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**Increasing the value of saving
in Personal Accounts:
taking small pension pots
as lump sums**

**Adam Steventon, Carlos Sanchez and
Chris Curry**

Pensions Policy Institute



**Women. Men. Different. Equal.
Equal Opportunities Commission**

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PENSIONS POLICY INSTITUTE
PPI

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CONTENTS

TABLES AND FIGURES	iii
ACKNOWLEDGEMENTS	iv
EXECUTIVE SUMMARY	v
1. INTRODUCTION	1
2. FINDINGS FROM ' <i>ARE PERSONAL ACCOUNTS SUITABLE FOR ALL?</i> '	3
2.1 Personal Accounts	3
2.2 Defining suitability	4
2.3 What affects returns from saving in Personal Accounts?	6
2.4 What is an acceptable return?	11
2.5 What individual characteristics affect returns?	14
3. TAX-FREE LUMP SUMS	17
3.1 Pension saving and lump sums	17
3.2 Tax advantage	19
3.3 Means-tested benefits	24
3.4 People who rent in retirement	29
3.5 People who spend time self-employed	31
4. TRIVIAL COMMUTATION	34
4.1 Policy rationale	35
4.2 Affect on returns from saving	37
4.3 People with non-pension saving	39
4.4 People with other pension saving	43
4.5 People who have contracted-out of S2P	45
4.6 People who are above the trivial commutation limit	47
5. WHAT COULD BE THE IMPACT OF INCREASING THE LIMITS?	48
5.1 The role of pension saving	48
5.2 Reform A: Increase the limits	53
5.3 Reform B: Align the limits	61
5.4 Reform C: A new drawdown product	62
4. CONCLUSION	65

APPENDICES	
A. Characteristics of the individuals modelled	68
B. Modelling assumptions and methodology	71
GLOSSARY	76
REFERENCES	81

TABLES

1	Paul's estimated income, assuming he owns his own home in retirement, £ per week, 2006/7 earnings terms	22
2	Kate's estimated income, £ per week, 2006/7 earnings terms	29
3	Capital eligible to be taken into account for Pension Credit	42
4	Proportion of different types of pensioner benefit units in receipt of means-tested benefits in 2004/5	43
5	Percentage of employees aged between 50 and state pension age with pension wealth of more than £15,000, by earnings	45
6	Estimated proportion of people in England in 2002 aged between 50 and state pension age able to trivially commute	57
7	Illustrative projections of the impact on Government spending on pensioner means-tested benefits of increasing the trivial commutation limit to £30,000, the capital disregard to £10,000 and the upper capital threshold to £50,000, in £ million, 2006/7 earnings	59
8	Illustrative projections of the impact of Reform A on Government spending in 2050, including the impacts on means-tested benefits and income tax revenue	60
9	Estimated internal rates of return and risk categories	62
10	Estimated internal rates of return and risk categories	64

FIGURES

1	Many factors affect incentives to save	8
2	The proposed reforms could increase returns from saving in a pension	11
3	Three risk groups are used	12
4	Small amounts of pension saving can be trivially commuted	18
5	Income can fall during retirement	23
6	Small amounts of capital can be treated more advantageously than income for Pension Credit	26
7	Around 13% of retirees may be able to trivially commute under the current limit	36
8	Trivial commutation can increase entitlements to means-tested benefits	39
9	If Jane has ISA savings, then trivial commutation may make her return from saving worse	40
10	If Jane has ISA saving, deemed income from a lump sum can be higher than annuity income	41
11	Income from a level annuity could fall by two-thirds by life expectancy	50
12	Increasing the trivial commutation limit and capital disregard would improve returns from saving	55
13	An additional 9% of retirees may be able to trivially commute if the limit was doubled	56
14	The drawdown product could result in a more even stream of income than spending a lump sum immediately	64

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EXECUTIVE SUMMARY

Personal Accounts

Many people are not currently saving enough for retirement to secure the level of income they are likely to consider adequate. As a response, the Government has proposed Personal Accounts, a new national pension savings scheme targeted at low to median earners not currently saving for retirement, which would be introduced in 2012.

Individuals over the age of 22 and earning more than around £5,000 would be auto-enrolled into a Personal Account or an approved equivalent scheme, with the right to opt out. Auto-enrolment has many potential advantages and should increase the number of people who save for retirement. However, there are risks involved with the policy. Stakeholders have expressed concern that some employees may be auto-enrolled into a product that is not suitable for them. This could lead to a significant number of individuals seeing little or no benefit from saving in Personal Accounts, which may have had an adverse impact on the number opting out. This risks reducing the benefits of the reform package and undermining the potential for reducing long term reliance on means testing.

There are several different definitions of 'suitable'. Many factors could be taken into account when deciding whether saving in a Personal Account is suitable for a particular person, including whether they can afford the contributions, their levels of unsecured debt and their desire to smooth consumption over their lifetime. This paper categorises individuals as being at low risk, medium risk or high risk of Personal Accounts being unsuitable for them, depending on the effective rate of return they are likely to receive. The effective rate of return takes into account the complex interaction between Personal Accounts, state pensions and the tax and means-tested benefits systems.

There are certain characteristics that, when combined, could lead to lower effective returns from Personal Accounts. Many of these factors, such as low earnings, broken working histories, low levels of saving and being single in retirement are factors more likely to affect women than men whereas men are more likely than women to be self-employed. Women and men have similar rates of renting accommodation in retirement.

Lump sums in retirement

Taking a lump sum can lead to higher entitlements to means-tested benefits and a higher return from saving. This is because small amounts of capital can be treated more advantageously than equivalent amounts of pension income, when calculating entitlements to means-tested benefits.

All individuals can take 25% of their pension saving as a tax-free lump sum, which can increase their returns from saving. Trivial commutation allows people with small pension funds (limited to those below £15,000 in 2006/7) to take their entire pension saving as a lump sum, without having to buy an annuity. The Government has suggested that individuals with small amounts of saving in Personal Accounts could use trivial commutation as a way of improving their effective return.

Currently around 13% of people are on course to have pension saving that is within the current trivial commutation limit of £15,000 when they retire. Women are more likely to be able to trivially commute than men (16% of women and around 10% of men) because they typically have smaller pension funds. They also have lower incomes in retirement.

However, trivial commutation would not be appropriate for everybody who is at-risk of Personal Accounts being unsuitable for them:

- For people who have non-pension saving, the current system of trivial commutation may provide a particular incentive to spend lump sums quickly. This is because their capital disregard (the amount of saving and other capital that is ignored when calculating entitlement to means-tested benefits, currently £6,000) may have been used up by the non-pension saving, so that capital is treated less, rather than more, advantageously than equivalent amounts of pension income. For these people, it may not be possible to save lump sums for later consumption without a large negative impact on their entitlement to means-tested benefits.
- The trivial commutation limit is a global limit, applying to a person's combined private pension saving from all sources. Pension saving besides Personal Accounts, perhaps made before 2012 into an occupational or personal pension, may reduce the potential for an individual to trivially commute their saving in Personal Accounts.

- People who have previously contracted-out of the State Second Pension, without making voluntary saving in addition to the rebate, may be less likely to be able to trivially commute small amounts of Personal Accounts saving than those who have remained contracted-in. This is because any private pension that results from the contracting-out rebate counts against the trivial commutation limit.
- People who are even marginally above the trivial commutation limit will not be able to trivially commute. People in this group may be at medium or high risk of Personal Accounts being unsuitable for them, such as some people with a combination of low earnings and broken working histories, those who rent in retirement and those who spend time self-employed.

Reforms proposed by the EOC

The Equal Opportunities Commission (EOC) has specifically asked the PPI to analyse a series of reforms to the trivial commutation limit, which could improve the suitability of Personal Accounts. These include increasing the trivial commutation limit from £15,000 to £30,000. The capital disregard for means-tested benefits would at the same time be increased from £6,000 to £10,000 and the upper capital threshold, which marks the cut-off point for eligibility to Council Tax Benefit and Housing Benefit, would be increased from £16,000 to £50,000.

This policy could increase the proportion of retirees who are able to trivially commute by around 9%, from 13% to 22%.

The policy could improve returns from saving for both women and men. Some examples of people with a combination of low earnings and broken working histories could be lifted from medium risk to low risk of Personal Accounts being unsuitable. Some examples of people who rent in retirement or who spend time self-employed could be lifted from high risk to medium risk.

Increases to the trivial commutation limit and capital disregard may increase the rate of return for some people who would already be in the low-risk group under current policy, such as some individuals in couples.

The EOC also asked the PPI to analyse a new drawdown product. This would enable individuals to choose to take their trivial commutation lump sum and use it to buy a special type of temporary annuity lasting ten years, which would not count in the calculation of entitlement to means-tested benefits. If the drawdown product was incorporated alongside a trivial commutation limit of £30,000 and a capital disregard of £10,000, then it may encourage individuals to buy voluntarily an annuity with part

of their lump sum. Voluntarily buying this special type of annuity could increase the effective rate of return even more for some individuals and mean that the examples of people who spend time in self-employment could be lifted from medium risk to low risk.

Reform costs

The reforms to increase the trivial commutation limit to £30,000 and the capital disregard to £10,000, could cost the Government around £500 million a year if they were introduced in 2012. The bulk of the cost would result from higher entitlements to means-tested benefits. To put these figures in context, £500 million is around 4% of the current cost of pensioner means-tested benefits, or around 2% of the current fiscal cost of tax and National Insurance relief on private pension saving.

The cost of the reforms would grow over time, to around £1,400 million by 2050. This would represent an increase of 20% on the projected level of spending on pensioner means-tested benefits in 2050.

It is very important to realise that these cost estimates are subject to a very high degree of uncertainty and should only be considered illustrative. Estimates are based on current behaviour and the pattern of pension incomes observed today persisting into the future.

Returns could be further increased by increasing the capital disregard to £30,000. This could cost an additional £2 billion a year on top of the current system in 2012.

Conclusion

The lower the risk that people are auto-enrolled into a product which is not suitable for them, the lower the risk that they later discover that Personal Accounts did not deliver for them, which may have repercussions for future Governments. However, the reforms proposed by the EOC could improve the suitability of Personal Accounts as a savings scheme for both women and men by improving their rate of return.

Estimating the number of women and men who fall into the different risk categories can only be carried out by use of dynamic models, such as those used by the Government. Ideally, the Government should project the number of individuals in each group who are likely to be affected by Personal Accounts, and the possible range of outcomes from a policy of auto-enrolment. The clearer the Government can be about the value of saving in Personal Accounts, the more likely Personal Accounts are to meet their aim.

1 INTRODUCTION

Many people are not currently saving enough for retirement to secure the level of income they are likely to consider adequate. As a response, the Government has proposed Personal Accounts, a new national pension savings scheme.

Previous PPI research has shown that certain individual characteristics can lead to lower returns from saving in Personal Accounts. Of the characteristics, only one affects more men than women, namely self-employment. Men and women are equally likely to rent accommodation in retirement. The others - low earnings, broken working histories, level of saving and being single in retirement - are all currently more likely to affect women than men.

This paper has been commissioned by the Equal Opportunities Commission to provide an independent assessment of one approach for improving individuals' returns from saving, and therefore the suitability of Personal Accounts for these individuals.

Three reform options are modelled to explore their differing effects on a number of hypothetical individuals. In each, the trivial commutation limit is increased. Trivial commutation is where individuals with pension savings of £15,000 or less (in 2006/7) can choose to take all their pension saving as a lump sum, rather than having to buy an annuity. People with pension savings over this limit are only permitted to take 25% as a tax-free lump sum.

Increasing the trivial commutation limit would allow more people to take their entire pension saving as a lump sum rather than as an annuity. At the same time, the capital disregard is increased. This is the level of savings (£6,000 since 2003) that is not taken into account in the calculation of an individual's entitlement to means-tested benefits. Raising the capital disregard means that lump sums have less of an impact on an individual's entitlements. The reforms analysed in this paper are:

- A. Double the trivial commutation limit to £30,000 and increase the capital disregard to £10,000.
- B. Increase both the trivial commutation limit and the capital disregard to £30,000.
- C. As reform option A but in addition launch a new drawdown product. This is a special type of limited-term annuity that would not count in the calculation of entitlement to means-tested benefits. It could encourage individuals to voluntarily buy an annuity with part of their trivial commutation lump sum.

Chapter 2 describes the Government's proposal to introduce a new national pension savings scheme called Personal Accounts and summarises existing PPI research on the suitability of Personal Accounts.

To analyse the possible impacts of the proposed reforms, the paper needs to examine in detail how lump sums can be used under the current system. Chapter 3 investigates the existing potential for individuals to use tax-free lump sums as a way of improving their returns from saving, while Chapter 4 considers trivial commutation lump sums.

Chapter 5 analyses the three reform options in detail, considering their effect on hypothetical individuals and Government expenditure.

This paper is intended as a contribution to the policy debate on Personal Accounts. Figures shown in this paper are illustrative only and do not provide any indication of a guaranteed return. It should not be relied on by individuals or their advisors as the basis for saving and investment decisions.

2 FINDINGS FROM 'ARE PERSONAL ACCOUNTS SUITABLE FOR ALL?'

This chapter describes the Government's proposal to introduce a new national pension savings scheme, called Personal Accounts. It summarises previous PPI research on the suitability of Personal Accounts, published in *Are Personal Accounts suitable for all?*¹ The current paper uses the same framework as this previous research. (Readers who are already familiar with it may safely skip over this chapter.)

2.1 Personal Accounts

The Government set out its intention to introduce major reforms to the UK pension system in a White Paper in May 2006. These include substantial reforms to both state and private pensions.

The Pensions Bill that is currently being scrutinised in Parliament will, if enacted, implement the Government's proposed reforms to the state pension system. It will also establish a Delivery Authority that will advise on the implementation of a new national pension savings scheme called Personal Accounts.

The Government published a second White Paper in December 2006 setting out more details of how it proposes to implement the new Personal Accounts. The consultation closed in March 2007 and the Government is now expected to introduce a second Bill in Autumn 2007.

Many of the details of Personal Accounts are yet to be finalised but the basic framework would be:

- Auto-enrolment for all employees aged between 22 and state pension age and earning more than £5,035 a year into a Personal Account (or an approved equivalent), with the opportunity to opt out.
- A minimum contribution of 4% from the individual on band earnings between £5,035 and £33,540 a year. This would be matched by a minimum 1% contribution of band earnings from the Government and a compulsory 3% contribution of band earnings from the individual's employer.
- Low charges, aiming for an annual charge of 0.3% of assets under management in the long term.

