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The UK Occupational Pension System in Crisis

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Abstract. The UK three-pillar system of pension and retirement income has been touted as a way forward for failing continental European pay-as-you-go social security systems. A minimum state-provided pension combined with a generous occupational pension and individual savings was seen by many as a way of simultaneously managing future nation-state liabilities while encouraging individuals through their employer or on their own account to make provision for their income aspirations. However, it is clear that this system is failing at all levels including at the level of occupational pensions: declining coverage rates, the retreat of plan sponsors from final salary schemes, and the surprising low rate of provision of defined contribution schemes suggests that the second pillar of retirement income provision may not last another generation. How and why this came to pass and the prospects for those still covered by occupational pension schemes in the public and private sectors are the topics of this paper. It is also argued that the recent establishment of a Pension Protection Fund for the private sector carries with it unfortunate implications for the long term efficiency of the market for corporate control while the unfunded nature of many public-sector occupational pensions plans suggests a very uncertain future as to the robustness of past pensions promises and the welfare of working people.

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Introduction

There was a moment during the mid-1990 when the British political establishment congratulated themselves on the robustness and integrity of the United Kingdom (UK) pension system. At the time, debate centred upon the probable costs and benefits of a European single currency; the prospective unfunded liabilities of continental European pension systems were identified as an important reason for not supporting the single currency. By contrast, UK pension liabilities were believed to be much less significant through to 2050 due in large part to modest state pension benefits and the significance of funded occupational pensions (Clark 2003a). A decade later, as the Pensions Commission [Turner Report] (2005) demonstrates, few commentators are so confident about the prospects for UK pension and retirement income.

Being related to unionisation in manufacturing industries, and being important in nationalised industries and the public sector, around 1970 pension coverage rates were quite high compared to other Anglo-American countries. Diffusion of occupational pension coverage through British industry involving large and small firms was a desired goal of government with tax benefits to match. In the mid-1960s the then minister for employment and pensions, Margaret Thatcher, observed that the state-provided pension benefit was so modest that it would have to be supplemented by occupational pensions and individual savings (Rhodes 1965). Occupational pensions were deemed, for at time at least, an essential ingredient of UK retirement income (Blackburn 2002).¹

Funded pension systems are also important financial institutions in their own right (Davis and Steil 2001). As such, they rely upon a myriad of financial services including those that plan and execute investment strategies and those that monitor and evaluate investment performance (Clark 2000). It is arguable that the UK financial services industry, dominant as it is in Europe and second only to Wall Street (New

¹/. There is a certain irony in Prime Minister Thatcher's actions twenty years later allowing individuals to opt-out of employer occupational pension schemes to take their chances in the market for financial products and services. The costs of that policy were borne by many of those who took the option, by financial providers via the "mis-selling scandal", and by British taxpayers in the form of higher levels of expenditures to cover individuals' shortfalls in retirement income. Forty years later, based upon US research on the psychology of decision-making, the Turner Report recommended that government make enrolment in company pension schemes automatic and that opt-out would be, in effect, once again discouraged.

York) in the global marketplace, has benefited enormously from the growth of the UK occupational pension system (Clark 2003a). London's securities markets owe their liquidity, in part, to these institutions and their service providers. Academic research suggests that these institutions have provided the UK economy a significant long-term advantage in terms of its growth potential compared to continental European economies (see Hu 2005).

So much for the story told in the 1990s. A decade later, UK coverage rates are much lower than anticipated, private defined benefit (DB) or final salary plans are facing extinction, and the provision of other types of pension plans such as defined contribution schemes have not made-up the difference (as in the US and Australia). As we shall see, however, the problems in UK occupational pensions are more than coverage rates and benefit levels. Private sector sponsors of existing defined benefit plans face an uncertain future notwithstanding the establishment of the Pension Protection Fund (PPF). As for the public sector, it is argued that the unfunded status of many defined benefit plans raise significant doubts about their long-term viability. There are efficiency and equity issues to be considered when evaluating the prospects of UK occupation pensions. Whatever happens to the Turner Report (2005), the UK pension crisis has just begun; it is bound to dominate domestic politics for another generation.

As calibration of the future costs of employer-sponsored pension benefits has become a recognised industry here and abroad, and as the actuarial profession has become more attuned to the market price of those future benefits, financial markets have become wise to the otherwise previously hidden costs of defined benefit pensions.² As well, the modern corporation has undergone profound long-term changes such that occupational pension schemes are much less significant for human resource management programmes. What remains unclear is why, in the UK private sector, the decline in defined benefit plans was not matched by early growth coverage in defined contribution or hybrid plans (as in the US; see Munnell 2006). And yet, DB pension

²/ A number of large investment and advisory companies have made calibration of DB obligations an important part of their business—see, for example, the websites of Credit Suisse, Bear Stearns, and Standard & Poors. Recent estimates of the funding shortfall of UK private pension benefits by Mercer Human Resource Consulting (2006) puts the cost at £93 billion. There have been many such estimates made in the light of revised estimates for longevity, the equity premium, and the rate of interest if pension benefits were to be capitalised (amongst other issues).

plans are not about to evaporate over-night: for many of the FTSE100 firms, the scale of pension obligations are likely to constrain corporate strategy and the market for corporate control. There remain significant efficiency costs for UK society in holding-in-place private-sector defined benefit pension obligations just as there are likely to be significant equity costs with unfunded public-sector pension plans.

Like Turner, I am pessimistic about the future of UK occupational pension plans. The Turner Report rightly recognized the retreat of private plan sponsors from the institution. But I am not convinced that the solution is to be found in a national savings system designed to mimic the features of a quasi-compulsory private pension scheme. The average value of supplementary pension benefits is unlikely to be significant, and there may be considerable inequality of benefits. The scale of such an institution is daunting, and reference to the experience of small countries such as New Zealand and Sweden simply amplify the differences between those countries and the UK. Most importantly, the Turner Report promotes an institutional arrangement that will last a century but lack the capacity to change form and innovate in the light of changing national, European and global financial circumstances. In terms of the value of state pension benefits, Turner has found a way back to social democracy rather than promoting innovation in the private sector.

