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Incentives to save in a pension: a review of the PPI's research

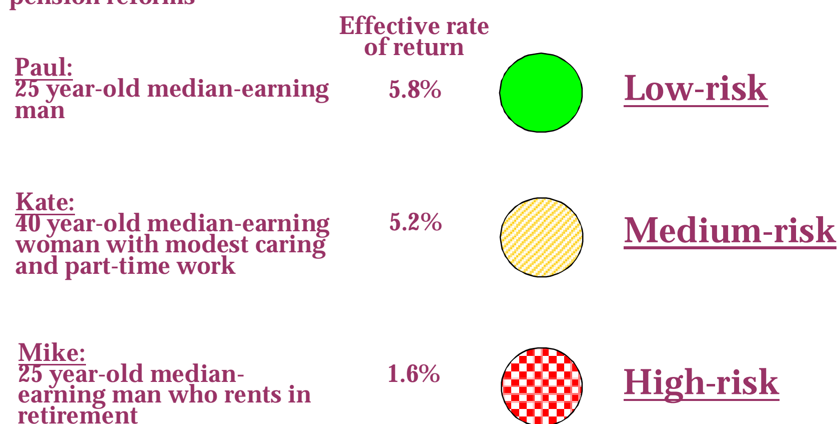
Introduction

The Government has announced that it will undertake a work programme to establish a shared understanding of the evidence on financial incentives to save for retirement following the introduction of the Government's pension reforms. The work programme will assess the potential costs, benefits and other impacts of measures that could affect incentives to save for retirement.

The PPI has undertaken a number of research projects that will be relevant to this work programme. This Briefing Note summarises the PPI's research on this issue to date and highlights areas where there are still gaps and where clarity is needed from the Government. It provides the background to a PPI seminar on this topic in March, sponsored by B&CE Benefit Schemes and the Equality and Human Rights Commission.

What is the concern?

The Pensions Bill going through Parliament would introduce the Government's private pension reforms. These include auto enrolling most employees into saving in a private pension. Employees would have the right to opt out but, if they remain opted in, their employer would contribute 3% of a band of earnings. Employees would be auto enrolled into a new national pension saving scheme, called personal accounts, or into an exempt existing pension scheme.



While the reforms should increase the number of people saving in a pension, concern has been expressed that some of the people who are auto enrolled may ultimately end up little, or no, better off from their saving, as a result of the interaction between pension saving and the tax and benefit system.

Who is at risk of low returns?

The PPI has analysed the effective returns that different individuals could receive from saving in a personal account.

Many factors will affect the effective rate of return[1] from saving in a personal account. Some factors will tend to increase the returns from saving, such as the proposed employer contribution, tax relief and investment returns. Others will reduce the effective rate of return, such as the charges levied by providers, any income tax paid on pension income in retirement, and any reduction in eligibility for means-tested benefits that may result from saving in a pension (Pension Credit, Housing Benefit, Council Tax Benefit).

The PPI's research categorises individuals by the risk of personal accounts being unsuitable for them. Pension saving is defined as being 'suitable' for an individual if he or she does not lose out as a result of saving. There are three risk groups: 'low', 'medium' and 'high', depending on the effective rate of return.

People in the low-risk group are likely to receive back the value of their own pension contributions, plus inflation and a full investment return on those contributions. This group includes people in their twenties in 2012 with a full work history (for example, Paul in Chart 1).

People at 'medium risk' are likely to receive back the value of their own pension contributions, plus inflation and some investment returns on their own contributions, although they may not receive full credit for the investment returns. This group includes some older people with low earnings and broken work histories, who may have less time to benefit from the recent state pension reforms and less time to save in a pension (e.g. Kate in Chart 1).

People at 'high risk' are unlikely to receive back the value of their own pension contributions with inflation, although they may still have a higher retirement income than if they did not save. This group includes people likely to rent accommodation in retirement, who are potentially eligible for Housing Benefit to help with rent (e.g. Mike in Chart 1).

All of these people are single with no other saving. People who are married in retirement or have non-pension saving may have higher returns from saving in a pension.