¹ Steventon (2006) published by PPI.

Many people are not currently saving enough for retirement to secure the level of income they are likely to consider adequate.² The Government is proposing auto-enrolment as a way of increasing the number of people saving for retirement:

- Automatic enrolment can combat people's tendency not to act when faced with difficult financial decisions.³
- Automatic enrolment is associated with increased participation rates. On average, 56% of those who are eligible to join a pension scheme in the workplace do so. This compares to 90% where auto-enrolment exists.⁴
- There is also evidence that employers and individuals are in favour of automatic enrolment.⁵

However, there are risks involved with the policy. One concern that has been raised by stakeholders is that employees may be auto-enrolled into a product that may not be suitable for them.⁶

2.2 Defining suitability

'Suitability' could be defined in several different ways:

1. That saving in a Personal Account is the best thing for individuals who stay auto-enrolled. This condition would not be met if another product would have been preferable than a Personal Account, even if an individual would not strictly lose out from saving in a Personal Account.
2. A less stringent condition is that individuals who stay auto-enrolled should not lose out as a result of their saving. This compares the difference between the amount saved and the likely amount eventually received as pension income. It aims for there to be at least a minimum return on saving.

The first of these criteria is more consistent with the definition of 'suitability' that the Financial Services Authority (FSA) requires firms to consider when giving advice on investment products to consumers. The FSA definition broadly aims to ensure that,

² Recent analysis suggests that approximately 7 million people are not saving enough to give them retirement incomes they are likely to consider adequate, DWP (2006 PA) page 47. Estimates of the number undersaving for retirement rely on assumptions for the appropriate saving target and retirement age. Assumptions and approximations are also needed due to inadequate data. For a review of the problems with undersaving analysis see O'Connell (2006) pages 12-13.

³ DWP (2006 SR) page 63.

⁴ Based on a survey of private companies with at least five employees, Deloitte (2006) page 17. It should be noted that other factors than the existence of auto-enrolment could be affecting participation rates, such as whether employees receive encouragement to save from their employer, see PPI (2006) paragraph 3.29.

⁵ DWP (2006 SR) page 63.

⁶ PPI Briefing Note 34.

when consumers are being advised about investments, any recommendation takes account of clients' particular circumstances.⁷

The Government has specified that Personal Accounts should have a low charge. This charge means that Personal Accounts will most likely provide a system of broad generic advice rather than specific advice tailored to individuals' detailed circumstances, which could be more costly to provide.

This paper therefore adopts the second of the suitability criteria as the definition of 'suitability', rather than the FSA definition. It compares the difference between the amount saved and the likely amount eventually received as pension income, and treats a product as being suitable if there is at least a minimum return on saving.

No single definition of 'suitability' is likely to be appropriate for the circumstances of every individual. This paper analyses the effective rates of return (or 'internal rates of return') that individuals could receive on their contributions into Personal Accounts. The next section of this chapter will consider what is meant by a 'return' in this paper. It will take into account the complex interactions between Personal Accounts, state pensions and the tax and means-tested benefit systems. While returns are a useful computation tool to illustrate the possible outcomes for hypothetical individuals, in practice, individuals should take into account other considerations when deciding whether or not Personal Accounts are suitable for them.

For example, it may be rational for some people to save even if they have a low return. Possible reasons include:

- Individuals may perceive that there are risks in not saving for retirement. For some individuals, not saving for retirement could mean a low level of retirement income, relative to income during working life. It could also mean reliance on means-tested benefits, which could be changed by future Governments and are not claimed by everybody. Individuals may have more control over their private pension savings than over what they can expect from the state in future through state pensions and means-tested benefits.
- Individuals who have relatively high disposable income in working life but who have made little savings for retirement may want to smooth their consumption over their lifetime. This refers to the possibility that an individual may value the extra income in retirement that results from saving more than the reduction in income in working life that also results from saving.
- An individual may desire the inflexibility of saving in a Personal Account, as a way of taking away the temptation of spending money now.

⁷ For full details, see FSA Handbook Conduct of Business Section 5.3.

On the other hand, saving for a Personal Account may not be suitable for some individuals, even if they have a high return. Possible reasons include:

- Individuals may have a high level of unsecured debt.
- Individuals may decide they cannot afford the contributions.
- Saving for a pension is less flexible than saving in some other products. For example, contributions usually cannot be accessed until retirement. Some individuals may prefer to save in a product that can give them more immediate access to their capital.
- There are risks involved with any long-term savings product. For example, an individual may require a high expected return to compensate for the risk that the value of his or her investments could fall.
- Individuals may also perceive that there is a political risk in long-term saving, as well as in not saving for retirement.

These considerations may vary in significance over a person's lifetime. For example, contributions may be less affordable at certain stages of life, for example, when individuals have large amounts of student debt to repay or when they have dependent children. So although returns are a useful illustration of outcomes for hypothetical individuals, they only show one aspect of suitability.

Even if Personal Accounts are not suitable for everybody, this does not necessarily mean that individuals should not be auto-enrolled. The Government has not proposed that Personal Accounts should be compulsory but has given individuals the right to opt out if they choose.

2.3 What affects returns from saving in Personal Accounts?

Returns will differ from individual to individual depending on their own personal characteristics. The combination of compulsory employer contributions, tax relief and expected investment returns could make saving in Personal Accounts relatively attractive for some individuals. But on the other hand, the tax and means-tested benefit systems in retirement could put some people at risk of a low return from Personal Accounts.

The employer contribution to Personal Accounts can be a significant incentive to save in a Personal Account. For every £1 that an employee contributes, his or her employer will be compelled to contribute at least 77p,⁸ unless the employee has opted out.

⁸ Because of the interaction with income tax and tax relief, this is effectively £1 for higher rate taxpayers for every £1 contributed. If the Budget 2007 proposals to change the rates of income tax are implemented, then basic rate taxpayers would receive 75p for every £1 contributed.

The Government contribution to Personal Accounts can also be an incentive to save. For every £1 that an employee contributes, the Government would contribute at least 28p.⁹ As the Government contribution would function through the current system of tax relief for private pensions, it would be larger for higher rate taxpayers who would receive 67p from Government for every £1 contributed. Retirement income from Personal Accounts would be taxable, so some of this Government contribution could be reclaimed by the Government as income tax in later life.

Therefore, every £1 contributed to a personal account by an employee is matched by at least 100% by the combined contributions of their employer and the Government. However, while the employer and Government contributions can be incentives to save, means-tested benefits in retirement can be disincentives to save.

There are currently a number of means-tested benefits for which pensioners may be eligible:

- Pension Credit was introduced in 2003 and consists of two elements, Guarantee Credit and Savings Credit.¹⁰ Guarantee Credit aims to ensure that the poorest people over age 60 have a minimum level of income. Savings Credit is an additional amount that aims to reward saving for some low-income pensioners.
- Council Tax Benefit was introduced in 1993 and is an income-related benefit that aims to help people on low incomes pay their Council Tax.
- Housing Benefit was introduced in 1983 and is an income-related benefit that aims to help people on low incomes pay for rented accommodation.

All three of these means-tested benefits aim to target state spending where a certain type of need is greatest. However, one disadvantage of means-tested benefits is that they can be disincentives to save. This is because, if an individual makes private saving, the extra income received in retirement can mean lower entitlements to means-tested benefits. In extreme situations, individuals may be no better off from having saved.

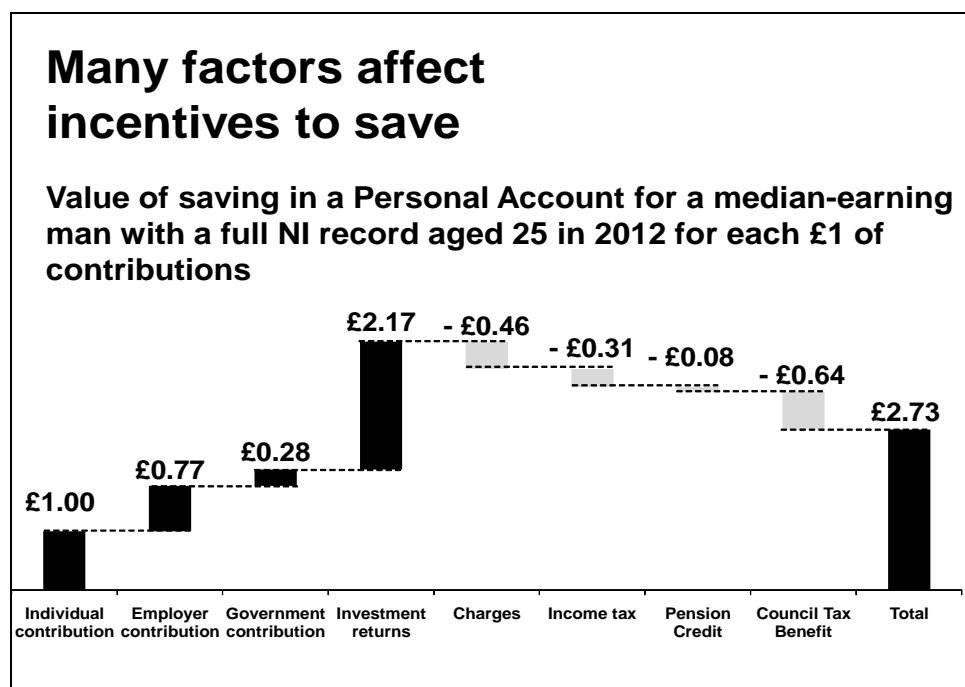
⁹ If the Budget 2007 proposals to change the rates of income tax are implemented, then basic rate taxpayers would receive 25p for every £1 contributed.

¹⁰ For a more detailed description of Pension Credit, see *The Pensions Primer*, available on the PPI website, www.pensionspolicyinstitute.org.uk.

These factors - the employer and Government contributions, income tax and means-tested benefits - interact in complex ways. This means that the internal rate of return will vary from individual to individual. For a median-earning man with a full National Insurance record who is aged 25 in 2012 (Figure 1):

- Each £1 he contributes would be increased to more than £2 by the combination of the employer and Government contributions.¹¹
- The effect of investment returns would depend on how his investments perform up to when he takes his Personal Account. On the assumptions used in this paper,¹² investment returns could increase the value of his saving to £4.22.
- Charges in Personal Accounts could reduce this value by 46p, to £3.76.
- He would pay income tax in retirement on the income from his Personal Account, reducing the value by a further 31p, to £3.45.
- He would be entitled to smaller amounts of means-tested benefits as a result of saving. Pension Credit could reduce the value of his saving by 8p and Council Tax Benefit could reduce the value of his saving by 64p. He would not be affected by Housing Benefit in retirement as he is assumed to own his own home in retirement and is therefore not eligible for Housing Benefit.
- So, overall, the value of his £1 saving could be around £2.73.

Figure 1¹³ Many factors affect incentives to save



¹¹ This is a net present value calculation. It is expressed in today's prices. If the Budget 2007 proposals to change the rates of income tax are implemented, then basic rate taxpayers would receive exactly £2 for every £1 contributed.

¹² An investment return of 3.0% in excess of prices. See Appendix B for details.

¹³ PPI analysis using the Individual Model. The example is assumed to save continuously in a Personal Account from age 25 until retiring at state pension age (age 68).

This paper uses the 'internal rate of return' to illustrate the complex interactions between Personal Accounts, state pensions and the tax and means-tested benefit systems. The internal rate of return is the nominal interest rate that the individual receives on his or her individual contributions, after allowing for the effects of tax relief, employer contributions, investment returns, charges, income tax and means-tested benefits.¹⁴ It is the same as the 'effective rate of return' used by the Pensions Commission to investigate returns from saving.¹⁵

Important note

It is important to realise that the internal rate of return cannot be compared with investment returns on other forms of saving. For example, it is **not** possible to say that, if an individual has an internal rate of return of 4% from saving in a Personal Account, and another savings product such as an ISA has an investment return of 5%, then saving in the ISA is preferable to saving in a Personal Account. This is because the 4% figure for the internal rate of return of saving in a Personal Account takes account of the impact of means-tested benefits.

Means-tested benefits can also affect the value of saving in an ISA, and many other products, as the saving would be taken into account for the calculation of entitlement to means-tested benefits. The impact of means-tested benefits is not taken into account in the 5% figure for the investment return from the ISA, and so the 4% and 5% figures cannot be directly compared.

There are therefore two types of 'return' that are discussed in this paper – the internal rate of return and the investment return - and they cannot usually be compared. For clarity, where investment returns are meant, the full term is always used. Sometimes, for brevity and where the context means that there can be no confusion, 'internal rate of return' is abbreviated to 'return'.

Note that these calculations require assumptions to be made about an individual's characteristics and future levels of price inflation, earnings growth and investment returns. The same assumptions are made in this paper as in previous PPI research

¹⁴ Formally, the internal rate of return is defined to be the discount rate that sets the net present value to £1 (i.e. to the value of the contributions paid in). Although net present values are calculated by summing income in real terms in this paper, they could be calculated by discounting payments at any given rate, rather than necessarily with inflation. The definition of the internal rate of return means that if the net present value is calculated at a discount rate equal to the internal rate of return, then the net present value would be equal to £1.