Pensions and modern capitalism

In one form or another, occupational pensions have been with us for centuries. The provision of old-age and invalid pensions has been motivated by a variety of considerations including gratitude, a paternal concern for welfare, and the orderly transfer of long-serving employees from work to some form of non-work dependence (Thane 2006). Of course, relatively few “loyal servants” survived through to what we would now count as a conventional retirement age. Retirement as we understand the term was rare; the early national pensions systems relied on this fact-of-life when estimating likely obligations.³ Over the 19th century, public and private institutions began to establish formal administrative procedures designed to manage the

³/ An implication often drawn about the eligible age for retirement benefits in Bismarck’s regime, and a deliberate policy consideration of the UK Treasury when considering the costs of various pension reform bills brought to Parliament at the turn of the 20th century (see Clark et al. 2006 on Treasury estimates of the likely costs of the 1907 Old Age Pension).

assessment of claims for a pension and the allocation of benefits of certain value and duration. By the early 20th century, some of Britain's largest employers including railways and manufacturing companies had established pension institutions based upon the inherited common-law trust institution (Clark 2000).

The rapid growth of pension coverage in the public and private sectors in the years following the Second World War can be explained in a variety of ways (Clark 2005). A set of inter-related forces together raised levels of coverage rates through to about 1970 to just about 50 per cent of working people. Reconstruction of industry after the destruction occasioned by war precipitated the concentration of industry and, in some cases, nationalisation of industry through the formation of near-monopoly public corporations. The scale of these institutions was such that the management of internal labour resources became a profession in its own right with the principles of scientific management covering all forms of compensation including pensions. Pension benefits were conceived as deferred wages being included in negotiated wages and salaries by class of employee and were therefore less subject to the whims of employers.⁴ In any event, competition for labour resources was such that attracting and retaining labour through defined benefit pensions was believed consistent with firms' interests (Shonfield 1965; Galbraith 1967).

Pension benefits became a standard part of compensation packages, and defused from large employers to small employers via the competition for labour through private industry and the public sector. Of significance for the structure and performance of UK securities markets, the forward-funding of pension benefits became established practice and was then codified in statute, contributing to the growth of a vast reservoir of assets that were to change the economic structure of the Anglo-American world (see Clark 2000, Clowes 2000, and Hawley and Williams 2000). With the stability and growth of large employers over some decades, pension funds evolved from

⁴/ Even so, employers hardly ever refer to the labour contract when altering pension benefits, contribution rates and the like; the controlling document is, more often than not, the plan covenant which established the pension plan. This is a significant difference between the UK and the US (compare with Ghilarducci 2006). It has provided UK firms, depending upon the terms of the covenant, room to manoeuvre without consultation with employees and unions should they wish to change the structure and nature of promised pension benefits. The nature and significance of plan covenants for managing DB liabilities is still subject to debate (Institute of Actuaries 2005). It is not clear whether statutory obligations (brought into force in April 2006) requiring plan sponsors to consult beneficiaries about prospective changes will affect the powers claimed by many employers.

immaturity, to maturity and beyond relying upon the expertise available in the City of London. If established as beneficial institutions, the speculative bubble of the 1990s fuelled pension funds to become important financial institutions in their own right in the Anglo-American world (Clark and Hebb 2004).

[INSERT TABLE 1 ABOUT HERE]

The recent history of UK occupational pensions is shown in Table 1. The growth in private-sector pension coverage from 1953 through to about 1970 was dramatic peaking at about 48 per cent of all private sector employment. By contrast, public-sector occupational pension plan coverage was already significant in 1953, and has continued to grow albeit relatively slowly through to about 90 per cent in 2002. When considered in the light of trade union membership in the United Kingdom, the growth of private pension coverage through to about 1970 was correlated with the growth of private sector trade union membership; thereafter, not only has private trade union membership declined precipitously but so too has private sector pension plan coverage rates (compare Table 1 with Figure 1). That these two trends are correlated is self-evident; behind the correlation, however, is the decline of manufacturing industries and firms with heavy union representation (pension plan coverage) and the rise of industries and firms with low rates of unionization (pension plan coverage).

[INSERT FIGURE 1 ABOUT HERE]

Much has been written about the decline of UK manufacturing and the transformation of the UK economy to one dependent upon the export of financial services. Likewise, much has been written about the decline of the trade union movement and the transformation of national politics from one dependent upon social solidarity with its roots in social democracy counter-posed with liberal conservatism to one based upon identity politics and middle-class consumer aspirations.⁵ If work and pensions have been transformed in the private sector, the growth of public-sector employment and

⁵. This transformation remains highly contested and its long-term significance disputed (see Booth 2001); as a political issue, it is embedded in inter-regional rivalries (North and South) and is apparent in the tensions within the governing Labour Party. Notwithstanding claims made on behalf of social solidarity in a stakeholder society Hutton (1995), it is not obvious that these ideals have the same status in the UK as opposed to continental Europe (especially in pension policy; cf. van Reil et al. 2006).

the equitable expansion of pension benefits within that sector have sustained overall rates of pension plan coverage particularly amongst women. These trends carry significant implications for understanding current circumstances and future prospects.

Corporate capitalism in a global environment

Reading commentaries on post-war capitalism one is struck by the sense in which it was believed that capitalism had found a settled form of organisation and production that would last a century (see Williamson 1991). It is now obvious that the form of capitalism inherited from the post-war era has become the object of corporate and industrial restructuring; in play in the market for corporate control are the systems of management and compensation such as defined benefit pensions that played important roles in buying industrial peace in the years following the Second World War. The corporation is neither a constant nor is it necessarily homogeneous. The challenge is to design a private pension system that is neutral in relation to the evolution of the corporation recognising that its form and functions are becoming more differentiated (Zingales 2000). To illustrate, consider four "models" of the corporation and their implications for the nature and value of pension benefits (Clark 2005).

