PROBLEMS ENCOUNTERED WITH PRIVATE ACCOUNTS IN THE UNITED KINGDOM

Since 1987, the United Kingdom (UK) has allowed employees to voluntarily withdraw from part of social security by reducing their contributions and receiving reduced benefits. Instead, employees contribute to an individual account. This Fact Sheet outlines problems the UK has experienced with this system of voluntary carve-out accounts (VCOs).

Workers are being encouraged to leave the individual account system.
Insurance companies are encouraging many policyholders to stop contributing to their VCOs and return to the traditional social security program. The UK government determines the benefit offset, the amount by which social security benefits are reduced for those workers choosing the VCO. Although not its intent, the UK government set the VCO benefit offset so that it is no longer favorable for most workers to take the VCO, according to some UK insurance companies. Two large insurance companies, Prudential and Norwich Union, have sent letters to their 750,000 policyholders with VCOs telling them they are better off leaving their VCOs and returning to the traditional social security program ("Pru and NU tell policyholders to go back to S2P," 2004). In 2004, 500,000 people abandoned VCO pensions and returned to the state system (Cohen 2005).

The UK government paid large subsidies to participants in the individual account system.
VCOs resulted in a large government subsidy in the early years. The UK government initially established a favorable benefit offset for workers to encourage them to choose VCOs. It subsequently estimated that the present value of the savings due to the reduction in future state benefits was $22 billion less than the cost to the government in incentives provided to take the VCO. The cost to the government in incentives to take the VCO was roughly twice as much as it saved through reduced benefit payments (Budd and Campbell 1998).

Individual accounts have been a bad deal for many workers.
Many workers are worse off by having taken the VCO. Due to many workers' lack of financial sophistication, pension service providers who have a financial interest in workers choosing accounts, even when those accounts are inappropriate for the individual worker, may have taken advantage of those participating in the VCO system. That problem has occurred in the UK, with the "pensions mis-selling" scandal; more than two million people bought accounts when they would have been better off remaining in social security. Those affected represent more than 40 percent of workers who initially took VCOs with personal pensions, and the compensation they will receive from financial service providers as a result of being misled is in the billions of dollars. The people mis-sold were primarily lower-wage workers (Gillion et al. 2000).

The VCO is like a loan. Workers are allowed to invest part of their social security tax, but they must repay the "loan" at retirement by accepting reduced social security benefits.

There is a long lag between when the government collects contributions and when it credits them to the VCOs. The UK government does not credit contributions to VCOs until 18 months after the start of the tax year in which the worker made the contributions, and it pays no interest during this period. While a system could be established to credit accounts more quickly, such a system would increase individual accounts' administrative costs.

The administrative costs of VCO accounts are high. In 1998, the combined effect of the fees charged on individual accounts equaled an average reduction in yield of 3.2 percent per year for people in these plans for 10 years and 1.7 percent per year for people in plans for 25 years (Blake and Board 2000).

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