¹⁵ Pensions Commission (2006) page 21. See also Pensions Commission (2004) Chapter 6 and Pensions Commission (2005) Chapter 7.

for consistency. Adopting different assumptions would lead to different projections.¹⁶

Returns from saving in a pension could be improved by the state pension reforms currently being scrutinised in Parliament and by the proposed employer contribution and low charges in Personal Accounts. The median-earning man with a full NI record who is aged 25 in 2012 could have an internal rate of return of 2.6% if he saved under the current state pensions system in a Stakeholder pension that levies the maximum possible charge. Under the proposed state pension reforms and Personal Accounts, this could be increased by 3.3%, to 5.9% (Figure 2):

- The state pension reforms could increase his internal rate of return by 1.3% to 3.9%. The reforms would mean he gets a higher state pension, as a result of uprating the Basic State Pension in line with average earnings, and would reduce the generosity of Savings Credit. His saving would therefore have less of an interaction with means-tested benefits.
- The proposed 3% employer contribution could increase his internal rate of return by a further 1.6% to 5.5%. In 2004/5, around 14 million employees either did not have access to an occupational pension scheme, or else had access to one with an employer contribution of less than 3%.¹⁷ Personal Accounts should mean that many of these employees (those aged over 22 and earning more than £5,035 a year) will have access to an employer contribution for the first time, of at least 3%.
- The proposed low charges in Personal Accounts could also increase his internal rate of return by 0.4% to 5.9%. This assumes that Personal Accounts operate with an Annual Management Charge (AMC) of 0.5% of assets under management. The Government has said it believes Personal Accounts could operate with an AMC of 0.5% in the short term and below 0.3% in the long term.¹⁸ There are significant uncertainties in the actual level of charges for Personal Accounts, as well as choices for the charging structure.¹⁹

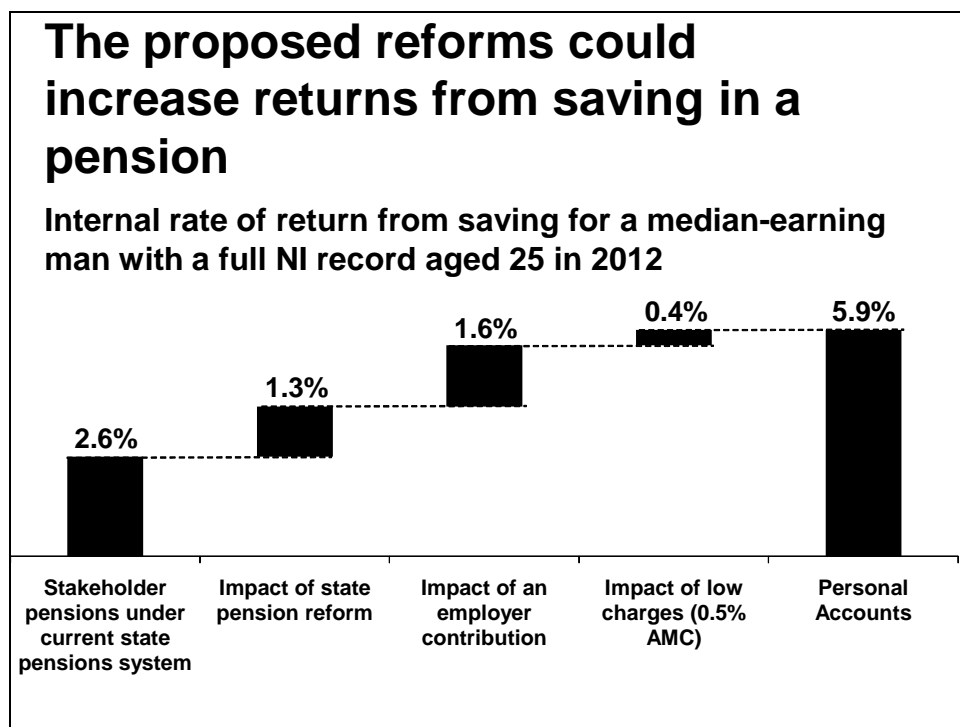
¹⁶ See the appendix of Steventon (2006) for a discussion of the likely impact of different assumptions.

¹⁷ DWP (2006 SR) page 65.

¹⁸ DWP (2006 PA) paragraph 4.7.

¹⁹ See the PPI research on charges in Steventon and Sanchez (2007) and PPI Briefing Note 33.

Figure 2²⁰ The proposed reforms could increase returns from saving in a pension



2.4 What is an acceptable return?

Different individuals could have different requirements for expected returns from Personal Accounts. As discussed in pages 4 to 6, many different considerations will determine whether or not Personal Accounts are suitable for an individual, including his or her desire for consumption smoothing, perceptions of risk, need to have ready access to capital, levels of debt and decision about the affordability of contributions.

Rather than saying definitively whether or not Personal Accounts are suitable for an individual, hypothetical individuals are categorised in this paper as being at low risk, medium risk or high risk of Personal Accounts being unsuitable for them. The risk group depends on the level of return he or she is likely to receive:

- An individual is classified as **high-risk** if he or she has a return of less than inflation. An individual in this situation would not receive the inflation-protected value of his or her own individual contributions back from Personal Accounts.
- An individual is classified as **medium-risk** if he or she has a return of more than inflation but lower than the expected investment return. An individual in this situation would receive the inflation-protected value of his or her own individual

²⁰ PPI analysis using the Individual Model. See Appendix B for details of the assumptions used. For illustration, the Stakeholder pension is assumed to have the maximum possible charge (an Annual Management Charge of 1.5% of assets under management for the first ten years, reducing to 1.0% thereafter). Not all providers of Stakeholder pensions levy the maximum possible charge.

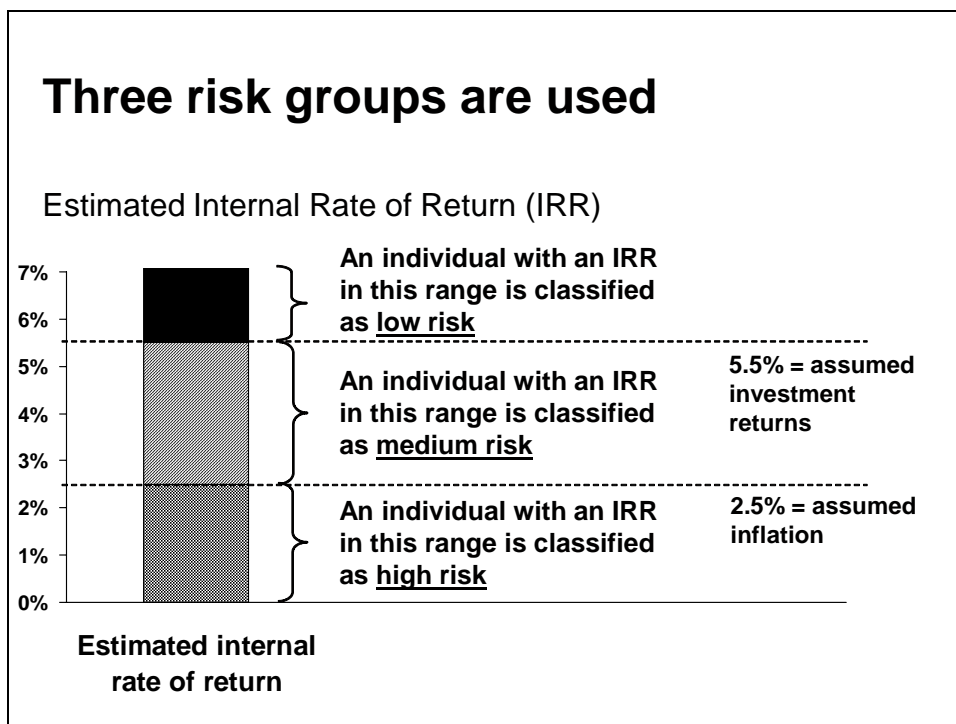
contributions *plus* some credit (but not necessarily total credit) for the real investment returns earned by investing those contributions.

- An individual is classified as **low-risk** if he or she has a return that is higher than the expected investment return. An individual in this situation would receive the value of his or her own individual contributions *plus* full credit for the real investment returns earned by investing those contributions. In addition, he or she would receive back some (but perhaps not all) of the value of the employer contribution, the Government contribution and investment returns on the employer and Government contributions.

The internal rate of return is used as the computational tool to assign hypothetical individuals into a risk category (Figure 3). An internal rate of return of:

- Greater than the assumed future level of investment returns (5.5% a year) implies that an individual is in the low-risk category.
- Less than the assumed future level of price inflation (2.5% a year) implies that an individual is in the high-risk category.
- Between the assumed future levels of price inflation and investment returns (so between 2.5% and 5.5% a year) implies that an individual is in the medium-risk category.

Figure 3 Three risk groups are used



The risk groups used in this paper are one approach for assessing the suitability of Personal Accounts. There are other approaches. For example, the Government has used the notion of 'payback', which is the same as the net present value used in Figure 1.

The net present value of an individual saving £1 in a Personal Account is the total amount received in pension income during retirement as a result of that saving, in today's prices. The net present value calculation allows for the factors that affect the returns from saving in Personal Accounts: employer contributions, tax relief, expected investment returns, charges, tax and means-tested benefits.

Government analysis found that:

People's expected payback from saving will generally be improved as a result of reform, with the large majority of people able to expect a payback of at least £1 plus inflation for each £1 that they save. This is the basis on which we are introducing automatic enrolment.²¹

This is consistent with the lowest benchmark of the risk groups in this paper, since:

- Being in the high-risk group means that an individual is likely to receive back less than the value of his or her contributions into Personal Accounts. He or she would receive back less than £1 for each £1 they contribute, failing the Government's test.
- Being in the medium-risk group means that an individual does receive back the value of his or her contributions, plus possibly some of the real investment return on those contributions. So a person in this group would satisfy the Government's test.
- Being in the low-risk group would also satisfy the Government's test, since an individual would receive back the value of his or her contributions, plus a full investment return.

Although the Government uses a test that is consistent with the lowest benchmark used in this paper, other organisations have advocated a higher benchmark than any of those used in this paper.²² They argue that individuals should receive back not only the value of their own contributions with full credit for investment returns, but also part of the value of the contributions made by the employer and/or the Government.

²¹ DWP (2006 FISR) paragraph 1.12.

²² For example, Royal London (2006).

2.5 What individual characteristics affect returns?

Personal Accounts could give many people access to a low-cost pension savings product with an employer contribution for the first time.

Individuals are classified as being at '**low risk**' of Personal Accounts being unsuitable for them if they are likely to receive a full investment return on their contributions, in other words, where individuals receive a full investment return *plus* protection against inflation. Examples are:

- Single people in their twenties in 2012 with full working histories.
- Single men in their forties and fifties in 2012 who have a full working history and large additional savings.

People at '**medium risk**' of Personal Accounts being unsuitable for them would receive back the value of their individual contributions, protected for inflation, and some investment returns on their contributions, although they may not receive full credit for the investment returns. This group includes:

- Single people in their twenties in 2012 with low earnings and broken working histories, whether because of caring breaks or unemployment.
- Single people in their forties and fifties in 2012 with low earnings and full working histories.
- Single people in their twenties in 2012 who stay opted in to Personal Accounts while employed, and then become self-employed at a later date.

People at '**high risk**' of Personal Accounts being unsuitable for them are likely to receive back less than the value of their contributions into Personal Accounts. This group includes:

- Single people who are likely to rent in retirement and have no additional savings. These people may be entitled to less Housing Benefit in retirement as a result of their saving in Personal Accounts.
- Although they would not be auto-enrolled, single people in their forties and fifties in 2012 on low to median incomes who are self-employed.

All other things being equal, individuals who are in couples in retirement are likely to have higher returns on their saving than single people. This is because cut-off levels for entitlement to of means-tested benefits are set relatively lower for individuals in couples than for single individuals. The examples in this paper are assumed to be always single in retirement. However, it is important to note that the majority of pensioners are in couples at some point in their retirement.

Some of the factors that affect the suitability of Personal Accounts could be more problematic than others to incorporate into a system of generic information, such as that proposed to be introduced alongside Personal Accounts.²³ Clearly, no-one can predict with certainty all of their future life circumstances when making a savings decision. Some factors may be relatively straightforward to reflect in a system of generic information, such as current age, earnings and level of debt. Others may be more difficult, such as the affordability of contributions and likely future housing or marital status.

Certain individual characteristics can lead to lower returns from saving in Personal Accounts. Not all of these would necessarily lead to an individual being at medium or high risk when taken in isolation. However, they could be significant if an individual had several in combination:

- Low earnings.
- Part-time work.
- Interrupted working and saving histories.
- Not having any existing saving and already being close to state pension age.
- Being single in retirement.
- Spending time self-employed.
- Renting accommodation in retirement.

Only one of the characteristics currently affects more men than women: 12% of men of working age are self-employed, compared to 5% of women.²⁴ PPI analysis suggests that men and women are equally likely to rent in retirement.²⁵ Women are more likely to have each of the remaining characteristics than men:

- Women in full-time work earn on average 23% less a year than equivalent men.²⁶
- 42% of women employees work part-time compared to 9% of men employees.²⁷
- Women are more likely to take time away from the labour market than men.²⁸

²³ DWP (2006 SR).

²⁴ Family Resources Survey 2004/5 Table 7.1.

²⁵ PPI analysis using the Family Resources Survey 2004/5. Around one-third of single men and single women over state pension age currently rent accommodation. The figure is lower for couples in which the man is over state pension age, at around 15%.

²⁶ ONS Annual Survey of Hours and Earnings 2006 Table 1.1a.

²⁷ EOC (2006) page 11.

²⁸ EOC (2006) page 11.

- 48% of women aged between 50 and state pension age are on course to have enough private pension saving to provide an income in retirement, compared to 80% of men.²⁹
- 42% of women over age 65 are married, compared to 70% of men.³⁰ Women over age 65 are three times more likely than equivalent men to be widowed.

²⁹ These are people who are projected to have final pension saving of more than the trivial commutation limit of £15,000 and so would not be eligible to take their entire pension saving as a lump sum. The analysis assumes retirement at state pension age. PPI analysis of wave 1 of the English Longitudinal Study of Ageing. Marmot, M. et al. , English Longitudinal Study of Ageing: Wave 0 (1998, 1999 and 2001) and Waves 1-2 (2002-2005) [computer file]. 6th Edition. Colchester, Essex: UK Data Archive [distributor], January 2007. SN: 5050. The National Centre for Social Research, University College London, Institute for Fiscal Studies and the UK data archive bear no responsibility for their further analysis or interpretation.

³⁰ Population Trends Winter 2006 Table 1.5. Figures are for 2004.

3 TAX-FREE LUMP SUMS

This chapter shows that taking tax-free lump sums can improve the internal rate of return that an individual receives on their saving in Personal Accounts. The extent of the improvement depends on how the individual spends the tax-free lump sum and whether or not the individual pays tax in retirement or is eligible for means-tested benefits.

3.1 Pension saving and lump sums

Any funds in a pension that have not already been drawn-down must be used to buy an annuity by the time a person reaches age 75. An annuity provides a regular income for life, regardless of how long an individual lives. It is, therefore, a type of insurance product that helps protect against the need for additional income in the event of long life. The Government argues that:³¹

- *Tax relief on pension contributions is provided so people can save for an income in retirement, not for other purposes.*
- *Annuities pool people's risk, ensuring that they are the most financially efficient way of turning capital into an income stream.*
- *Annuities make sure that people continue to receive an income from their savings no matter how long they survive, thus reducing their possible future need for income-related support from the Government.*

The Government does allow the flexibility for pension saving to provide a cash lump sum, within certain limits. There are currently two main ways in which an individual can use their private pension saving to provide a lump sum, depending on the total value of their pension saving at retirement:

- All individuals are generally able to take one-quarter of their pension saving as a tax-free lump sum.
- Individuals with small pension saving, less than the trivial commutation limit (1% of the Lifetime Allowance³² or £15,000 in 2006/7), are able to take all of their pension saving as a lump sum. This is known as a trivial commutation lump sum. One-quarter of the trivial commutation lump sum is tax-free.