Let us begin with Firm A, a large market-leading corporation that has been around for many years having dominated its home market before spreading its wings to the rest of the world. Let us assume, as well, that Firm A was known as a progressive firm in terms of providing its employees with defined benefit pensions whatever their tasks or functions. But now, let us introduce three points of contention: with the rise of the market for corporate control, senior managers are encouraged to take up stock-options as part of their compensation packages; the management of brand-name products moves from the traditional home of the corporation in provincial Britain to London and New York and into very different labour markets for talent; and, new production technologies radically increase productivity while decreasing the demand for skilled labour.⁶ In effect, social solidarity between workers is fractured by the changing

⁶. A number of writers have noted the significance of the geography of industrial structure for the concentration of defined benefits in the UK, and the increasing separation between company sites of production and the executive and financial control of UK firms (north and south). These trends resonate with observations made by Charles Booth amongst other reformers of the late 19th century that with the increasing geographical separation between where workers lived and worked the paternal commitment of employers for workers' welfare was discounted by their social separation. See Martin and Minns (1995), for example.

demand for labour, volatility in the supply of labour, and consequent changes in the forms of compensation.

Having fostered a well-funded defined benefit pension system, Firm A introduces early-retirement pension benefits to encourage home-based managers and employees to retire. Notice three effects of this strategic move: first, the internal “market” for defined benefit pension benefits shrinks as home-based tasks and functions are rationalised; second, the industry “market” for defined benefit pensions shrinks as tasks and functions move to external service providers in other labour markets characterised by higher turnover and defined contribution, personal pensions, or no plans at all; and third, the national “market” for DB schemes shrinks as other forms of compensation become more attractive particularly for managers who no longer expect to remain with the firm or industry for their careers. Within a decade, the ratio of active to deferred and retired plan participants dramatically declines with an emerging funding “problem” compounded by lower-than-expected investment returns in the aftermath of the bubble in global securities’ markets (Shiller 2002) and actuarial revisions to the expected longevity of beneficiaries.

To complicate the picture, let us introduce Firm B which “produces” its products by contract relying upon an extensive network of suppliers governed according to specific performance criteria.⁷ Given the premium on quality and lower costs, B’s suppliers face a trade-off between capital investment and labour’s wages and benefits. This is resolved, in almost all cases, in favour of the former such that suppliers seek sites of production which are relatively cheap with little in the way of long-term commitments in terms of wages or pensions. To the extent that suppliers offer pension benefits, most offer defined contribution benefits based upon employee contributions rather than employer contributions. Likewise, Firm B employs part-time workers many of whom are women and many of whom have little commitment to the firm. Few of B’s employees are eligible for the company’s available defined contribution pension systems. Perhaps paradoxically, at the most senior level,

⁷. Here, the distinction made is between firms that rely upon their own resources and organizational infrastructure for scale and scope, and firms that rely upon the network of suppliers for scale and scope. The former have a huge inventory of tangible assets, the latter are dominated by intangible assets such as brand image and corporate reputation (see Lev 2001; Teece 2000). That corporations can become effectively just governance systems dispels claims made on behalf of the virtues of the embedded firm (compare Grabher 1993 with Clark 1993b).

managers participate in incentive-based compensation schemes that include highly lucrative defined benefit pensions (see Bebchuk and Fried 2004).

Imagine that a new Firm C enters the market. Assume this company was formed to take advantage of the “gap” in the market between firms A and B in that neither are focused on new products designed to latch-on to emerging tastes and fashions otherwise ignored by existing branded products and generic products. What kinds of compensation and pension benefit systems are consistent with the interests of Firm C’s principals? In the first instance, it would seem that human capital is the cornerstone of Firm C’s competitiveness: by buying into the market knowledge and quality control experience of senior executives, investors place bets on their capacity to conceive and implement a competitive strategy that cannot be replicated by large competitors. The time horizon for such a bet is longer than many public capital market investors would accept; but a series of “sign-posts” indicating positive progress could result in investors being carried through to an IPO. To get that far, however, requires a governance regime that integrates the short-term with the long-term between the partners and within the firm.

For example, a firm could offer a standard defined contribution pension to all employees regardless of status. This would have the advantage of treating all employees as equal whatever their tasks and functions, building solidarity and commitment around teams of individuals committed to the long-term growth of the firm. Because the success of Firm C is doubtful, a defined contribution pension plan with an external service provider may provide an exit option for workers unwilling to carry the risk of the firm's survival. And given the contingent nature of funding, it is unlikely that Firm C would match individual contributions to the DC scheme. Indeed, the level of contributions to offered DC schemes and its variants are much lower than an equivalent DB scheme. But the firm hold-outs the promise of significant wealth through stock options should the company be floated through an IPO. Here, employees are required to trade-off short-term insecurity and limited pension benefits with the prospect of wealth or higher incomes in the medium-term.⁸

⁸/. These types of firms were lauded for their innovativeness at the peak of the 1990s speculative bubble, and especially in North America. One aspect of their compensation schemes that has attracted attention is the use of company stock or stock options as matching contributions to individuals’

Then there is Firm D. It comes to market from another country that has neither private pension schemes nor well-developed or comprehensive social security entitlements. Its costs of production are a fraction of incumbent firms' although it has access to the most recent generation of production technologies which dominate the industry. It is able to enter the market, in the first instance, through Firm B's supply chains. However, once established, Firm A recognises opportunities to out-source component manufacturing of brand-name products and Firm C gambles on a relationship with Firm D in order to cover short-term limitations in its own capacity. The unit of retirement income insurance is neither the firm nor the state. It is the family, the village community, or the prospective life-time opportunities of the city.⁹

Lessons for public policy

In previous sections, the rise and fall of occupational pensions in UK industry was explained by reference to the transformation of industrial structure and long term changes in corporate form and functions. This will be familiar to many and carries with it widespread recognition of the social and economic transformation of Western societies from their dependence upon manufacturing to becoming diversified commercial and financial economies. For example, Esping-Andersen (1990, 1999) began with an account of modern welfare states referencing traditional industry and then reformulated his argument to take account of changes in the nature of work referencing and changes in society including reference to gender, the family, and so-called non-traditional modes of income generation. It is not surprising that defined benefit pensions have lost their centrality given the decline of related institutions.

contributions to DC pension schemes. While there are fewer instances than sometimes claimed, the consequences of such schemes in terms of concentrating risk are often highly deleterious for those involved. There is little data on such schemes in the UK; but they do exist (especially as supplementary bonus and incentive schemes).