This analysis illustrates the individual characteristics that can lead to lower returns from saving in a pension, and suggests that saving in a pension may not be suitable for some groups of people. However, other factors are relevant, including individual preferences to smooth consumption over the lifetime, levels of debt and the affordability of the pension contributions. A full discussion is available on the PPI website.[2]

Chart 2: Future levels of eligibility for means-tested benefits are uncertain

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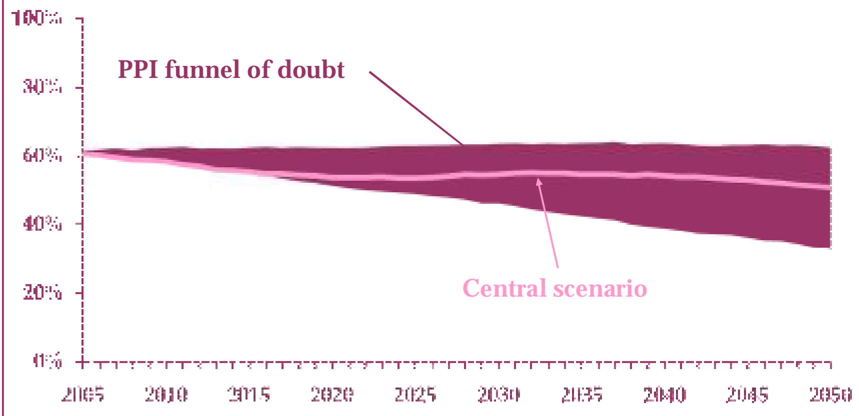
PPI Projections of the future proportion of pensioner benefit units eligible for a means-tested benefit under the Government's pension reforms



How many people are at risk?
There are no precise estimates of how many people fall into the different risk groups. This would require a projection of the life histories of a representative sample of individuals. There is only one model in the UK that could potentially produce such estimates, Pensim2, which is only available to Government analysts. Even if it could be used, there may still be substantial technical barriers.

It is possible to project the proportion of pensioners who will be eligible for means-tested benefits in future. This only illustrates the potential size of the risk groups, since it is possible to be eligible for means-tested benefits yet have a high return from saving in a pension, or conversely to be ineligible and have a low return.

PPI modelling shows future levels of eligibility for means-tested benefits are very uncertain. The central projection for the proportion of pensioner households eligible for any means-tested benefit shows a fall from 60% today to 50% by 2050—with a broad 'funnel of doubt' for 2050 being 35% to 65% (Chart 2).[3]

More relevant is the number of people eligible for the combinations of means-tested benefits that are most likely to lead to low returns from saving: such as the Guarantee Credit element of Pension Credit (in the absence of Savings Credit), or Housing Benefit.

Chart 3 shows new PPI analysis, of the proportion of pensioner households facing different Marginal Deduction Rates (MDRs) in 2005 and 2050. The MDR is the proportion of a small additional increase in private pension income that would be offset by

lower entitlements to means-tested benefits. For example, an MDR of 40% means that, for an extra £1 a week of pension income, the individual would lose 40p a week in means-tested benefits, so gain by 60p overall.

As with all long-term projections, MDR projections are subject to a degree of uncertainty. The PPI will continue to refine the projections and explore the potential range of outcomes. In the current figures, the proportion of households facing moderate MDRs (20-60%) falls between 2005 and 2050. The proportion facing high MDRs (80%+) remains at around 20%.

The proportion facing high MDRs is only an illustration of the size of the at-risk groups:

- Some of the people with high MDRs may not have been auto enrolled or may have been able to take their pension as a lump sum using trivial commutation.
- Some people with lower MDRs may still have had low overall returns from saving: for example, if they are just above the threshold at which people become eligible for Savings Credit.[4]

Chart 3: The proportion of pensioner households by marginal deduction rate

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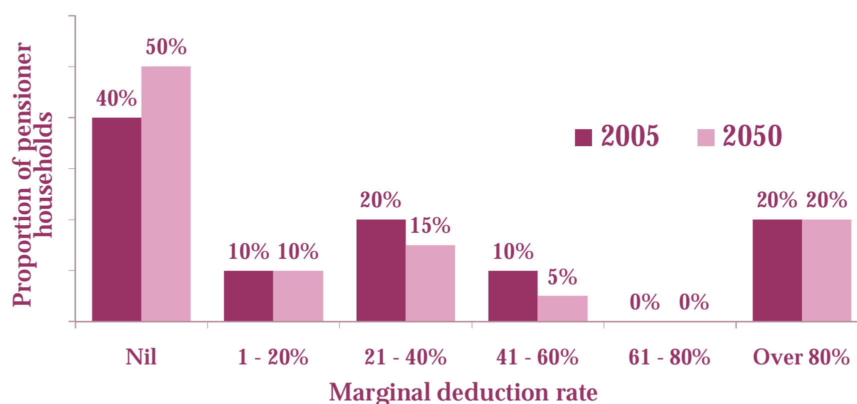
Illustrative PPI projections under the Government's pension reforms



Policy responses

If pension saving is not suitable for all, this does not mean that individuals should not be auto enrolled. PPI analysis suggests that if broad groups of people were excluded from auto enrolment—such as today's older people or people on low earnings—this would risk excluding some people who could benefit from saving in a pension.[5]

People will need clear information to help them decide whether they should stay in or opt out of saving. The question is whether information alone can be clear enough, or whether other policy options need to be considered.