In addition, lump sums can also be taken in certain specific circumstances such as serious ill-health. Funds above the Lifetime Allowance (£1.5 million in 2006/7) can also be taken as a lump sum, after a tax recovery charge has been paid.

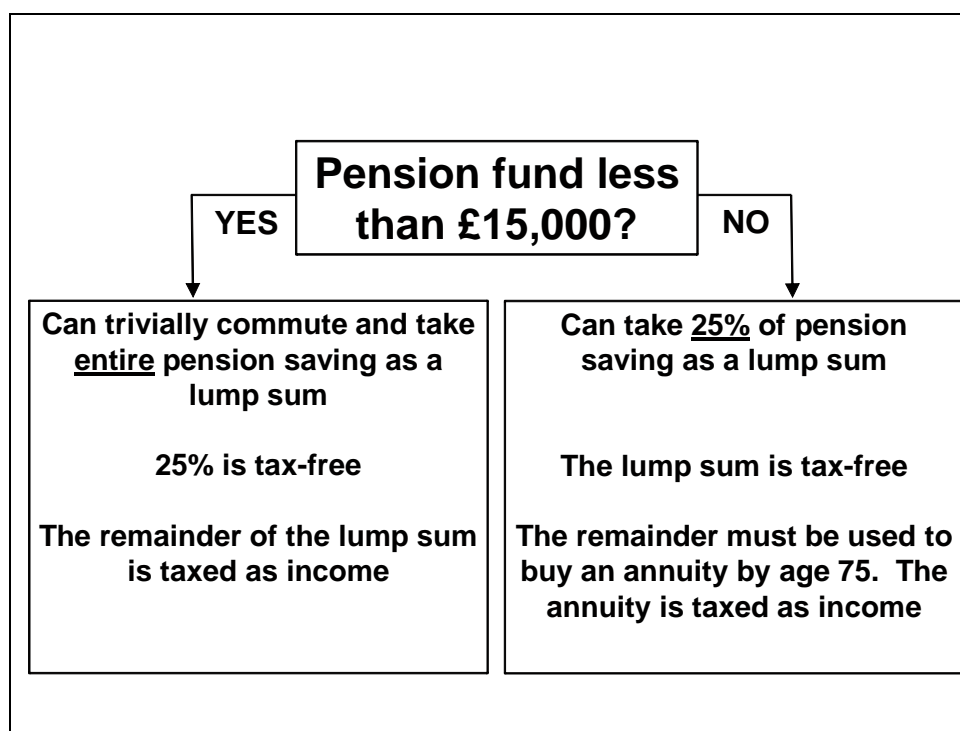
³¹ The text in italics is a quote from page 5 in IR (2002).

³² The limit on the total amount of pension savings that an individual can have without incurring a tax recovery charge, which can mean that the fund is taxed at a rate of up to 55%.

If a person has more than one private pension, then the total value of all of them is what is used when assessing whether or not an individual can trivially commute. So there is cliff-edge effect (Figure 4), for example:

- An individual retiring in 2006/7 with a total pension saving of £14,000 would be under the trivial commutation limit for that year. He or she could choose to trivially commute the pension saving and take all £14,000 as a lump sum.
- An individual retiring in 2006/7 with a total pension saving of £16,000 would be over the trivial commutation limit for that year. He or she would not be able to trivially commute but would still be able to take a tax-free lump sum of 25% of the value of his or her saving (£4,000).

Figure 4 Small amounts of pension saving can be trivially commuted



The remainder of this chapter will focus on the tax-free lump sum, while the next chapter will consider trivial commutation lump sums. Both chapters are based on the continuation of current policy.

Taking tax-free lump sums can improve the internal rate of return that individuals receive on their saving in Personal Accounts through two separate effects:

- **Tax advantage:** People do not pay tax on their tax-free lump sum, but do pay tax on income from annuities, so taking tax-free lumps can reduce a person's liability to income tax.

- **Means-tested benefits:** Small amounts of capital can be treated more advantageously in the calculation of entitlement to means-tested benefits than small amounts of pension income, so taking tax-free lump sums can lead to higher entitlements to means-tested benefits.

These are considered in turn. The analysis makes use of modelling on hypothetical individuals and uses the risk groups introduced in Chapter 2. The characteristics of the individuals are described in a box the first time the individual is used and are also set out in Appendix 1 for reference.

3.2 Tax advantage

Tax-free lump sums could be considered to act as an incentive to save in a pension. The current tax regime for private pension saving in the UK is generally thought of as **EET**:

- pension contributions attract tax relief at the individual's then marginal rate (**Exempt**);
- investment returns roll-up partly tax free (**Exempt**);
- and the pension income is **Taxed** when received at the individual's then marginal rate.³³

In some ways, this system could be seen not to provide a subsidy for pension saving but to act as a system of tax deferral since tax is not paid on pension contributions but is paid later in life when income is received from pensions. However, the following two elements of the system make it tax advantaged:

- Tax relief may be granted at a higher rate than is paid on the pension income in retirement, if a person has a lower income after retirement than before retirement.
- The tax-free lump sum. This allows one-quarter of a person's pension saving to be taken tax-free rather than as a taxable income.

The tax advantage can benefit people who would pay tax on an annuity. Around 5 million people over state pension age currently have income high enough to pay tax and the remaining 6 million people do not pay income tax.³⁴ Overall, the tax-free lump sum cost the exchequer up to an estimated £3.2 billion in lost income tax revenue in 2005/6.³⁵

³³ For further information see the PPI report for Age Concern England, Curry and O'Connell (2004).

³⁴ Estimates based on figures from the Survey of Personal Incomes supplied by HM Revenue & Customs. The rules for income tax will change from April 2008, see PPI Briefing Note 37.

³⁵ HMRC (2006) estimates that £9.5 billion of income tax was paid on private pension income. Under the assumption that this is paid on 75% of withdrawals from accumulated pension funds, taxing the

As an illustration, Paul is a hypothetical median-earning man who saves in a Personal Account for most of his working life. The value of his Personal Account saving would be worth an estimated £65,500 at retirement (in 2006/7 earnings terms). Since this is more than the trivial commutation limit of £15,000, he would not be able to trivially commute. He could take a tax-free lump sum worth 25% of his pension saving, equal to £16,300, and would have to buy an annuity with the remainder by the time he reaches age 75.

Paul: 25 year-old median-earning man

Paul is a single man, aged 25 in 2012, who works mainly full time but with some unemployment and part-time work.

- He starts working full-time from age 21, but was unemployed for two years in his twenties and worked part-time between age 55 and age 60.
- When in full-time work, he earned at median age-specific earnings for men.
- He and his employer contribute the minimum amount to a Personal Account from 2012, while he is working. He takes his Personal Account at state pension age, at age 68 in 2055.

In this section, Paul is assumed to own his own home in retirement. In later sections of this paper, he will be assumed to rent in retirement, to illustrate the potential impact that Housing Benefit has on his returns from saving.

His pension saving would be worth around £65,500 (2006/7 earnings) at state pension age on the assumptions used in this paper.

To illustrate the impact of taking a tax-free lump sum on his return from saving, consider the alternative, that he uses all of his pension saving to buy an annuity. All of this annuity would be subject to income tax. If he bought this annuity at state pension age, then his total income at that time could amount to £204 a week, in 2006/7 earnings terms. This includes £135 from state pensions, £83 from Personal Accounts, and is after income tax of around £14 has been deducted.

His income would fall gradually during his retirement, relative to national average earnings, from £204 a week to £157 a week by his life expectancy of age 89. This is because:

remaining 25% would have raised an additional $£9.5 / 3 = £3.2$ billion. See Emmerson (2005) page 5. Note that this is a theoretical cost and could not be recovered fully, even if the tax relief on the pension commencement lump sum were fully abolished, because some individuals may change their behaviour and save less in pensions and more in other tax-advantaged saving vehicles, such as ISAs.

- Although the level of the Basic State Pension (BSP) would be uprated in line with average earnings as a result of the reforms currently being scrutinised in Parliament, income from State Second Pension (S2P) would only increase with prices once in payment. Since average earnings are expected to increase faster than prices, income from S2P would fall relative to average earnings.
- Paul is assumed to buy a level annuity, so that the amount received from the annuity does not increase from year to year.³⁶ The alternative is to buy an annuity which keeps pace with inflation; however this is not the assumption made in this paper since the majority of annuities bought today are level. A level annuity means that income from Personal Accounts could fall quickly in retirement relative to average earnings, from £83 at state pension age to £33 at life expectancy.
- Partly offsetting these reductions, Paul's lower income means that he pays less income tax later in life and receives more in means-tested benefits.

Taking a tax-free lump sum could increase his retirement income and his return from saving:

- Column A in Table 1 shows the scenario described above: what would happen if Paul did not take a lump sum at all but used all his pension savings to buy an annuity. Columns B to D show various options for taking a tax-free lump sum.
- One option is to take a tax-free lump sum and use it to buy a voluntary annuity (Column B).³⁷ This option would enable Paul to benefit from the tax relief on the lump sum because of the tax treatment of voluntary annuities.³⁸ In this option, Paul would pay less income tax than if he does not take a tax-free lump sum (Column A), increasing his overall income at state pension age to £208 a week.
- Another option would be to take the tax-free lump sum and save it in a bank account. In this scenario (Column C) he gradually draws on his capital, spending 5% of the remaining balance each year. His income at state pension age could be similar to not taking a tax-free lump sum as in Column A, at £204 a week. However, there would be some capital remaining in the bank account when he dies that he could leave as an inheritance. If he died at his life

³⁶ Individuals would have the choice to use their Personal Account fund to buy a level annuity or an annuity that increases from year to year. In this paper, individuals have been assumed to buy a level annuity, since most annuities bought today that are not from the proceeds of contracted-out rebates are level, Canon and Tonks (2006).

³⁷ This paper makes the simplifying assumption that rates are the same for both voluntary and compulsory annuities. In practice, providers may charge different rates.

³⁸ Voluntary annuities are subject to a special tax treatment. The element which is assumed to be the return of capital to the individual is not liable for income tax and only the element which is assumed to be investment growth is taxable, Pensions Commission (2006) Appendices page 220. In this paper, the simplifying assumption is made that all income from the voluntary annuity is tax-free.

expectancy (age 89) then he could have £4,300 of the tax-free lump sum remaining in his bank account (or around 7% of his pension fund at retirement).

- In Column D, Paul takes the tax-free lump sum and spends it all immediately. His income could be much higher at state pension age when he spends the lump sum, at £504 rather than £204 under Column A. His income would be lower later in life, at £150 rather than £157 a week at life expectancy. The impact of spending the lump sum immediately on his income in later life is mitigated by higher entitlements to means-tested benefits. He could receive £11 a week in means-tested benefits at life expectancy in Column D, rather than £10 a week if he annuitised all of his pension saving as in Column A.

Table 1³⁹ Paul’s estimated income, assuming he owns his own home in retirement, £ per week, 2006/7 earnings terms

	(A) Does not take a lump sum	Takes a tax-free lump sum		
		(B) Buys a voluntary annuity	(C) Saves it, spending 5% of the balance each year	(D) Spends it all immediately
Income at SPA (68):	204	208	204	504
State pension	135	135	135	135
Personal Accounts	83	83	63	63
Income tax	(14)	(10)	(10)	(10)
Capital drawn down	-	-	16	314
Means-tested benefits	-	-	-	2
Income at life expectancy (89):	157	157	154	150
State pension	115	115	115	115
Personal Accounts	33	33	25	25
Income tax	(1)	(1)	(1)	(1)
Capital drawn down	-	-	4	-
Means-tested benefits	10	10	11	11
Internal rate of return	5.6% Low-risk	5.8% Low-risk	5.8% Low-risk	6.3% Low-risk

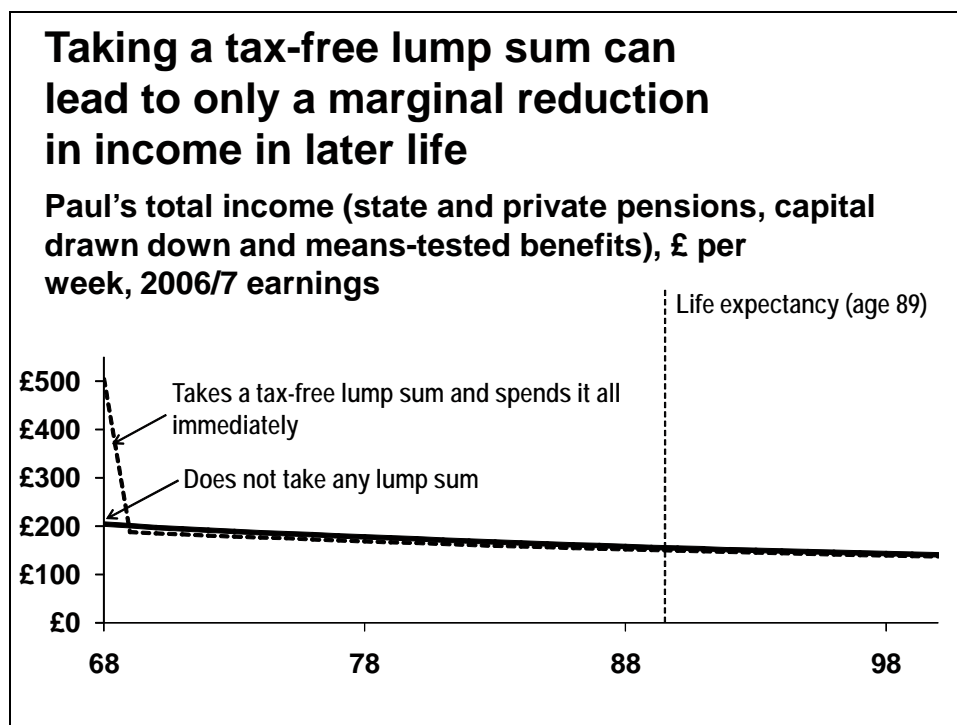
Under all of the options, Paul’s internal rate of return (as shown in the last row of Table 1) would be more than 5.5%, putting him at low-risk of Personal Accounts being unsuitable for him. This reflects his long saving history. His internal rate of

³⁹ PPI analysis using the Individual Model. See Appendix B for details of the assumptions used.

return is increased by taking a tax-free lump sum, as a result of the tax advantage and the interaction with means-tested benefits.