⁹. In effect, my argument joins together immanent tendencies of change in corporate form and functions with the consequences of globalization for western markets and third-world producers. This argument is developed in more detail in Clark (2003b). It resonates with argument in political science and sociology over the future of the welfare state and whether variations in state-market national formations can survive international competition (see Scharpf and Schmidt 2000). Notwithstanding the intellectual attraction of concepts such as path dependency, we show in Clark and Wójcik (2005) for Germany, at least, that the rewards of financial markets can undercut corporate commitment to national and regional social and political regimes (compare Hall and Soskice 2001).

Plan sponsors are very different than what they were 50 years ago—companies have become highly differentiated with a myriad of links to related organisations at home and abroad. Expectations of a constant or settled corporate form and function based on a hierarchical division of authority and tasks have given way to very different models of the internal organisation of the firm with alternative modes of motivation and compensation (compare Williamson 1991 with Roberts 2004). Furthermore, what counts as a firm and what counts inside and outside of its legal borders has changed, driven in part, by capital market expectations and, in part, by the core competencies of managers (Orszag and Sand 2006). In many ways, the leading firms of the FTSE100 are iconic representations of a past era; if we want to know more about the future form of corporate capitalism we should look closely at the firms that enter and leave the FTSE100 lower down the ladder.

From these observations, there are four lessons for the framing of public policy relevant to the provision of occupational pensions in the private sector. The first is entirely obvious: there must be positive incentives to encourage both the demand and supply of occupational pensions in the private sector. If left to the market, employers and employees need not see the relevance of an occupational pension for their long-term welfare. To reinforce this point, refer to Table 2. There is shown the coverage of occupational pension plans by millions of employees by sector and by type of plan (including defined contribution and hybrid plans). Given the decline of defined benefit plans already noted above, defined contribution and other types of plans have made only a modest difference to trends in coverage. In fact, compared to the US defined contribution plans remain a surprisingly small segment of the market notwithstanding recent developments (see Munnell and Sundén 2004).¹⁰

[INSERT TABLE 2 ABOUT HERE]

¹⁰ /. It may appear odd to suggest that DC schemes have been relatively unsuccessful in the UK considering recent publicity about the closure of DB schemes and their replacement by DC schemes. My point here is twofold: first, the available official data suggest that DB schemes dominated DC schemes much longer than was the case in the US, and; second, as far as can be determined, many DC schemes were established to replace DB schemes—the provision of DC schemes in their own right, unrelated to DB schemes, has been much less significant than in the US. While many US observers would agree that the value of a DC scheme compared to a DB scheme is almost always much less, in the UK many private sector workers have often been denied even this mixed blessing.

A second lesson to be drawn from both the transformation of industrial structure and the increasing variation in corporate form and function is that any policy designed to encourage the provision of occupational pensions must be neutral with respect to prospective corporate structure. In the UK, occupational pensions were so intimately linked with particular industries and particular forms of the firm that new industries and new forms of corporate organisation have found the existing incentives and regulatory apparatus either an enormous burden or irrelevant to their market prospects. It is arguable that this is likely to be even more important in the future than it was over the past 50 years because of accelerating levels of competition occasioned by globalization. How firms are organised over time and space is rapidly changing especially in those firms and industries that encounter competing forms of corporate organisation from jurisdictions that share neither liberal democratic traditions nor a commitment to social and economic justice (Schoenberger 2000).

The third lesson from the transformation of corporate form and functions is that any policy designed to encourage the provision of occupational pensions must be flexible with respect to the design and implementation of such pensions. It is self-evident that defined benefit pensions do not match the interests of many employers in providing flexible but targeted retirement savings options. It is not surprising that corporations have sought to withdraw from these types of plans; if important as an institution of public policy, defined benefit pension plans are constraints on the nature and variety of corporate compensation practices. At another level, public policy should recognise the varying objectives of employees and those that would be plan participants and beneficiaries. None of this should be licence to adversely discriminate between different classes of employees: government has an interest in setting minimum standards of provision and retirement saving (as suggested by the Turner Report).¹¹

¹¹/. Embedded is an issue of profound political philosophy and public policy: the degree to which governments should respect the autonomy of employers and employees to fashion their own arrangements in relation to their particular interests as opposed to requirements imposed on employers and employees to meet certain standards of pension provision etc. It is arguable that having promoted private pension plans as a necessary supplement to modest national pension entitlements, governments had to regulate eligibility and standards of provision transforming private pensions from contractual arrangements into national institutions. See Clark (2006) and LaBoul and Yermo (2006) for more extensive treatments of these topics.

Most importantly, any public policy designed to encourage the provision of occupational pension benefits must do so in a manner that neither compromises the compensation objectives of the firm nor introduces conflict between the objectives of the firm and the welfare of different generations of workers within the firm. Unfortunately, one of the legacies of defined benefit pensions has been conflict between managers and workers over the distribution of retained earnings (between investment and pension contributions) and conflict between shareholders and workers over the distribution of corporate profit (between dividends and pension contributions). Although not so evident, there is also conflict between younger workers, older workers, and retirees within firms that offer defined benefit pensions—the conflict being between those workers with an interest in higher rates of corporate investment (income growth), those workers with an interest in higher prospective benefits (older workers coming to retirement), and retirees with an interest in maintaining the real value of benefit entitlements.¹² Such conflicts can be profound constraints upon the strategic options of firms in the context of global competition.

For some observers, these lessons for public policy may so favour corporate interests that they are dismissed without serious concern. In effect, these implications suggest that the weight be taken off the corporation as an instrument of government policy with respect to the provision of supplementary retirement income. This is also an important conclusion of the Turner Report (even if the evidence used to suggest that employers are now resistant to providing supplementary pensions is slight). The Turner solution is, moreover, entirely social democratic: by arguing for greater significance to be attached to an enhanced state pension sustained by a longer working career, the Turner Report would both reduce the relative significance of supplementary pensions and would provide an institutional structure whereby the provision of supplementary pensions is a government responsibility not an employer responsibility.

