an earnings-related Social Security program, which was not done until the 1970s. At that time, a well-established private pension sector was already in place. Voluntary carve outs were permitted in the United Kingdom not to reduce or privatize a preexisting Social Security program, but to protect a preexisting defined benefit private pension system. Later, for ideological reasons, workers were allowed to establish individual account plans to reduce their participation in Social Security.

Since the early 1990s, there has been little growth in the number of people contracted out, which has resulted in a decline in the percent of the workforce contracted out from 69% to 61%. Contracting out has been much more popular through defined benefit plans than defined contribution plans. Although in the private sector nearly everyone with a defined benefit plan is contracted out, only one-third of those with defined contribution plans are contracted out (Pensions Policy Institute 2004).

The U.K. government serves as a clearinghouse for contributions to VCO accounts. Workers and employers pay the full amount of Social Security contributions to the government. For workers taking the VCO, part of the Social Security contributions (the contracting-out rebates) are diverted by the government to the workers' individual accounts, in exchange for which the workers receive lower Social Security benefits at retirement. Once annually, approximately 18 months following the beginning of the tax year, the government pays the workers' VCO contributions for the entire previous tax year to the workers' individual accounts. During the 18 months before the government makes the payment to the workers' individual accounts, the government pays no interest on the accumulated contributions it holds.

This long delay between workers making contributions and the contributions being credited to the workers' accounts is done to reduce administrative expenses, compared to the expenses required for quick crediting of contributions. This delay compares with the requirement for U.S. 401(k) plans that all contributions be credited to the workers' accounts as soon as feasible, but no later than by the 15th business day following the month in which the contributions were made.

Although the U.K. government receives and disburses contributions to individual accounts, it does not have a recordkeeping function for the VCO accounts. In the U.K. system, rather than the government serving as the recordkeeper for the entire system, each worker has an account with the company managing the investments of the VCO, usually an insurance company.

The amount of the VCO payment relative to total Social Security contributions can act as an incentive or disincentive to contracting out, depending on whether the resulting benefit is more or less than the Social Security benefit that is given up. That result depends on the rate of return the worker receives on the VCO. Workers can contract out (take the VCO) and contract in as many times as they like so long as any change is maintained for a complete tax year.

Since 1993, an age-related payment to the individual account has been used in the United Kingdom. The payment to the individual account rises with age to provide a financial incentive not to contract back into the Social Security system at later ages.

Workers must begin receiving the individual account benefit between ages 60 to 75. Because men cannot receive Social Security benefits until the age of 65 (women can receive them at 60), the availability of contracted-out benefits at the age of 60 may provide an incentive to men to contract out. Benefits can be received as a phased payout up to the age of 75 and then must be annuitized on a unisex basis.

Workers are not required to annuitize their benefits when they first take them but are given flexibility as to when they annuitize. This flexibility permits workers to pick a time to annuitize when they think that interest rates are relatively high, and thus they would receive relatively high annuitized benefits. In this way, they can try to mitigate interest rate risk, with low interest rates at the time of annuitization reducing their benefits. However, in practice most workers annuitize when they retire and do not take advantage of the option to wait until a time when interest rates are more favorable.

Workers must contract with an insurance company to receive their annuitized benefits. Workers are responsible for investigating the prices charged by insurance companies. Generally, however, workers do not appear to search for the best offer and instead annuitize with the insurance company managing their pension account.

The pension benefit bought from the insurance company with the individual account must be price indexed (up to 5% per year). If the individual is married, the insurance company must provide a 50% survivor's benefit. However, an unmarried worker can use the entire amount to purchase a single life pension, and receive a benefit that could be 10-15% higher than the joint life pension received by a married person.

THE TERMS OF THE OFFSET BETWEEN THE VCO AND TRADITIONAL SOCIAL SECURITY BENEFITS

The payments the U.K. government currently provides to individual accounts for contracted-out workers are designed to be the actuarial equivalent of the benefits given up by a married person. The government payment to the individual accounts is calculated assuming pension fees of 1% per year.

The U.K. Government Actuary's Department (GAD) reevaluates the payment rate for individual accounts every five years, taking into consideration changes in life expectancy and interest rates. The payment rate fell during the late 1990s, but rose in 2002-2003. Changes over time in the government's payment rate for taking individual accounts may affect the workers' decisions as to whether to take the VCO.