Paul's internal rate of return is highest if he takes the tax-free lump sum and spends it immediately. This is because, compared to not taking a tax-free lump sum, the lump sum increases his income significantly at state pension age with only a marginal reduction later in life (Table 1 and Figure 5). This suggests that there may be an incentive for individuals like Paul to spend their tax-free lump sums quickly. However, factors other than the internal rate of return could affect people's decisions on spending. For example, Paul may want to save some of his lump sum as a precautionary measure to pay for events that may happen later in his life, such as need for house repairs or long-term care (Box 1).

Figure 5⁴⁰ Income can fall during retirement



Note that these figures are projections of the amount of income that Paul could receive. They are on the basis that current policy⁴¹ continues into the future and in particular that the structure of benefits such as Pension Credit, Council Tax Benefit and Housing Benefit remain unchanged. They also require assumptions to be made, including the future level of inflation, earnings growth, investment returns and annuity rates. While the projections can be useful in comparing his outcomes under different

⁴⁰ PPI analysis using the Individual Model. See Appendix B for details of the assumptions used.

⁴¹ In this paper, current policy assumes that the Pensions Bill 2006 is enacted and that Personal Accounts are introduced as proposed in the December 2006 White Paper.

choices for how he uses his lump sum, his actual outcomes are uncertain and will depend on what happens in the future.

Box 1: Internal rates of return and lump sums

The internal rate of return depends on exactly how individuals spend their lump sum. The calculation of the internal rate of return means that it attaches greater value to income received earlier in retirement.⁴² However, other factors could determine how individuals decide to spend their lump sum, such as the need to cover events that may occur unexpectedly in later life.

Paul's internal rate of return could be as high as 6.3% if he spent his lump sum immediately when he receives it.

The Government has said that:

*Successive Governments have offered tax relief on contributions to and investment growth in approved pension schemes in order that the savings produce an income in retirement.*⁴³

This suggests the need to design policy to be robust to the scenario that individuals draw down their capital more slowly. Therefore, this paper also illustrates the scenario where individuals save lump sums in a bank account and spend 5% of the outstanding balance each year. 5% has been chosen since it provides a similar initial income to buying a level annuity.

Note that the means-tested benefit system effectively assumes that individuals will spend 10.4% a year of any capital they have in addition to the capital disregard (£6,000 in 2006/7). Individuals who spend less than this will be considered in the calculation of means-tested benefits to have more income than they actually do, which could lead to lower entitlements to means-tested benefits. 5% has been chosen for this paper because it produces a more conservative outcome.

3.3 Means-tested benefits

Paul benefits from the tax-free lump sum mainly because he pays tax on his income in retirement and so benefits from not paying tax on the lump sum. Lower income pensioners may also benefit from the tax-free lump sum, even if they pay little income tax in retirement, because of the interaction with means-tested benefits.

⁴² The returns earned on pension saving post-retirement (either in buying an annuity or investing a lump sum in a bank account) are likely to be lower than investment returns earned pre-retirement. So the longer pension saving is held on to in retirement, the lower the average investment return earned over the life of the pension investment.

⁴³ HMT (2006) paragraph 5.1.

When calculating entitlements to means-tested benefits, there are different rules for pension income (such as from annuities) and capital (whether this is from savings, inheritance, redundancy payments or lump sums from state pension deferral or any other source):

- All pension income is taken into account in the calculation of entitlement.
- Any capital below the level of the capital disregard (£6,000 for 2006/7)⁴⁴ is ignored in the calculation, and any additional capital in excess of the capital disregard is converted into a 'deemed income' at the rate of £1 a week for each £500 of capital. Note that there are notional capital rules for means-tested benefits that are assumed not to apply (Box 2).

Box 2: Notional capital rules

In the calculation of internal rates of return, it is assumed that the examples of people who take lump sums do not spend them with the intention, or significant purpose, of increasing their entitlements to means-tested benefits.

For the purposes of calculating entitlements to Pension Credit, individuals can be treated as still having capital that they no longer have, if they are considered to have deprived themselves of their capital for the purpose of getting more Pension Credit. This is called 'notional capital'. The rules used by 'Decision Makers' state that people have not deprived themselves of capital if they disposed of it to reduce or pay a debt owed by themselves, or to buy goods or services and it was reasonable in their case to buy such goods or services.⁴⁵ There are similar rules for Council Tax Benefit and Housing Benefit.

If the examples of people who take lump sums are considered to have deprived themselves of capital for the purposes of getting more means-tested benefits, then their subsequent entitlements to means-tested benefits would be lower than assumed in this paper. Their internal rates of return would be lower as a result.

The capital disregard means that small amounts of capital can be treated more advantageously in the calculation of entitlement to means-tested benefits than small amounts of pension income (Figure 6). For example, if an individual had £10,000 of capital saving in an Individual Savings Account (ISA) then this would produce a deemed income of £8 a week.⁴⁶ But if an individual had £10,000 of pension saving –

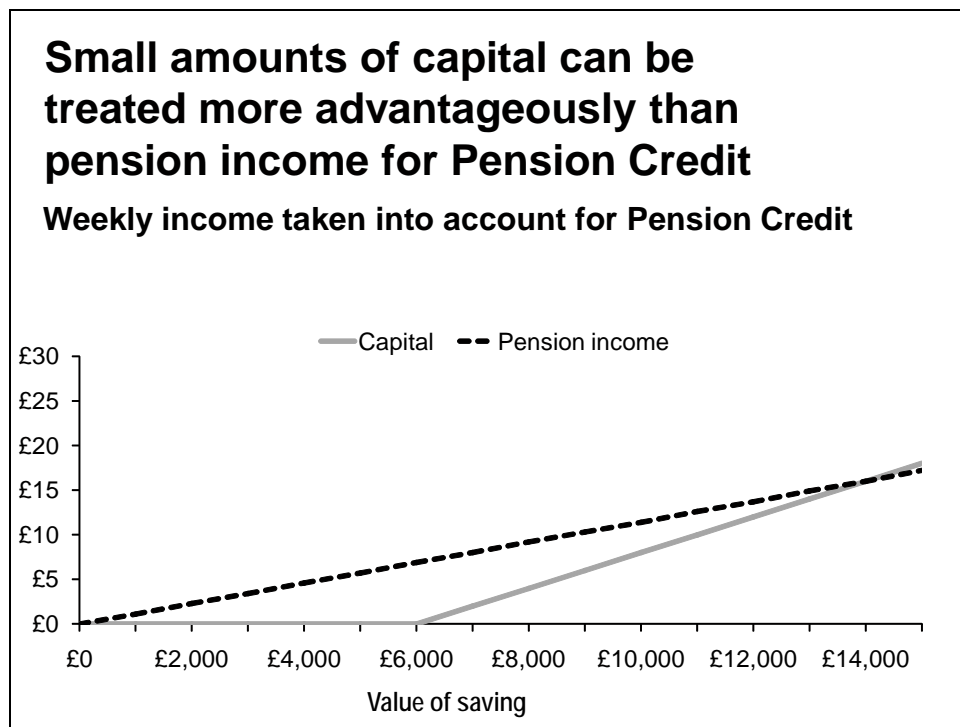
⁴⁴ The capital disregard is set higher, at £10,000, for those who permanently live in care homes

⁴⁵ DWP (2006 DM) Paragraph 84781

⁴⁶ $(10,000 - 6,000) / 500$

and did not convert this to a lump sum – then he or she would receive around £11 a week from his or her annuity, which would all be taken into account.

Figure 6 Small amounts of capital can be treated more advantageously than income for Pension Credit



If someone takes a tax-free lump sum, then the lump sum will count in the same way as any other capital for means-tested benefits. So taking tax-free lump sums can lead to higher entitlements to means-tested benefits. If a person did not take a tax-free lump sum, and instead bought an annuity with all of his or her pension saving, then all of the income from that annuity would count in the calculation of his or her entitlement to means-tested benefits. However, if he or she took a tax-free lump sum, then the first £6,000 of capital (or whatever the capital disregard is for the year in question) would not be taken into account.

As an illustration, Kate is older than Paul and does not begin to save in a pension until she is aged 40. She spends more time than Paul out of the labour market and has lower earnings, so the amount of her pension saving is lower. The value of her Personal Account saving would be worth an estimated £22,500 at retirement. Since this is more than the trivial commutation limit of £15,000, like Paul, she would not be able to trivially commute. She could take a tax-free lump sum worth 25% of her pension saving, equal to around £5,600, and would have to buy an annuity with the remainder by the time she reaches age 75.

Kate: 40-year old woman with modest caring and part-time work

Kate is a single woman, aged 40 in 2012, with a combination of full-time work, caring and 5 years of part-time work. She:

- Started work at the age of 21, working full-time until age 28.
- Then had a career break to care for a child for six years. She qualified for state pension credits during this period.
- She returned to part time work for five years.
- Then worked full-time until she took another career break for 5 years in her 50s to care for an elderly relative, for which she received no carer benefits or credits.
- She returned to full-time work again, until reaching state pension age.
- When in full-time work, she earned a median earnings for women.
- Both her employer and she contribute the minimum amount to a Personal Account from 2012, while she is working. She takes her Personal Account at state pension age, at age 67 in 2039.

Her pension saving would be worth around £22,500 (2006/7 earnings) at state pension age on the assumptions used in this paper.

If Kate does not take the tax-free lump sum and instead uses all of her pension saving to buy an annuity, then all of the income from the annuity would count in the calculation of entitlement to means-tested benefits. If she bought the annuity at state pension age, then her total income at that time could amount to £160 a week, in 2006/7 earnings terms (shown in Column A in Table 2). This includes £125 from state pensions, £26 from Personal Accounts and £10 from means-tested benefits. She pays a small amount of income tax of around £2.

If she takes the tax-free lump sum and uses it to buy a voluntary annuity, then she may pay slightly less income tax (£1 a week less at state pension age) but overall, her income would not be significantly affected (Column B in Table 2). The interaction of the tax-free lump sum with means-tested benefits can mean that retirement income is increased further.

One option for Kate is to take a tax-free lump sum and save it in a bank account. Because her lump sum (£5,600) is less than the capital disregard (£6,000), none of it would count in the calculation of her entitlement to means-tested benefits. Column C shows what may happen if Kate gradually draws on her capital, spending 5% of the remaining balance each year. In this scenario, Kate could benefit from:

- Paying around £1 a week less in income tax at state pension age than if she did not take a tax-free lump sum.
- Receiving around £1 a week more in means-tested benefits at state pension age than she would receive if she did not take a tax-free lump sum. This is around 4% of her income from her private pension.
- Any capital remaining in the bank account when she dies that she could leave as an inheritance.⁴⁷ If she died at her life expectancy (age 90) then she could have £1,400 of the tax-free lump sum remaining in her bank account (or 6% of her pension fund at retirement).

The combination of these three factors means that taking and gradually drawing on the tax-free lump sum could increase Kate's internal rate of return, from 4.3% (Column A) to 5.2% (Column C). An internal rate of return of 5.2% would mean that Kate would be at medium-risk of Personal Accounts being unsuitable for her. However, Kate would be close to the start of the low-risk group (5.5%).

An alternative would be to take the tax-free lump sum and spend it all immediately (Column D in Table 2). This would not lead to greater entitlements to means-tested benefits because the capital from her tax-free lump sum would be disregarded in the calculation of her entitlement to means-tested benefits, however she spends it.⁴⁸ It would increase her internal rate of return to 5.6% as a result of consumption being earlier in life (see Box 1). This would put Kate at low-risk of Personal Accounts being unsuitable for her. Of course, there may be other factors that will determine how she chooses to spend her lump sum, including any desire to have capital to cover events that may occur unexpectedly in later life.

This paper illustrates outcomes on the basis that the capital disregards are uprated in line with average earnings from 2012. However, this is not current Government policy and the capital disregard for Pension Credit has not been uprated since the introduction of Pension Credit in 2003. If the policy of no-uprating continued, then Kate could have a very low return on her saving, if she took the tax-free lump sum and spent 5% of it each year (as in Column C). In this scenario, Kate is likely to lose the entire value of her own contributions into Personal Accounts plus an additional 70p for every £1 contributed. This is because the capital disregard would have fallen to around £1,400 (in 2006/7 earnings terms) by the time she reaches state pension age, so only around a quarter of her lump sum would be disregarded when calculating her entitlement to means-tested benefits.

⁴⁷ In this paper, the calculation of the internal rate of return takes into account the value of leaving part of the lump sum as an inheritance. If this value was not taken into account, the internal rates of return would be lower than shown.

⁴⁸ Assuming that investment returns earned on the investment of the tax-free lump sum.

Table 2⁴⁹ Kate's estimated income, £ per week, 2006/7 earnings terms

	(A) Does not take a lump sum	Takes a tax-free lump sum		
		(B) Buys a voluntary annuity	(C) Saves it, spending 5% of the balance each year	(D) Spends it all immediately
Income at SPA (67):	160	160	160	263
State pension	125	125	125	125
Personal Accounts	26	26	20	20
Income tax	(2)	(1)	(1)	(1)
Capital drawn down	-	-	5	108
Means-tested benefits	10	10	11	11
Income at life expectancy (90):	138	138	138	137
State pension	107	107	107	107
Personal Accounts	9	9	7	7
Income tax	-	-	-	-
Capital drawn down	-	-	1	-
Means-tested benefits	21	21	22	22
Internal rate of return	4.3% Medium-risk	4.4% Medium-risk	5.2% Medium-risk	5.6% Low-risk

Both Paul and Kate have options for how to use their pension saving that can affect both the profile of income they have in retirement and their return from saving in Personal Accounts. They could both benefit from the tax-free lump sum, although the relative advantages of its interaction with income tax and means-tested benefits are different for each person.

People who rent in retirement and the self-employed have previously been identified as individuals who may potentially be at medium or high-risk of Personal Accounts being unsuitable. The next sections illustrate how the tax-free lump sum could improve their returns from saving in Personal Accounts.

3.4 People who rent in retirement

Around one-third of pensioner households currently rent accommodation. Around two-thirds of these (22% of all pensioner households) are currently eligible for

⁴⁹ PPI analysis using the Individual Model. See Appendix B for details of the assumptions used.

Housing Benefit. It is possible that future levels of home ownership among pensioners will increase in future but this is uncertain.⁵⁰

People who rent in retirement are potentially eligible for Housing Benefit for help with rent. Housing Benefit is a means-tested benefit that is withdrawn at the rate of 65p for each additional £1 of income.⁵¹ So saving in a Personal Account could result in a significant loss in income from Housing Benefit.