¹²/. Of course, the existence and significance of such trade-offs were muted by the speculative bubble of the 1990s wherein it appeared that all interests could be met without compromise for any party. So, for example, plan sponsors could take contribution holidays (thereby serving manager's interests in using financial resources for other goals), expand benefits for current workers, and meekly accept UK government policy mandating automatic inflation-adjusted retirement benefits. See Bergstresser et al. (2004) on the effects of the speculative bubble for reporting corporate earnings and Zion (2005) on aftermath of the bubble for pension funding (in the US but with the same implications for the UK).

By emphasising neutrality both with respect to current and prospective corporate structure and neutrality with respect to the objectives of the corporation as a profit-making enterprise, Turner would re-conceptualize the corporation as a means to an end (promoting growth in workers' incomes) rather than the instrument of social progress (provision of retirement income). It is clear that the current regime has fundamentally failed to deliver a modicum of private pension coverage with the prospect of further decline in pension provision of any kind.

Legacy costs—capital market efficiency

It appears that many employers have retreated from the provision of occupational pension plans rather than introducing accumulation funds or new workplace savings schemes for retirement. Even so, it should be acknowledged that there remain thousands of pension funds and a significant number of quite large pension funds. Not surprisingly, most of the largest firms listed on the London Stock Exchange carry defined benefit pension plans some of which remain open, some are closed to new members, and some have been effectively terminated. Over the past five years or so, these plans have been the object of government policy—including reviews of their governance, investment practice, and their integrity with respect to the “pension promise” exemplified by the recent establishment of the Pension Protection Fund.¹³

Though not often acknowledged as such, some of the largest UK pension funds are sponsored by firms that were once in the public sector: for example, British Telecom, British Petroleum, and British Airways (ranked by size of total assets of all UK funds as #1, #8, and #12; see Clark and Hu 2005). As well, a number of the largest pension funds are effectively the residual institutions of denationalised industries such as coal, electricity, railways, and the national power grid. When we look further down the list of large pension funds, four types of funds appear significant: those of banks, quasi-public sector funds (the BBC and USS) and especially local government authorities, the pension funds of companies that were once household names such as Marconi Corporation and Cable and Wireless, and a mix of retail companies and service companies such as Tesco's and Royal SunAlliance. Outside of the top 100 funds,

¹³/. For a review of recent government legislative initiatives regarding the governance of pension funds see Clark (2004). Many in the industry have been pre-occupied with meeting the requirements of the Myners Report and related initiatives designed to improve the competence of pension fund trustees and the management and performance of private pension funds (Clark et al. 2006).

there appear to be a myriad of large and small plan sponsors most of which are listed on the London stock market.

In the aftermath of the 1990s speculative bubble, and notwithstanding the recent performance of UK, US, and global stock markets, and the revaluation of pension fund assets and liabilities according to more restrictive national and international accounting standards (Whittington 2006), it is widely recognised that the majority of larger UK pension funds are under-funded. Whereas over the 1990s many plan sponsors were able to claim contribution “holidays” on the back of advancing stock market returns, many plan sponsors have had to dramatically increase their pension plan contributions even if those contributions still fall short of that needed to bring plans to fully-funded status. It has been also observed that many corporate plan sponsors have been reluctant to make such large contributions recognising competing claims by shareholders for increased dividends, and the volatility of pension funding implied by current market valuation.¹⁴ In this context, it is not surprising that it is claimed that more than 50 percent of FTSE100 corporate plan sponsors have closed their defined benefit pension plans to new entrants and, in some cases, have even sought to limit the accrual of benefits of existing participants.

It is apparent that there are reasons to be concerned about the long-term viability of such funds. In Table 3, the largest pension funds are classified by size and their relative maturity where maturity is defined in terms of the ratio of active pension plan participants against non-active plan participants including deferred beneficiaries and retirees. A large number of private pension plans can be characterised as “very mature” or “mature” whereas very few private pension plans could be characterised as “immature”. By contrast, many public pension funds are relatively “immature”.

[INSERT TABLE 3 ABOUT HERE]

Three implications can be drawn from these patterns. First, the combination of shortfalls in funding and increasing levels of maturity is such that in the future many

¹⁴/. Some informed observers suggest that contribution and funding shortfalls by corporate plan sponsors has been part of a deliberate attempt to discount worker expectations and force through long-term changes in the funding regime in anticipation of the Pension Protection Fund.

private plan sponsors will face greater calls on corporate assets and revenue. Second, as private plan sponsors close their plans to new participants, the maturity of those funds will accelerate. Third, as maturity accelerates private pension funds will inevitably shift their asset allocations towards less risky investments including government bonds. But lower rates of returns, the product of changing the allocation of assets to less risky investment classes, will put further pressure on plan sponsors to meet funding shortfalls. It is likely that the largest UK private pension funds will be less secure in 5 and 10 years than they currently appear to be.

For plan sponsors and their shareholders, pension liabilities may be very onerous. There are few instances where plan sponsors have been able or willing to renegotiate with stakeholders the promised value pension benefits. So far though, large UK plan sponsors have been unwilling to use bankruptcy to rebalance claims by creditors including pension plan beneficiaries on the assets of the firm (compare with US experience; see Clark 1993a and Ghilarducci 1992). With greater awareness amongst financial analysts of the potential costs of defined benefit pensions, and with the prospect of only modest returns from securities markets over the foreseeable future, there appears to be every chance of another crisis in UK occupational pensions: where many large plan sponsors renege on their pension promises notwithstanding claims made about the PPF's insulation from "moral hazard".

As the numbers of those that would benefit from a private pension become a relatively small subset of the UK working population, the government may be forced to re-assess the balance of costs and benefits of holding plan sponsors to account for past promises. Ultimately, these liabilities may impede capital market efficiency especially in cases where large pension plan liabilities are reported on the balance sheets of plan sponsors. If pension plan beneficiaries are privileged debt holders, an implication to be drawn from the actions of the PPF, and if pension plan trustees are required to exclusively represent the interests of beneficiaries, an implication to be drawn from the actions of the Pension Regulator, in some cases plan liabilities may be

so significant that they become an anti-takeover “poison-pill” limiting corporate rationalization through capital markets.¹⁵

Considering the collective interest in encouraging the competitiveness of the private sector in the global economy, this may be too high a price for protecting the interests of a privileged minority. The lack of mechanisms for re-negotiating the distribution of pension liabilities between interested parties prior to plan termination at the PPF or bankruptcy is a significant efficiency issue: the Dutch have better institutional mechanisms for managing current and prospective pension liabilities (Clark 2003a).