Savings Credit was introduced in 2003 in response to concerns about low returns from saving. It seems sensible to ask whether the balance of returns that we now have remains appropriate in the context of auto enrolment. Auto enrolment will extend pension saving to people who in the past have been less likely to save, such as people on low earnings and with broken working histories, who are more likely to have low returns.

The PPI has analysed two policy options that could improve returns from saving in a pension, commissioned by the Equal Opportunities Commission and B&CE Benefit Schemes.[6] These are not the only approaches, are not mutually exclusive and the precise design of both options can be altered.

Option 1 would increase the trivial commutation limit to allow more people with small pension pots to take their saving as a lump sum rather than as an annuity. It would also improve the treatment of lump sums in means-tested benefits. Option 2 would mean a limited amount of private pension income—say, the first £12 a week—is ignored when calculating entitlement to means-tested benefits, by introducing a 'pension income disregard'.

Both options would improve returns from saving in a pension, so none of the individuals

Chart 4: Summary of the two options analysed

	Option 1: Increase trivial commutation limits	Option 2: Introduce pension income disregard
Returns from saving	All of the individuals analysed would be in the medium or low risk groups	All of the individuals analysed would be in the medium or low risk groups
Cost: 2012	£500m	£600m
Cost: 2050	£1.4m	Expected to remain stable
Affect on proportion of pensioner households eligible for Pension Credit	Likely to increase (magnitude of increase unknown)	Increased by less than 5%
Other identified effects	Could lead to perverse incentives to spend pension saving quickly during retirement	Difficulties around contracting-out

explored so far would be in the high risk category.

Although both options would increase the number of people entitled to means-tested benefits, they would increase returns from saving in a pension since some of the pension saving would be exempt from means-tested benefits.

Both options would increase Government spending in 2012 by around £500m, or around 4% of total Government spend on pensioner means-tested benefits. Costs in Option 1 could increase to around £1.4bn by 2050, as more people take lump sums rather than buying annuities. Costs in Option 2 could remain stable relative to average earnings.

If the reforms were successful at encouraging further saving, they could reduce the costs of means-tested benefits in the long term.

Where is clarity needed?

The Government work programme will need to shed light on the numbers of people who face the risk of being auto enrolled into pension saving when it may not be suitable for them. Without a shared understanding of the evidence, it will be difficult to reach consensus about the appropriate policy response.

Another area of uncertainty is the possible effectiveness of generic advice at helping individuals make the right decision about staying in or opting out of saving in a pension.

The Government work programme will need to be clear about the goals of any reform that improves incentives to save for retirement. For example, is the goal to ensure good returns from saving in a pension for everybody, or just the majority? And is the goal to improve returns, or increase confidence in the value of pension saving?

A series of trade-offs will have to be made in any solution:

- Increased returns from pension saving vs. cost to the taxpayer.
- Increased returns from pensions, vs. poverty prevention.
- A clear message about the value of saving, vs. the danger that perceptions are worsened by more people being eligible for means-tested benefits.
- A simple message about the value of saving vs. further complicating the system.
- The balance between pensions and other forms of saving.

Although the reforms modelled have a cost, other changes to means-tested benefits might reduce or even eliminate the cost. Clarity from the Government about whether this is a priority for spending may help stakeholders find feasible solutions.

For more information on this topic, please contact
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[1] 'Return' means 'internal rate of return'
[2] PPI (2006) *Are Personal Accounts suitable for all?*
[3] PPI (2007) *Projections of future eligibility for means-tested benefits*
[4] These people could have a low marginal deduction rate but a high average deduction rate
[5] PPI (2007) *Response to the Government's White Paper, Personal Accounts: a new way to save* p14-16
[6] PPI (2007) *Increasing the value of saving in Personal Accounts: taking small pension pots as lump sums*, PPI (2007) *Increasing the value of saving in Personal Accounts: rewarding modest amounts of pension saving*

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