It is possible to be entitled to Housing Benefit, Council Tax Benefit and Pension Credit at the same time. In this situation, the combined value of these means-tested benefits would be withdrawn at a rate of 91p for each additional £1 of income. An individual on this rate of withdrawal would receive a net gain of 9p from each £1 of income received from Personal Accounts.

The high withdrawal rates that result from being on Housing Benefit can mean that people who rent in retirement receive less than the inflation-protected value of their Personal Account contributions, putting them in the high-risk category.

As an illustration, consider Paul, the hypothetical median-earning man who saves in a Personal Account for most of his working life. The value of his Personal Account saving would be worth an estimated £65,500 at retirement. Since this is more than the trivial commutation limit of £15,000, he would not be able to trivially commute. He could take a tax-free lump sum worth 25% of his pension saving, equal to £16,300, and would have to buy an annuity with the remainder by the time he reaches age 75.

If Paul rented in retirement then he could be in the high-risk group, even though he has a substantial amount of saving in Personal Accounts. His exact risk-group depends on whether he chooses to take the tax-free lump sum and how he spends it:

- If he did not take a tax-free lump sum, and bought an annuity with his entire pension fund, then all of the income from the annuity would count in the calculation of his eligibility to means-tested benefits, including Housing Benefit. He could have an internal rate of return of less than 0.1%. This would mean he is in the high-risk group, so that he does not receive the inflation-protected value of his own individual contributions back from Personal Accounts.
- If he took a tax-free lump sum and saved it in a bank account, spending 5% each year, then he would be in the high-risk group with internal rate of return of 1.6%.

⁵⁰ See the PPI's analysis of current housing tenure by age, Steventon (2006) pages 24-7.

⁵¹ For incomes above a lower threshold.

- If he took a tax-free lump sum and spent it immediately, then his internal rate of return could be 3.4%, putting him in the medium-risk group.

For this example, Paul is assumed to own his own accommodation during working age but then move to rented accommodation during retirement, possibly as a result of divorce. If he rented during his working life then his internal rate of return could be higher as a result of the interaction with Housing Benefit during his working life. This is because, during working life, half of the value of the pension contributions would be deducted from the income that is used to calculate his entitlement to Housing Benefit. His contribution would therefore increase both the value of his pension fund and also his entitlement to means-tested benefits before retirement (although it could reduce his entitlement during retirement).

3.5 People who spend time self-employed

Currently 12% of men and 5% of women of working age are self-employed.⁵² Although the self-employed would not be automatically enrolled into Personal Accounts, a period of self-employment can have implications for returns on saving made while employed:

- Individuals would not receive an employer contribution into Personal Accounts while self-employed.
- State Second Pension (S2P) is not accrued during periods of self-employment.

Spending time self-employed could reduce private pension income in retirement. Currently 36% of self-employed people of working age contribute to a pension, in comparison to 57% of employees of working age.⁵³ However, there is mixed evidence on the retirement incomes of people who have been self-employed. A study in 2000 found that pensioners who had been self-employed at some point during their working lives were only slightly more likely than pensioners who had never been self-employed to be in receipt of means-tested benefits (14% compared to 11%).⁵⁴

It is possible that business assets are built up during time spent self-employed, which are then used to finance retirement. However, this will not be the case for everybody. A recent survey by the Association of British Insurers found that only 6% of self-employed people thought it was realistic that the sale of their business could fund their retirement.⁵⁵ PPI analysis suggests that a woman who is self-employed for her

⁵² PPI analysis using Family Resources Survey 2004/5 Table 7.1.

⁵³ Family Resources Survey 2004/5 Table 7.12.

⁵⁴ Knight and McKay (2000).

⁵⁵ ABI (2006) page 5.

entire working life would need to have a business worth around £50,000 to take her completely above Pension Credit, if she had no other forms of private saving.⁵⁶

As an illustration, Jasmine is 25-years old in 2012 and spends seven years self-employed. She would have a final pension fund of £22,500, meaning that she would not be able to trivially commute. However, she could take 25% of her saving as a tax-free lump sum.

Jasmine: 25-year old woman with periods of employment and self-employment

Jasmine is a single woman, aged 25 in 2012, who has a combination of employment, self-employment and unemployment. She is:

- Employed from age 21.
- Self-employed for 7 years, from age 40 to age 46.
- Employed from age 47 to age 55.
- In receipt of Incapacity Benefit from age 56 to age 60.
- She then returns to part-time work from age 61 to retiring at state pension age (68).
- When in work, she earns at the 3rd decile of earnings for women of her age.
- She and her employer contribute the minimum amount to a Personal Account from 2012, while she is employed and working full-time. She does not save in a Personal Account when she is working part-time because she decides she cannot afford the contributions. The self-employed would not be auto-enrolled into Personal Accounts and she does not voluntarily opt-in when she is self-employed. She does not contribute when she is receiving Incapacity Benefit.

Her pension saving would be worth around £22,500 (2006/7 earnings) at state pension age on the assumptions used in this paper.

Jasmine could be in the medium or low risk group, depending on whether she chooses to take the tax-free lump sum and how she spends it:

- If she did not take a tax-free lump sum, and bought an annuity with her entire pension fund, then all of the income from the annuity would count in the calculation of her eligibility to means-tested benefits. She could have an internal rate of return of 5.0%. This would mean she is in the medium-risk group.
- If she took a tax-free lump sum and saved it in a bank account, spending 5% each year, then she would just be in the medium-risk group with internal rate of return of 5.3%.

⁵⁶ In 2006/7 earnings terms. See PPI (2006 SW) page 12.

- If she took a tax-free lump sum and spent it immediately, then her internal rate of return could be 5.6%, just putting her in the low-risk group.

Jasmine is self-employed for 7 years, which is close to the average duration of self-employment.⁵⁷ Maya is the same age as Jasmine (25 in 2012) but is in some ways a more extreme example, being self-employed for her entire working life. Although this may be unlikely, she is useful to illustrate the potential effects of self-employment.

Maya would have a final pension fund of £22,000, meaning that she would not be able to trivially commute. She is likely to be in the high-risk category, regardless of whether she takes a tax-free lump sum and how she spends it.

Maya: 25-year old lifetime self-employed woman

Maya is a single woman, aged 25 in 2012, who is self-employed for her entire working life, from age 18 until retiring at age 65:

- She earns at the 3rd decile of earnings for women of her age.
- Although the self-employed would not be auto-enrolled into Personal Accounts, she voluntarily opts-in from their introduction in 2012 until retiring at her state pension age (age 68).

Her pension saving would be worth around £22,000 (2006/7 earnings) at state pension age on the assumptions used in this paper.

This chapter has shown that taking a tax-free lump sum can improve returns from saving in a Personal Account. The extent of the improvement depends on:

- How the individual spends the tax-free lump sum.
- Whether or not the individual pays tax in retirement or is eligible for means-tested benefits. This in turn depends on the individual's characteristics, such as his or her working and saving history.

The next chapter considers trivial commutation lump sums.

⁵⁷ In comparison, a study found that on average a spell of self-employment lasts almost 8 years, Knight and McKay (2000).

4 TRIVIAL COMMUTATION

The original policy intention behind trivial commutation was to avoid the situation where individuals are obliged to have an annuity that would give them a very small monthly income by allowing them to take all of their pension saving as a lump sum. Despite this original policy intention, the Government has also suggested trivial commutation may increase returns from saving in Personal Accounts.

Currently around 13% of a sample of people in England aged between 50 and state pension age are on course to have pension saving that is within the trivial commutation limit when they retire (£15,000 in 2006/7). Women are more likely to be able to trivially commute than men because they typically have smaller pension funds.

This chapter shows that trivial commutation can increase individual's returns from saving in Personal Accounts.

For people who have non-pension saving, the current system of trivial commutation may provide a particular incentive to spend lump sums quickly. This is because their capital disregard may have been used up by the non-pension saving, so that capital is treated less rather than more advantageously than equivalent amounts of pension income. For these people, it may not be possible to save lump sums for later consumption without a large negative impact on their entitlement to means-tested benefits.

The trivial commutation limit is a global limit, applying to a person's combined private pension saving from all sources. Pension saving besides Personal Accounts, perhaps made before 2012 into an occupational or personal pension, may reduce the potential for an individual to trivially commute their saving in Personal Accounts.

People who have previously contracted-out of the State Second Pension, without making voluntary saving in addition to the rebate, may be less likely to be able to trivially commute small amounts of Personal Accounts saving than those who have remained contracted-in. This is because any private pension that results from the contracting-out rebate counts against the trivial commutation limit.

The existing trivial commutation limit will not ensure that everybody is at low-risk of Personal Accounts being unsuitable for them. There are examples of people at medium or high-risk of Personal Accounts being unsuitable who cannot trivially commute, such as people who rent in retirement and the self-employed.

4.1 Policy rationale

Individuals with pension saving of less than the trivial commutation limit (£15,000 in 2006/7) can choose to take all of their pension saving as a lump sum. 25% is taxed free and the remainder is taxed as income at an individual's marginal rate. Trivial commutation means that individuals below the limit can take a greater proportion of their pension saving as a lump sum than individuals above the limit, who would be restricted to the 25% tax-free lump sum.

Until 2005/6, the trivial commutation limit was much lower than currently at around £5,000.⁵⁸ As part of the wider 'A-day' simplification of pensions taxation that came in force on 6 April 2006, the Government increased the trivial commutation limit. It originally proposed a limit of £10,000 for 2006/7, arguing that the previous limit had not been updated for some years and was not index-linked, so had not kept pace with inflation, and that:

- *Having to administer small pensions only marginally above the trivial commutation is expensive and adds disproportionately to schemes' administrative burdens.*
- *Purchasing an annuity with such a small amount [less than £5,000] is also problematic, some insurers have minimum limits of £10,000, and even when an annuity can be secured the rates are often uneconomical.*⁵⁹

After consultation, the Government aligned the trivial commutation limit at 1% of the Lifetime Allowance, effectively meaning a further increase to £15,000 for 2006/7. The Government also set a schedule for how the trivial commutation would be increased over the next few years, reaching £18,000 by 2010/1. This is broadly in line with estimates of future earnings growth,⁶⁰ so that in effect the trivial commutation limit is proposed to stay constant relative to average earnings, at least until 2010/1.

In 2002, around 13% of a sample of people in England aged between 50 and state pension age were on course to have pension saving that is within the current trivial commutation limit of £15,000 when they retire (Figure 7).⁶¹ Women are more likely to be able to trivially commute than men because they typically have smaller pension

⁵⁸ For 2005/6, people were able to trivially commute provided their pension saving would provide an income of £260 a year or less. This is equivalent to around £5,200, assuming the standard annuity conversion rate for tax purposes of 20.

⁵⁹ DWP (2004) paragraphs 4.4.1 and 4.4.2.

⁶⁰ Assuming annual growth in average earnings is 4.5%.

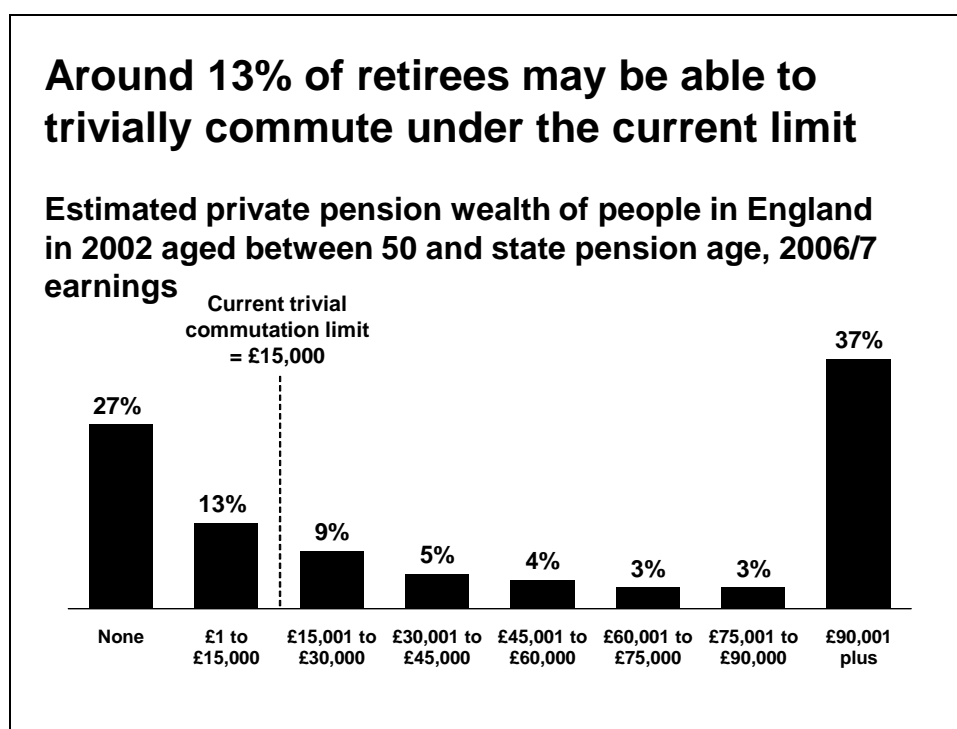
⁶¹ PPI analysis of wave 1 of the English Longitudinal Study of Ageing. Marmot, M. et al. , English Longitudinal Study of Ageing: Wave 0 (1998, 1999 and 2001) and Waves 1-2 (2002-2005) [computer file]. 6th Edition. Colchester, Essex: UK Data Archive [distributor], January 2007. SN: 5050. The National Centre for Social Research, University College London, Institute for Fiscal Studies and the UK data archive bear no responsibility for their further analysis or interpretation.

funds. Around 16% of women in the sample are on course to have a pension saving that is within the current trivial commutation limit, compared to 10% of men.

These estimates of the numbers of people able to trivially commute are subject to a high degree of uncertainty and should be taken as illustrative only, since:

- They need to make assumptions about future saving and retirement patterns. The estimates assume that individuals continue to save at their current rate until retiring at state pension age. However, some individuals may either stop saving or retire earlier in which case their pension wealth may be lower.
- They are based on a particular cohort of people, namely those aged between 50 and state pension age in 2002. On the assumptions made about retirement dates, this cohort will retire between 2002 and 2017. The pension wealth of subsequent cohorts of people could be higher or lower.
- They are based on a certain method of calculating pension wealth which may differ from that used for determining eligibility for trivial commutation.⁶²

Figure 7⁶³ Around 13% of retirees may be able to trivially commute under the current limit



⁶² The calculations in Figure 7 are based on a projection of the individual's stream of income from the private pension throughout their retirement, which is based on assumed annuity rates, and in turn discounts this stream of income to produce a wealth figure, Banks et al (2005). Eligibility for trivial commutation is determined by reference to the value of the pension pot at the time of trivial commutation (for Defined Contribution schemes) or by a standard conversion factor of 20 (for Defined Benefit schemes).