Legacy costs – public-sector privilege

Private sector occupational pensions face an immediate crisis in terms of coverage and a long-term crisis in terms of the viability of past pension promises. By contrast, the evidence presented in Table 1 would seem to suggest that public-sector occupational pensions have a long-term future. Coverage rates are very high including an important component related to gender equity such that both men and women share in the benefits of public-sector occupational pensions which is much less the case in the private sector. Furthermore, the growth in pension coverage in the public sector over the last 10 to 20 years has taken coverage to levels hardly contemplated in the private sector. Public-sector trends reflect a commitment to the equitable treatment of different classes of employees whatever their status.

Public-sector occupational pensions carry with them lucrative early-retirement benefits at a high level of income replacement, occupation-specific clauses and benefits relevant to the emergency services, and generous benefits for surviving spouses and dependants. Even so, UK public-sector occupational pensions are not nearly as lucrative as similar types of benefits in some continental European countries; the nature and scope of benefits remain more consistent with private sector benefits than with European customs and conventions. Nevertheless, public-sector occupational pensions have tended to lead private sector occupational benefits in

¹⁵/. In this respect, I am not convinced that the Pension Protection Fund’s use of risk-adjusted insurance premiums will either maintain PPF solvency or encourage better corporate management of their debt structures. Basically, the PPF can not charge the proper premium for the highest risk firms: to do so would precipitate plan closure and paralyse financial market solutions. Of course, my views on this matter are subject to dispute.

terms of their scope and value. Furthermore, in many cases individual contributions are only loosely related to promised benefits; commonly, employer and employee contribution rates are not high enough when compared to the value of benefits.¹⁶

As noted above, of the 100 largest UK pension funds a significant number come from the public sector. One of the largest funds is the multi-employer fund from the tertiary education sector: the Universities' Superannuation Scheme (USS) is rated the second largest fund in the United Kingdom and one of Europe's largest funds. Also important are a number of large local government pension funds, many of which are relatively immature compared to private sector counterparts. For example, it has been reported that on current estimates the USS fund will be in a net accumulation phase for at least 15 to 20 years before the net inflow of contributions becomes a net outflow of benefits. These large funds are not only significant in terms of their accumulated assets, they represent a core part of the market for financial services, and are often the most aggressive funds in terms of holding UK, European, and global corporations to account for their standards of governance and social responsibilities.¹⁷

For all the virtues of public-sector occupational pensions these pension systems face an uncertain future. First, it is apparent that public sector employees are quite privileged compared to their private sector counterparts in terms of access to occupational pensions and high levels of benefit especially when many private sector employees do not have the opportunity to participate in employer-sponsored pension schemes. This is a political issue. It is associated with the role that public sector unions have played in supporting the Labour government albeit, at times, a relationship under stress. Debate over pension equity and social justice is likely to include debate over the privileges of one sector of society in terms of access to defined benefit pensions (and occupational pensions of any kind). In recognising these issues, however, the Turner Report does not provide an easy way forward.

¹⁶/. It is arguable, though difficult to prove empirically, that public sector pension benefits compensate for relatively lower wages and salaries when compared with private industry. In fact, business interests contend that with the growth of public sector employment over the past 5 years, public sector pay has risen faster than private sector pay.

¹⁷/. See Clark and Hebb (2004, 2005) and Hawley and Williams (2000) on the role and significance of pension funds as institutional investors in the global marketplace.

[INSERT FIGURE 2 ABOUT HERE]

Of even greater significance for the long-term future of public-sector occupational pensions is the fact that many public sector pension schemes are either under-funded or unfunded (Pensions Policy Institute 2005). See Figure 2 for summary details. If public-sector pension schemes were subject to the same exacting accounting standards facing private sector plan sponsors, many public schemes would be so under-funded that plan trustees would be justified in calling upon government to increase the rate of contributions. The consequences for local government taxes, already subject to considerable political debate and highly publicised instances of non-compliance, would be far-reaching. The situation facing central government concerning the unfunded nature of occupational pensions in the emergency services sector and in the National Health Service is also alarming. In Table 4, the basic parameters of NHS pension plans are summarized including the numbers of employees who will have a claim on central government revenue for occupational pension benefits.

[INSERT TABLE 4 ABOUT HERE]

Unfunded or under-funded public-sector occupational pensions are a form of pay-as-you-go social security. As such, the government faces the prospect of increasing liabilities over time driven by a combination of past pension promises only loosely related to employee contributions, increasing longevity upon retirement, and the costs of early-retirement. Not surprisingly, attempts have been made to “reform” these pension schemes including attempts to introduce older-age thresholds and longer work-histories needed to obtain maximum benefits. In some emergency services, where early-retirement on high levels of income replacement has been the norm, these reform initiatives could carry significant political costs if pushed to the limit. Over the long-term, central government faces the prospect of a level of public sector union opposition to pension reform more often associated with France and Italy than the United Kingdom (see Clark 2003a).

Implications and Conclusions

One important element of the UK pensions crisis is the current and future prospects of occupational pensions: for all the significance attributed to these institutions in terms

of supplementing modest social security entitlements, most private sector employees do not have access to such benefits while public sector employees may see their entitlements passed back to central government to become yet another liability on an already overburdened state.¹⁸ The decline in coverage rates in the private sector can be traced to the transformation of UK industry and changes in corporate form and functions such that traditional occupational pensions appear largely irrelevant in terms of corporate compensation practices. We are at the end of an era in terms of the significance of these institutions for the retirement income of future generations of working men and women.