In the United Kingdom, as the terms of the tradeoff have changed for the VCO compared to staying in Social Security, past arrangements have been grandfathered, so that there are separate calculations for benefits accrued at different times. This creates a complex system for determining benefit payments out of Social Security, and makes it practically impossible for workers to determine what their Social Security benefits will be.

The value of the government's payments to the individual accounts, as periodically calculated by GAD, is affected by changes in real interest rates. If real interest rates fall, the expected investment returns that workers receive will fall, and the payment calculated in the United Kingdom would rise so that the expected payment and accrued investment earnings would be the equivalent of the Social Security benefit being foregone. In 2002, at the time the payment rate was last set, real interest rates had fallen. However, GAD expected that fall to be temporary so it did not fully adjust upward the payment rate. GAD is under competing pressures. On the one hand, keeping the payments low saves the government money. On the other, if it sets the payment rate too low, people would not take VCOs, and so it thus may be under some pressure to set a generous payment rate to encourage people to take VCOs.

In 2004, two large U.K. insurance companies, Prudential and Norwich Union, sent letters to hundreds of thousands of policyholders telling them that the GAD had set the benefit offset rate too low. The policyholders were advised that they would be better off to not participate in their VCO accounts and should return to the traditional Social Security program. As a result of that advice and for other reasons, in 2004, 500,000 people abandoned VCO pensions and returned to Social Security (Cohen 2005). This decline occurred in part because some insurance companies advised their clients that they would be returned to full participation in Social Security unless they advised the company otherwise.

The calculation of the government's payments to the individual accounts assumes the continued existence of the U.K. Social Security benefit in its current form. If further cutbacks occur in the generosity of the benefit structure, as is anticipated given population aging, the payments by the government into contracted-out accounts may turn out to have been overly generous in comparison to the benefit that would have been received from Social Security (Pensions Policy Institute 2004).

A VCO account is like a loan from the government because the worker must accept reduced future Social Security benefits in exchange for the diversion today of Social Security payroll taxes into the individual account. The terms of the offset between contributions to an individual account and reductions in future Social Security benefits are a key aspect of the structure of VCOs because they affect the decisions workers make as to whether to take the VCO.

The smaller the reduction in the worker's future Social Security benefits when taking the VCO, the more favorable to the worker is the VCO but the greater is the cost to the Social Security system of offering the VCO. A generous VCO with a low assumed rate of return for calculating the offset may result in the traditional Social Security system providing a substantial subsidy of individual accounts, therefore worsening the long-term financing of Social Security and increasing the need for additional funding.

The possibility of a government subsidy to privatized individual accounts resulting from VCOs is not purely hypothetical. The British government publicized that it initially established a favorable offset for workers to encourage them to choose VCOs. It subsequently estimated that the present value of the reduction in future state benefits was £5.9 billion (in 1988 prices) lower than its cost in incentives provided to take the VCO. The government's cost in incentives was roughly twice as great as the government's savings through reduced benefit payments (Budd and Campbell 1998).

The perceived generosity of a carve out depends on the state of financial markets. When prices in financial markets are rising, the VCO would be more attractive than when they are falling. If financial markets have a prolonged period of poor performance, political pressure may grow for increasing the generosity of the VCO or for allowing workers to leave the VCO and return to Social Security, if they were not otherwise permitted to do so.

When contracting out into personal pensions was first allowed in the United Kingdom, the government provided a single rate for workers of all ages for determining its payments to individual accounts. With the single rate, the payments were particularly generous at young ages, but were generally viewed by workers and policy analysts as insufficient at older ages. Since the tax year 1993-1994, the payments have been age related, with more generous payments at older ages. However, the age-related payments to the individual accounts are capped, so that for workers at older ages they are still insufficient.

Younger workers receive lower governmental payments to their individual accounts than older workers. Individual accounts are more favorable relative to the Social Security defined benefit plans for younger workers because the defined benefit Social Security plan in the United Kingdom is backloaded. In 2001-2002, a 20-year-old received a 4% payment rate, although a 50-year-old received the maximum payment rate of 9% of covered salary. Age-related payment rates designed to keep the contracting-out arrangements age neutral are complex, expensive to administer and poorly understood by workers.