⁶³ See footnote 61.

Although the original policy intention behind trivial commutation was to prevent the efficiency problems associated with annuitising small pension funds, the Government has also suggested trivial commutation may increase returns from saving in Personal Accounts:

A small number of people may see a lower expected payback [the Government's equivalent to the internal rate of return, see Chapter 2] due to complex circumstances such as entitlement to Housing Benefit and Council Tax Benefit as well as Pension Credit. Many of these will have only small, if any, personal accounts pension. Where they do have limited amounts of saving, they are likely to be able to take their pension as a [trivial commutation] lump sum which may improve the payback they can get.⁶⁴

The next sections explore the potential for trivial commutation to increase returns from saving in Personal Accounts. As with the previous chapter, it is based on current policy. The next chapter will investigate the impact of increasing the trivial commutation limit.

4.2 Affect on returns from saving

Trivial commutation can increase individuals' returns from saving in Personal Accounts where they are eligible for it.

As an illustration, Jane is aged 50 in 2012 and only saves for a pension for nine years. When she retires at age 66, the value of her pension saving is around £7,000, which is under the trivial commutation limit of £15,000. This means that, unlike Kate in the previous chapter, she can take all of her pension saving as a lump sum.

If Jane does not trivially commute and instead uses all of her Personal Account saving to buy an annuity, then she could receive around £8 a week from her annuity.⁶⁵ She would continue to receive her annuity for the rest of her life but the amount received each week would gradually decline relative to average earnings to around £3 a week by the time she reaches her life expectancy of 89. This assumes she buys a level annuity (i.e. one that is not increased from year to year and so pays the same amount throughout the person's lifetime).

⁶⁴ See for example DWP (2006 FISR) page 8.

⁶⁵ Assuming she takes a 25% tax-free lump sum and uses it to buy a voluntary annuity.

Jane: 50-year old woman with caring and part-time work

Jane is a single woman, aged 50 in 2012, who has taken time out of work to care for her child and for elderly relatives. She:

- Had her only child at age 21 and stayed at home caring until her child was aged 18.
- She then started full-time work, for 20 years until she is aged 58. During this time, she earns at the 3rd decile of earnings for women of her age.
- She cares for her mother and aunt from age 59 until state pension age, for 8 hours a week each, combined with some part-time earning below the Lower Earnings Limit. She would receive no state pension credits during this time.⁶⁶ She and her employer will contribute the minimum amount to a Personal Account from 2012, while she is working (i.e. for 9 years, for ages 50 to 58 inclusive). She takes her Personal Account at state pension age, at age 66 in 2028.

Her pension saving would be worth around £7,000 (2006/7 earnings) at state pension age on the assumptions used in this paper.

All of the income from the annuity would count in the calculation of entitlement to means-tested benefits. However, if she trivially commuted, she could receive a lump sum of £7,000. The first £6,000 of this would not count in the calculation of her entitlement to means-tested benefits, so that her pension saving would be virtually completely ignored. Regardless of how she spends the lump sum, her entitlement to means-tested benefits could be higher by around £2 at state pension age or £3 at life expectancy (age 89), compared to what would be the case if she did not trivially commute (Figure 8).

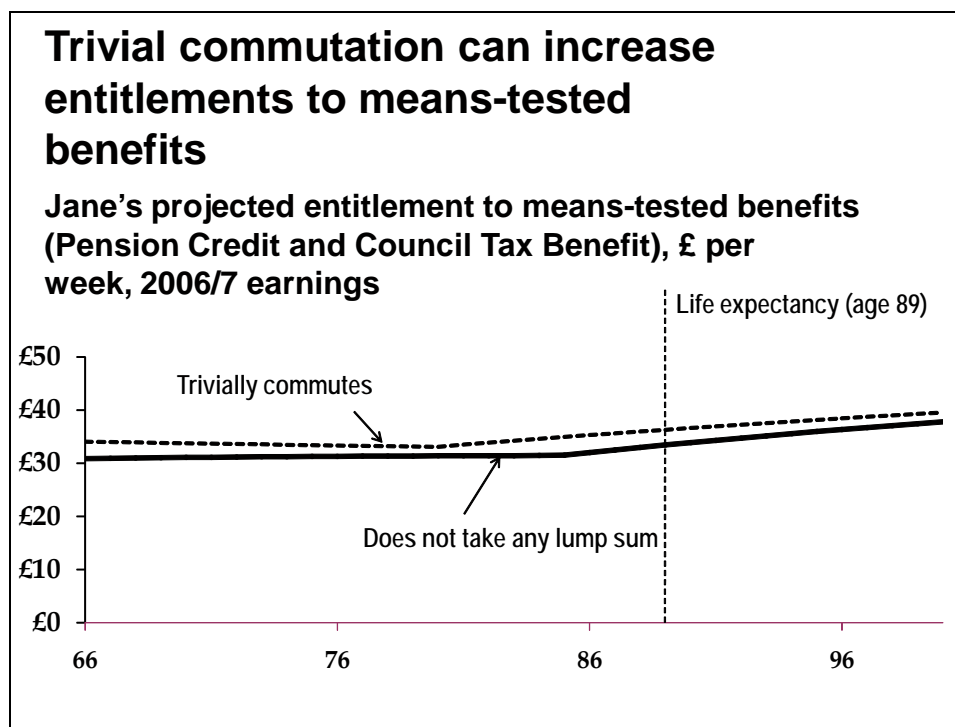
Trivial commutation would therefore increase Jane's returns from saving:

- If Jane bought an annuity with her pension saving, then her internal rate of return could be 4.1%. This would put her at medium-risk of Personal Accounts being unsuitable for her, meaning that she would receive back the value of her own individual contributions to Personal Accounts, protected for inflation, but may not receive full credit for the investment returns earned on those contributions.
- If Jane trivially commuted, then her pension saving would be virtually completely ignored in the calculation of her entitlement to means-tested

⁶⁶ Note however that if she cared for more than 20 hours a week, then she could receive state pension credits under the proposals currently being scrutinised in Parliament.

benefits. Her internal rate of return would depend on how she spends her lump sum but is likely to put her at low risk of Personal Accounts being unsuitable for her. This means that she would receive full credit for the investment returns earned on her own individual contributions into Personal Accounts.

Figure 8⁶⁷ Trivial commutation can increase entitlements to means-tested benefits



4.3 People with non-pension saving

For some groups of people, the current system of trivial commutation may provide a particular incentive to spend lump sums quickly. For example, if an individual's capital disregard has already been used up by non-pension saving, then it may not be possible to save lump sums for later consumption without a large negative impact on entitlement to means-tested benefits.

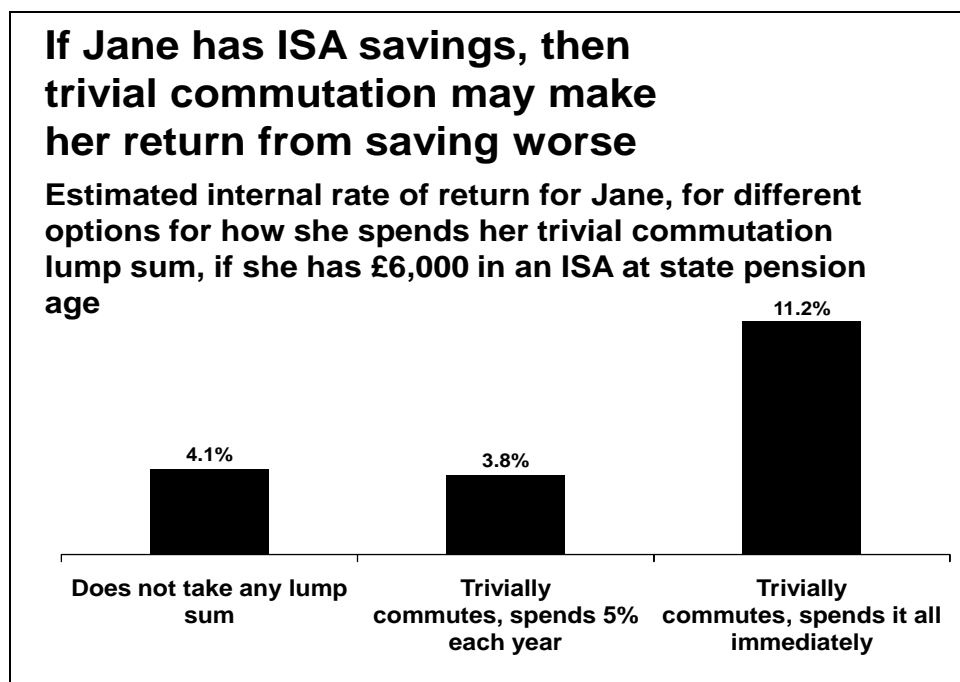
Many forms of capital are counted against the capital disregard, including cash, bank and building society accounts, Premium Bonds, investment trusts and shares, regardless of their original source. For example, the capital could be from savings, inheritance, redundancy payments or lump sums from state pension deferral. The value of a second home can also be counted.

If Jane's capital disregard was fully taken up by ISA saving when she reaches state pension age, and she decided to save her trivial commutation lump sum in a bank

⁶⁷ PPI analysis using the Individual Model. See Appendix B for details of the assumptions used.

account, then her internal rate of return could be lower if she trivially commutes than if she decides to convert her pension saving into an annuity. While she may receive an internal rate of return of 4.1% if she did not trivially commute, deciding to trivially commute and save the proceeds in a bank account could reduce this return to 3.8%, putting her further down the medium-risk group (see the first two bars of Figure 9).

Figure 9⁶⁸ If Jane has ISA savings, then trivial commutation may make her return from saving worse



Since Jane's capital disregard is already used up by her ISA saving, all of the proceeds from her trivial commutation lump sum would reduce her entitlement to means-tested benefits. Capital above the level of the capital disregard is converted into deemed income for means-tested benefits at a worse rate than would be the case if she converted that capital into an annuity (Figure 10):

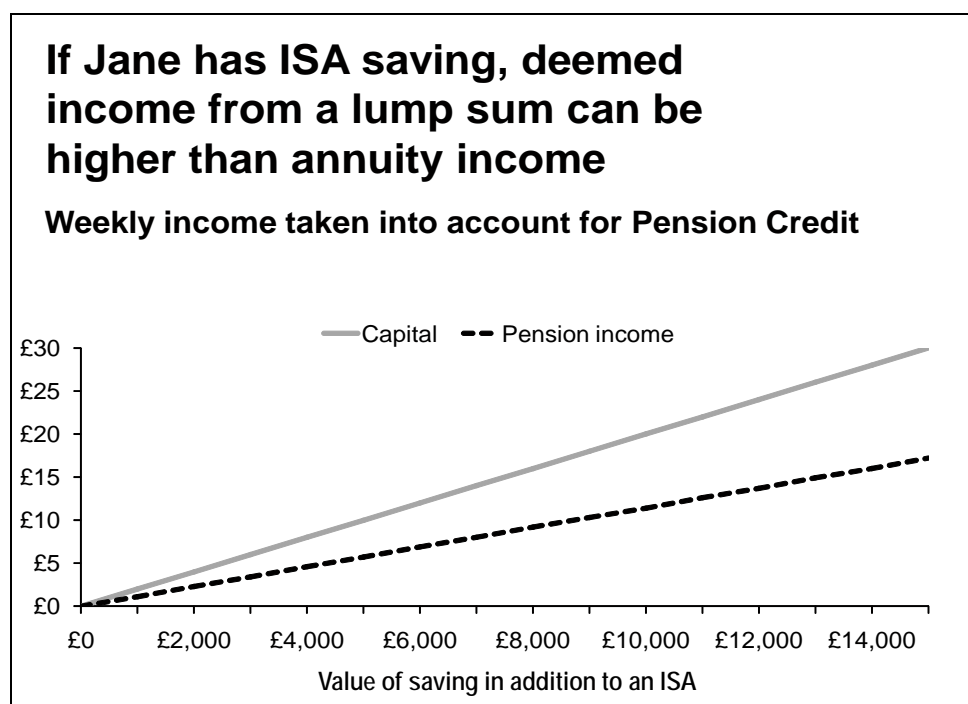
- If Jane decided not to trivially commute, then her pension saving would be converted into an actual income through an annuity. Assuming she buys a level annuity at state pension age, this may mean that each £1 of the lump sum is converted into an actual income of 6p a year, on the annuity rates used in this paper.

⁶⁸ PPI analysis using the Individual Model. See Appendix B for details of the assumptions used. In the calculations, saving in the ISA is assumed to be the 'first' slice of capital when comparing capital with the level of the capital disregard. Consequently, it is the lump sum that is considered to be above the level of the capital disregard, rather than the saving in the ISA. If instead the lump sum was assumed to be the 'first' slice of capital, then the internal rate of return on saving in a Personal Account would be higher (and the saving in the ISA would be converted into deemed income).

- However, if she did decide to trivially commute and save the proceeds, then Jane's lump sum would produce a deemed income for the purposes of calculating entitlement to means-tested benefits. Since her capital disregard is already used up by her ISA saving, each £1 of the lump sum would produce a deemed income of 10.4p a year.⁶⁹ This is more than the 6p of income that she could receive from the annuity, so that taking and saving a trivial commutation lump sum can lead to lower entitlements to means-tested benefits and a lower internal rate of return.

Trivial commutation can still increase Jane's internal rate of return on her Personal Account saving, even if her capital disregard has already been used up. However, for it to improve the return, Jane would have to spend more than 5% of the lump sum each year. This means that there is more of an incentive to spend trivial commutation lump sums quickly if the capital disregard has been used up by other forms of non-pension saving.

Figure 10 If Jane has ISA saving, deemed income from a lump sum can be higher than annuity income



⁶⁹ Under the current rules for the calculation of means-tested benefits, each £500 (or part of £500) of capital in excess of the capital disregard is converted to a deemed income of £1 a week, or £52 a year. $52/500 = 10.4p$.

Currently, 15% of the pensioner benefit units who are claiming Pension Credit have fully used up their capital disregard, with a further 13% having used up at least half of it (Table 3). Increasing the capital disregard may mean that people are eligible for Pension Credit who would not be eligible under current policy. The capital of these people may differ from that shown in Table 3, which focuses on current claimants.