The fact that a significant number of public-sector employees participate in underfunded or unfunded pensions schemes that are better understood as old-fashioned pay-as-you-go pension systems than as viable stand-alone financial institutions suggests that the UK crisis of occupational pensions is not just a private sector phenomenon. However, this issue has been met by the current government with a degree of political commitment missing from concern about private sector pension issues. Prior to the publication of the Turner Report (2005), the government through the minister responsible effectively withdrew public sector pensions from the reform agenda guaranteeing current workers their benefits and contribution rates while shifting to new public sector employees more of the burden of contributions. While the relationship between public sector unions and the Labour government has been fraught with controversy, there is little doubt about the government's interest in union quiescence prompted a deal that left the Turner Report irrelevant on the issue. There seems little prospect, at present, of re-aligning public sector pension entitlements with what is deemed appropriate for the private sector.

Government faces a significant challenge in resuscitating occupational pensions as a viable institution for private sector employees. If occupational pensions are to play the role assigned to them as crucial supplementary retirement income institutions, government policy may have to respond by allowing employers and employees to re-

¹⁸/. In the long-run, as the costs of retirement of the baby-boom generation affect government balance sheets and as governments come to recognise the limits of fiscal policy in a world of global competition for scarce labour and capital, there may be unpalatable trade-offs to be faced including support for the elderly as opposed to the education of the young. Some analysts such as Tanzi and Schuknecht (2000) would argue that these issues have already begun to appear on western governments' balance sheets.

craft these institutions in ways that make them relevant to different classes of employees. The regulatory burden and the public interest in private pension provision must be both discounted while retaining a judicious mix of oversight and scrutiny with regard to pension security. By this account, the private sector is unlikely to make-up the apparent decline in coverage rates whatever the claimed significance of new kinds of pension benefits and institutions such as defined contribution and hybrid schemes unless these types of benefits are directly related to corporate compensation practices. If so, we may have to accept increasing levels of inequality in the nature and value of benefits recognising that different classes of employees have different value and commitment to their employers.¹⁹

Recognising the decline of the private pension system, the Turner Report (2005) recommended a series of structural changes to the UK pension system. Returning to a long-running debate over indexation of state benefits, the Turner Report recommended improving the long-term value of state-pensions by linking benefits to income growth in the economy. To be paid, in part, by increasing the retirement age at which workers could claim maximum benefits. Turner also recommended the establishment of a National Pension Savings Scheme (NPSS)—a quasi-compulsory earned-income pension contribution system. By creating such a contributions system, by regulating the available choice of investments, and by setting cost constraints on investment options, the Turner Report argued that UK workers could have the benefits of supplementary pensions without having to rely upon employers to sponsor such plans. At the same time, Turner would allow employer-sponsored schemes to function as long as they met certain standards (being better than the NPSS).

In doing so, Turner would bypass the market for individual pension products. It is widely recognised that individual consumers of pension and retirement income products are not well-informed consumers in a marketplace that is highly differentiated with enormous (often opaque) costs associated with seeking and finding the best solutions (Venti 2006). Furthermore, it is clear that contracts to supply retirement income carry with them inadequate incentives or obligations with respect

¹⁹/. In effect, if pensions are to be important to employer compensation strategies, the nature and value of benefits are likely to be more closely related to workers' current and expected productivity given the market for labour of different quality and quantity (as suggested by Lazear 1998).

to protecting the welfare of intended beneficiaries compared to the underlying ethic informing occupational pension funds (Clark 2006). Finally, it is clear that the average consumer is not well-equipped to competently and consistently act on their own best interests when compared to institutions of long-term mutual benefit and concern. In rejecting the market for private pension savings products, the Turner Report eschewed a return to 19th century liberalism in favour of a 20th century social market solution.

It is beyond the scope of this paper to mount a critique of the Turner Report except to suggest some points of concern. First, it has to be shown that the NPSS would be cost-effective and capable of delivering a risk-adjusted rate of return above the long-term government bond rate. Second, it has to be shown how such a scheme would be governed such that it would remain efficient and adaptive to changing financial circumstances nationally and internationally. Third, it has to be shown how it would be innovative in terms of the nature of offered investment products and responsive to the interests of more or less skilled participants. In effect, the question is: can such a saving scheme match the qualities of a well-managed large occupation pension plan?

One problem with the Turner Report is that its supplementary savings regime may be so limited in terms of warranted costs and consequent investment options that it becomes isolated from the never-ending quest for financial innovation in the global marketplace. Furthermore, it may dampen the capacity of employees and employers to develop compensation schemes that are truly responsive to the labour market conditions of the 21st century. A third problem, noted above, is that, given the parameters of such a scheme, the rate of return may not be much better than holding a government bond which is a proxy for national economic growth. Consequently, for many people, the supplementary savings regime will not take the weight off their dependence upon an enhanced state-pension; in fact, it may be perceived as just another tax on earned income. Those that have the great fortune of remaining with an employer-sponsored scheme, however, may have access to much greater benefits than those offered by the supplementary savings regime.

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Table 1. UK occupational pension plans, private and public sectors (1953-2000)

	Total members	Private sector (in millions)		Public sector (in millions)		Coverage rate (%)	
		Total employed	Total members	Total employed	Private sector	Public sector	Total
1953	3.1	16.3	3.1	5.6	19.1	54.9	28.3
1956	4.3	16.9	3.7	5.8	25.5	63.3	35.2
1963	7.2	17.0	3.9	5.9	42.4	66.1	48.5
1967	8.1	16.9	4.2	6.9	47.9	60.9	51.7
1971	6.8	15.8	4.3	6.7	43.0	64.2	49.3
1975	6	15.8	5.4	7.2	38.0	75.0	49.6
1979	6.1	15.7	5.5	7.4	38.9	74.3	50.2
1983	5.8	14.3	5.3	6.8	40.6	77.9	52.6
1987	5.8	15.2	4.8	6.4	38.2	75.0	49.1
1991	n.a.	n.a.	n.a.	5.8	n.a.	n.a.	n.a.
1995	n.a.	n.a.	n.a.	5.2	n.a.	n.a.	n.a.
2000	5.7	15.0	4.5	5.1	38.0	88.2	50.7

Source: Occupational Pension Schemes Surveys, Government Actuary Department, various years; Pension Policy Institute (2005); Office for National Statistics, UK.