A further difficulty with VCOs is the problem of structuring a gender-neutral benefit offset. Because women have a longer life expectancy than men, a gender-blind offset would not be gender neutral in its effect on workers who are deciding whether to take it. The annuitized benefit from a defined benefit Social Security program is worth more to women than to men because women tend to live longer. For this reason, women need a higher payment than do men into their individual account to provide them with an annuitized benefit of equal annual value to the annuitized benefit forgone from Social Security. If the payment into the individual account is the same for men and women, women will be less likely to take the individual account.

The government payments into VCO accounts in the United Kingdom are the same for men and women, but they are not gender neutral. In the 45 to 54 age range, 93% of eligible men choose the individual account pension versus 32% of eligible women. The explanation for this difference presumably is the longer life expectancy of women, but it could also be explained by greater risk aversion among women than men causing women to be less likely to choose an individual account.

It is difficult for VCO accounts to replicate features of the benefits provided by Social Security, such as inflation protection. However, price indexation of benefits of up to 5% per year in individual accounts is provided in the United Kingdom, with the government paying for price indexation beyond 5% if inflation exceeds that amount.

THE EFFECTS OF VOLUNTARY CARVE-OUT INDIVIDUAL ACCOUNTS

The lack of financial sophistication of many workers creates the potential for abuse of a VCO system by pension service providers with a financial interest in workers choosing those accounts. That problem occurred in the United Kingdom with the personal pensions "mis-selling" scandal. More than two million people were mis-sold individual accounts, meaning they were sold accounts when they would have been better off remaining in their company's defined benefit plans or in Social Security. More than 40% of those who initially took VCOs with personal pensions were affected.[4] Financial service providers have had to pay £12.5 billion (approximately $25 billion in an economy a sixth the size of that of the United States) in compensation to those who were misled, who were primarily lower-wage workers (Gillion et al. 2000). Regulation is needed to control financial advice given when service providers have a conflict of interest.

VCO accounts are more expensive to administer than mandatory individual accounts because of the expanded element of choice. High charges were a key weakness of the United Kingdom's first attempt at introducing individual VCO accounts. These plans are subject to both high front-loaded charges and high annual charges. In 1998, the combined effect of these charges was equivalent to an average reduction in yield of 3.2% per year for ten-year plans and 1.7% per year for 25-year plans (Blake and Board 2000: Table 3), with the difference by tenure due to front-loaded charges. Further, plans change their fee structures on a regular basis (see *Money Management's* annual *Personal Pensions* publications), which makes it difficult to compare funds over time. Also, it raises questions as to whether particular fee structures, and changes to them, are used to conceal the true impact of fees. One study found that fees reduced the value of VCO accounts by 40-45% (Murthi, Orszag and Orszag 2001).

In the United Kingdom, market forces alone were not sufficient to drive down charges to competitive levels on pensions for individual account holders. Because of this market failure, the U.K. government introduced "stakeholder" pension plans in 2001 that are subject to a statutory maximum annual fee of 1% of asset values with no entry or exit fees.[5] As a consequence of this regulatory limit, providers of stakeholder pensions have greatly reduced the amount of "free" advice they provide to workers trying to decide whether to choose these accounts (Bolger 2001).

When workers have the option to end their participation in the VCO and return to full participation in the Social Security system, there may be problems arising from low persistency of participation in the VCO. Low persistency suggests dissatisfaction with VCOs. A regular premium pension plan involves a substantial commitment of time and resources by both the plan provider and its members if the desired objectives are to be achieved. As argued by the U.K. Personal Investment Authority (PIA):[6] "if investors buy policies on the basis of good advice, . . . they would not normally be expected to cancel premiums to their policies unless forced to do so by unexpected changes in their personal circumstances. This means that persistency can be a powerful indicator of the quality of the selling process." (Personal Investment Authority 1999, p. 3). PIA defines *persistency* as "the proportion of investors who continue to pay regular contributions to their personal policies, or who do not surrender their single premium policy" (p. 3).

Persistency rates (i.e., the percentage of policies that have not lapsed) after four years of membership are between 57% and 67% in the United Kingdom. (Personal Investment Authority 1999, Table 1), and industry estimates suggest that the persistency level after 25 years is just 16% (Blake and Board 2000). These figures suggest that very few personal pension plan members are likely to maintain plan membership for long enough to build up an adequate pension.