Table 2. UK occupational pension plans participants (millions) in different plans (1995-2004)

	Defined benefit plans		Defined contribution plans		Hybrid		Total
	Private sector	Public sector	Private sector	Public sector	Private sector	Public sector	
1995	5.2	4.1	0.9	0.0	0.1	0.0	10.3
2000	4.6	4.5	0.9	0.0	0.1	0.0	10.1
2004	4.0	5.0	1.4	0.0	0.0	0.0	10.4

Source: Occupational Pension Schemes Surveys, Government Actuary Department, various years; Pension Policy Institute (2005); Office for National Statistics, UK.

Table 3. Largest pension funds (97) by size (£billion), maturity and sector

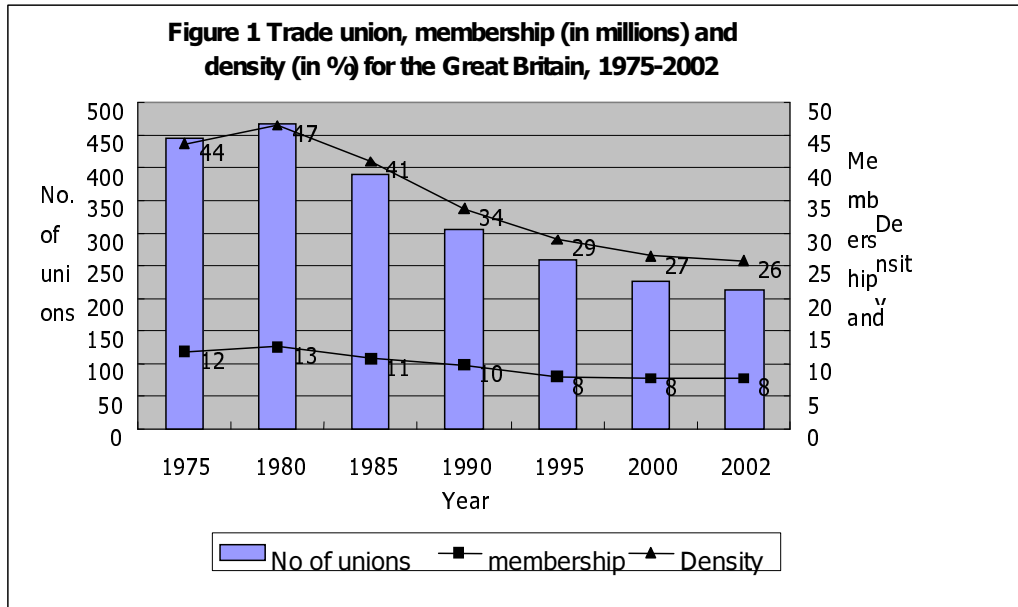
	>4bn		2-4bn		1-2bn		Total
Very mature	Public	0	Public	0	Public	0	0
	Private	9	Private	12	Private	12	33
Mature	Public	0	Public	1	Public	0	1
	Private	4	Private	5	Private	9	18
Immature	Public	1	Public	6	Public	7	14
	Private	5	Private	5	Private	3	13
Very immature	Public	4	Public	0	Public	6	10
	Private	2	Private	3	Private	3	8
Total		25		32		40	97

Source: Pension Funds and their Advisors. Note: Very mature is defined as the ratio of the difference between the number of pensioners and the number of active members to the number of active members greater than 100%, mature is defined as the ratio between 0% and 100%, immature as the ratio between -50% and 0%, and the very immature as the ratio less than -50%. Three pension funds, i.e. Coal Pension Trustees, Church Commissioners for England and The Royal London Mutual Insurance were dropped, due to lack of information.

Table 4. National Health Service (NHS) pension plans, 1962-2004

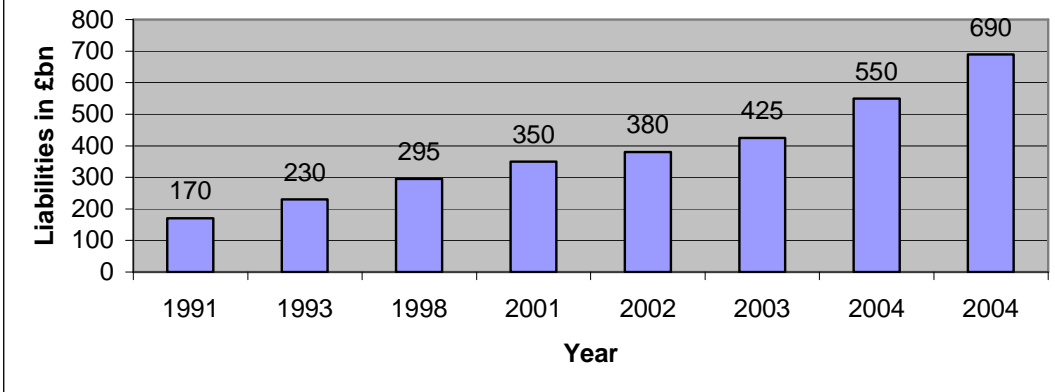
	1962	1974	1984	1994	1999	2004
No. of plan participants	392,570	600,000	979,500	1,086,200	1,404,200	2075136
No. of total employed	575,000	911,000	1,223,000	1,177,000	1,422,000	2975136
Coverage rate, %	68.3	65.9	80.1	92.3	98.7	69.7
Total assets (£,million)	951	2,437	n.a.	44,062	57,500	n.a.
Total liabilities (£, million)	882	3,440	n.a.	51,616	71,300	104,200
Funding ratio, %	107.9	70.8	n.a.	85.4	80.6	n.a.

Source: Reports by the Government Actuary on the National Health Service Superannuation Scheme, various years. Definitions: Participants are the sum of plan contributors plus pensioners; Total assets are the net present value of future contributions from employees and investment income; Funding ratio is total assets/total liabilities.



Source: **Annual reports of the Certification Officer**, and Office for National Statistics, various years. LH (in columns) shows the number of unions, while the RH (in lines) the memberships (in millions) and density (in %).

Figure 2. Pension liabilities of unfunded public sector schemes (£bn), 1991-2004



Source: House of Commons Hansard, various years; PPI (2005); Watson Wyatt (2005). There are two estimates for 2004, one at 550bn is from the UK government, while the other at 690bn is from Watson Wyatt