PIA regards these persistency rates as "disturbing" (1998, p. 10) and offers a number of explanations: Members were mis-sold pensions that were either unsuitable or too expensive; regular premium policies might be unsuitable for those with irregular earnings or uncertain long-term employment; a change of employment may lead to members joining employer-provided pension plans and abandoning their individual account VCOs; and adverse general economic conditions could worsen persistency rates.

The United Kingdom has encouraged workers to choose a VCO and permits defined benefit plans to be used for the carve out. Of those that remain fully in Social Security, 65% are women and 70% earn less than half of average full-time male earnings (Budd and Campbell 1998). Thus, most of the workers who remain fully in the Social Security system are lower-paid workers. The reduction in Social Security benefits when a low-income worker takes a VCO would be considerably larger as a percent of their total retirement income than for a high-income worker for whom Social Security is a much less important source of benefits. Thus, the change in the risk that a low-income worker would bear by reducing Social Security benefits and taking a VCO would be considerably larger. To the extent that lower-income workers are more risk averse than higher-income workers, they would likely invest in low-risk assets and have a lower expected return.

CONCLUSIONS

Although the strengths and weaknesses of individual accounts as part of Social Security reform have received considerable attention, most analysis has focused on mandatory accounts. Relatively little attention has been paid to voluntary carve-out accounts. This article draws lessons for the United States from the experience of the United Kingdom.

- **Many people in the United Kingdom are leaving VCOs and returning to the traditional Social Security program.** Two large insurance companies have sent letters to hundreds of thousands of policyholders telling them that they are better off not participating in their VCO accounts and should return to the traditional Social Security program. Proposals for the United States have not contained the feature that workers would be allowed to return to Social Security, but the British experience suggests that there would be political pressure at times for that to be allowed.
- **The administrative costs of providing annuitized benefits would be relatively high.** The cost of converting each individual account to an annuity, with private insurance companies providing the annuities, would be relatively high because of the high cost of individualized transactions, especially with many of the accounts being relatively small.
- **In periods of financial market downturns, there would be pressure on the government to let people participating in VCO accounts return to Social Security.** In part because of the poor performance of financial markets, workers are being encouraged in the United Kingdom not to take a VCO. If the goal is to offer VCO accounts on a

basis that is neutral with respect to the Social Security benefits workers have foregone, then many workers who take them will be made worse off because of the fluctuations in asset markets. If the government subsidizes VCOs, the first problem will be lessened, but the expense to the government will increase.

- **VCO accounts would not be a good arrangement for low-income workers who depend on Social Security benefits.** The reduction in Social Security benefits when a low-income worker takes a VCO would be considerably larger as a percent of their total retirement income than for a high-income worker for whom Social Security is a much less important source of benefits. Thus, the change in the risk that a low-income worker would bear by reducing Social Security benefits and taking a VCO would be considerably larger. To the extent that lower-income workers are more risk averse than higher-income workers, they would likely invest in low-risk assets and have a lower expected return.

In conclusion, while a number of issues have arisen with VCO accounts in the United Kingdom, perhaps the most fundamental problem is that it is difficult to determine the appropriate relationship between the reduction in the worker's payment to Social Security and the reduction in that person's Social Security benefits. Because of this problem, insurance companies in the United Kingdom, the only country with such a system, are now arguing that the government made an error in setting the current rate and that workers should not take the VCO. ◀

Endnotes

[1] They can be defined benefit if they are arranged via the worker's company. This option was historically important, but most private sector companies have terminated their defined benefit plans.

[2] If these defined contribution plans are arranged by the worker's company, they are known as contracted-out money purchase plans. If they are arranged by the worker directly, they are known as contracted-out or appropriate personal pension plans or contracted-out stakeholder pension plans. Contracted-out stakeholder pension plans are low-cost personal plans in 2001 having annual charges capped at 1.5 % for the first ten years and 1% annually thereafter, and imposing no entry or exit charges. For further details, see Blake (2003).

[3] Payroll taxes in the United Kingdom are called National Insurance Contributions.

[4] Personal pensions are similar to individual retirement accounts.

[5] This was subsequently raised in 2004 to 1.5% for the first ten years as a result of complaints to the government from stakeholder plan providers that they could not make any profit with a 1% fee.

[6] Replaced in 2001 by the Financial Services Authority.

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