Table 3⁷⁰ Capital eligible to be taken into account for Pension Credit

	Number of claimants (000s)	Proportion of claimants
No capital that could be taken into account	830	31%
£1 to £1,000	560	21%
£1,001 to £2,000	280	11%
£2,001 to £3,000 ½ capital disregard	240	9%
£3,001 to £4,000	140	5%
£4,001 to £5,000	120	4%
£5,001 to £6,000 capital disregard	110	4%
£6,000 or over	400	15%
Total	2,670	100%

The capital disregard is currently set at the same level for couples as for single people, so there may be less scope for individuals in couples to use trivial commutation to increase returns from saving than for single individuals to do so.

However, individuals who are in couples in retirement may typically have higher returns from saving in Personal Accounts than individuals who are single in retirement. This is because pensioner couples are less likely to be in receipt of means-tested benefits than single pensioners:

- Currently, 12% of pensioner couples are eligible for Pension Credit, compared to 22% of single male pensioners and 30% of single female pensioners (Table 4).
- Similar patterns are observed for Housing Benefit and Council Tax Benefit, with single pensioners more likely to be in receipt than men.
- PPI analysis suggests that Pension Credit could be even more concentrated on single pensioners rather than couples in future, under the White Paper proposals. The Government has published similar findings.⁷¹

⁷⁰ DWP Pension Credit Quarterly Statistical Enquiry February 2005 Tables 1.1 and 10.1. Figures may not add due to rounding.

⁷¹ DWP (2006 PC) page 1.

Table 4⁷² Proportion of different types of pensioner benefit units in receipt of means-tested benefits in 2004/5

	Pensioner couples	Single male pensioners	Single female pensioners
Pension Credit	12%	22%	30%
Housing Benefit	8%	21%	24%
Council Tax Benefit	17%	31%	39%

Many pensioners are either married or cohabiting for at least part of their retirement. In 2003, around 55% of individuals over state pension age were married. This proportion is projected to fall slightly by 2030 due to an increase in the number of people never getting married and an increase in divorce.⁷³

4.4 People with other pension saving

The trivial commutation limit is a 'global limit', applying to a person's combined private pension saving from all sources. Pension saving besides Personal Accounts, perhaps made before 2012 into an occupational or personal pension, may reduce the potential for an individual to trivially commute their saving in Personal Accounts.

The PPI's previous research on the suitability of Personal Accounts found that having an existing pension, in addition to Personal Accounts, can improve an individual's rate of return on their Personal Account saving.⁷⁴ This is because the income received from the existing pension can push the individual at least partly out of means-tested benefits, reducing the impact that means-tested benefits have on the income received from Personal Accounts.

As an illustration, consider Jane once more, this time assuming that she did not save in the ISA. She started saving in a Personal Account at age 50. Her Personal Account is projected to be worth £7,000 when she retires at age 66. If she did not have existing pension saving, she could trivially commute, since the value of her pension saving (£7,000) would be below the trivial commutation limit (£15,000).

If Jane had access to an occupational Defined Contribution (DC) pension scheme with an employer contribution from age 39 (when she begins full-time work after taking time from work to care for her child) to age 50 (when she begins to save in a Personal Account), then she could have had a pension fund worth £16,500 from the

⁷² Family Resources Survey 2004/5 Table 3.15.

⁷³ GAD 2003-based population projections by marital status for England and Wales.

⁷⁴ Steventon (2006) pages 29 and 30.

occupational pension.⁷⁵ This would take her combined pension fund at retirement, including Personal Accounts, up to £23,500. In this scenario, she would be over the trivial commutation limit of £15,000, so would not be able to trivially commute either her occupational pension or her Personal Account.

Although Jane could not trivially commute, she could still take a tax-free lump sum from both her occupational pension and her Personal Account, equal to one-quarter of the fund value (a total of around £5,500). This could improve her internal rate of return. Assuming that she takes a tax-free lump sum and saves it, spending 5% of the balance each year, Jane could have an internal rate of return of 5.5% from her Personal Account saving. This would still be high enough to put her in the low-risk group but is not as high as the previous example.

There is also a related effect. For some people, saving in a Personal Account may mean an individual loses the ability to trivially commute occupational or personal pensions built up previously. For these people, returns from Personal Accounts can be very low because of the impact of no longer being able to trivially commute previous forms of saving. In effect, the value of previous forms of saving is reduced by saving in Personal Accounts.

Some people may well have other forms of pension saving in addition to Personal Accounts, particularly people in their forties, fifties or sixties in 2012. In 2002, 64% of a sample of employees in England over the age of 50 and under state pension age already had pension saving that would put them above the current trivial commutation limit (Table 5), but fewer women than men were in this position (48% of women compared to 80% of men).

Some organisations have suggested that it may be worth considering how the trivial commutation limit is applied and whether it should be a local limit, applying separately to each pension scheme that an individual has, rather than a global limit, applying to the combined value of an individual's private pension saving from all sources.⁷⁶ This may avoid the possibility that having other pension saving affects the ability of an individual to trivially commute saving in Personal Accounts (or an alternative equivalent). However, it would have other effects that would need to be considered in detail. For example, it could result in the proliferation of small pension

⁷⁵ Assuming that 9% of her earnings is contributed by her and her employer combined into an occupational pension scheme. This is the current average contribution rate for Defined Contribution occupational schemes including schemes where the standard contribution is zero, GAD (2006).

⁷⁶ See for example comments made by a representative of the Association of British Insurers in oral evidence taken by the House of Commons Work and Pensions Select Committee on Monday 19 February 2007, House of Commons (2007) Ev 9.

funds, if people try to build up many separate pension funds, each below the local limit, in order to increase the total amount that they can trivially commute.

Table 5⁷⁷ Percentage of employees aged between 50 and state pension age with pension wealth of more than £15,000, by earnings

Annual earnings	Men	Women	Both
None	70%	37%	55%
£0 - £5,000	75%	24%	36%
£5,000 - £10,000	74%	36%	43%
£10,000 - £15,000	66%	52%	57%
£15,000 - £20,000	73%	62%	69%
£20,000 +	88%	79%	86%
All	80%	48%	64%

4.5 People who have contracted-out of S2P

People who have previously contracted-out of the State Second Pension, without making voluntary saving in addition to the rebate, may be less likely to be able to trivially commute small amounts of Personal Accounts saving than those who have remained contracted-in.

There are two contributory state pensions in the UK, the Basic State Pension (BSP) and the State Second Pension (S2P), which are both financed by the payment of National Insurance (NI) contributions by workers and employers. Employees can choose to 'contract-out' of S2P, meaning that their NI contributions, instead of building up entitlement to S2P, are instead diverted into a private pension.⁷⁸ The NI contributions diverted into a private pension are called the 'contracted-out rebate'.

The original policy intention behind trivial commutation was to prevent individuals having to buy an annuity with a small amount of pension saving. Accordingly, the part of an individual's private pension which results from the contracted-out rebate is

⁷⁷ PPI analysis of wave 1 of the English Longitudinal Study of Ageing. Marmot, M. et al. , English Longitudinal Study of Ageing: Wave 0 (1998, 1999 and 2001) and Waves 1-2 (2002-2005) [computer file]. 6th Edition. Colchester, Essex: UK Data Archive [distributor], January 2007. SN: 5050. The National Centre for Social Research, University College London, Institute for Fiscal Studies and the UK data archive bear no responsibility for their further analysis or interpretation.

⁷⁸ Depending on the type of private pension involved, the individual may either receive a rebate of his or her National Insurance contributions paid directly into the private pension or else may pay lower National Insurance contributions at source. The size of the rebate was designed so that, if the investment returns on the rebate are as assumed, then the amount of pension resulting from the rebate would broadly be the same as the amount of SERPS or S2P that is foregone from contracting-out.

included when the size of the pension fund is compared to the trivial commutation limit to determine eligibility for lump sums.

It is possible to contract-out of S2P into a private pension without making voluntary saving in addition to the amount of the contracted-out rebate. In this case, contracting-out may not increase the total amount of income an individual has in retirement, although it could use up the individual's trivial commutation limit. If such a person begins saving in a Personal Account from 2012, then they may not be able to trivially commute even small Personal Account funds.

As an illustration, Jane was assumed to be contracted-in throughout her entire working life (for this section, Jane is considered to have neither the ISA saving or the occupational DC pension assumed in the two previous sections). Her pension fund is estimated to be £7,000 when she retires in 2027, meaning that she can trivially commute. The ability to trivially commute increased her internal rate of return from 4.1% to 7.2%.

If Jane decided to contract out of S2P during the 20 years she spends as an employee (ages 39 to 58), then she would have received contracted-out rebates into her pension fund. These could be worth a total of £30,500 at her retirement date. Her higher pension fund does not necessarily mean she would be any better off in retirement because she would receive less S2P from the state as a result of her decision to contract out. However, she would now be over the trivial commutation limit of £15,000, meaning that she would not be able to trivially commute.

Depending on the individual involved, the treatment of contracting-out in the trivial commutation rules may mean that he or she is unable to use trivial commutation to improve the rate of return received on small amounts of saving Personal Accounts. This is more likely to be an issue for today's older people than today's younger people, since the ability to contract out into Defined Contribution occupational schemes and personal pensions would be removed under the proposals in the Pensions Bill currently being scrutinised by Parliament.

The ability to contract-out into Defined Benefit pension schemes would remain. However, the benefits accrued in Defined Benefit schemes are typically larger than the value of the contracted-out rebate. As a result, having existing saving in a Defined Benefit scheme, before Personal Accounts are introduced, may mean that an individual is taken out of means-tested benefits.

4.6 People who are above the trivial commutation limit

The existing trivial commutation limit will not mean that everybody is at low-risk of Personal Accounts being unsuitable for them. There are examples of people at medium or high-risk of Personal Accounts being unsuitable who cannot trivially commute, such as people who rent in retirement and the self-employed.

Chapter 3 included some individuals who are above the trivial commutation limit but who are at medium or high risk of Personal Accounts being unsuitable. These are people:

- With a **combination of low earnings and broken working histories** such as Kate (pages 26-29). Kate could be at medium-risk of Personal Accounts being unsuitable for her, unless she took a tax-free lump sum and spent more than 5% of it each year.
- Who **rent in retirement** such as Paul (pages 30-31). Paul could be at high-risk of Personal Accounts being unsuitable for him, unless he took a tax-free lump sum and spent it all immediately. If he spent the tax-free lump sum immediately then he could be at medium-risk.
- Who spend time **self-employed** such as Jasmine and Maya (pages 31-33). Jasmine is self-employed for 7 years and could be at medium-risk of Personal Accounts being unsuitable, unless she took a tax-free lump sum and spent it all immediately. Maya is self-employed for her entire working life and is likely to be at high-risk, regardless of how she spends her tax-free lump sum.

The Equal Opportunities Commission has asked the PPI to analyse a specific proposal that could increase the internal rate of return that such people could receive on their saving in Personal Accounts. This is considered in the next chapter.

5 WHAT COULD BE THE IMPACT OF INCREASING THE LIMITS?

The previous two chapters have investigated the potential for individuals to use lump sums as a way of improving their returns from saving in Personal Accounts. The Equal Opportunities Commission has commissioned the Pensions Policy Institute to provide an independent analysis of a variety of reform options for increasing the trivial commutation limit and capital disregards, which are considered in this chapter.

Increasing the trivial commutation limit and capital disregard is one way of reducing the risk that people are auto-enrolled into a product that is not suitable for them. Other policy options exist that are not considered in this paper:

- Introduce a new disregard for pension income so that income received in retirement from private pensions is either fully or partly disregarded in the calculation of entitlement to means-tested benefits.
- Not auto-enrolling some groups of people, such as the low-paid or today's older people.⁷⁹
- Tailoring the generic advice given to these groups to help them make the right decision about staying opted-in or opting out of Personal Accounts.⁸⁰
- Significantly cutting back the generosity of means-tested benefits.

5.1 The role of pension saving

Increasing the trivial commutation limit and capital disregard could mean that more people with small amounts of pension saving could have higher returns on their saving. It could also change the way in which some people – those with small pension funds – use their pension saving in retirement. This section briefly discusses some of the trade-offs that will have to be made.

The Government has argued that pension funds built up with the benefit of tax relief must be used to buy an annuity by age 75, because:⁸¹

- *Tax relief on pension contributions is provided so people can save for an income in retirement, not for other purposes*
- *Annuities pool people's risk, ensuring that they are the most financially efficient way of turning capital into an income stream*
- *Annuities make sure that people continue to receive an income from their savings no matter how long they survive, thus reducing their possible future need for income-related support from the Government.*

⁷⁹ For a discussion of this policy option, see PPI (2007 WP) paragraphs 1.1-1.23.

⁸⁰ For a discussion of this policy option, see PPI (2007 WP) paragraphs 30-36.

⁸¹ The text in italics is a quote from page 5 in IR (2002).

Increasing the trivial commutation limit would increase the scope for certain individuals to use their pension saving for other purposes than providing an income in retirement.

It could also increase the scope for individuals to leave their private pension saving to others as an inheritance. This is because annuity income cannot usually be inherited but lump sums can. The Government is currently consulting on measures to prevent the inheritance of tax-advantaged pension savings.⁸² Income tax is payable on three-quarters of trivial commutation lump sums and inheritance tax would be payable on inheritances worth more than £350,000.

An annuity provides a guaranteed income for life and can protect against the risk of low income in old age. If an individual decided to trivially commute and wanted to use the proceeds to provide an income in old age, then the options open may be riskier or less efficient than using an annuity:

- The individual could choose to save the lump sum in a bank account or some other savings product. If the individual spends some of their capital, rather than just the interest received in each year, and lives longer than expected, then his or her savings may have been exhausted in old age.
- The individual could choose to only spend the interest earned on the investment of the lump sum. However, this would not give the individual the option of gradually spending his or her capital.⁸³ It could also put him or her at risk of low investment returns.

However, although taking a lump sum rather than a pension income can mean individuals have lower incomes in later life, the size of the reduction in income is mitigated by several factors including the type of annuity that is bought and potentially increased entitlements to means-tested benefits.

Individuals typically choose to use their pension saving to buy level annuities, which are not increased from year to year, rather than annuities that are protected against inflation.⁸⁴ The result is that private pension incomes can fall in real terms throughout retirement. For individuals with pension funds under £30,000, the amount of income provided by a level annuity in old age can be small.

For example, a woman reaching age 68 in 2055 with a pension fund of £30,000 could buy a level annuity of £27 a week. By her life expectancy of age 92, her

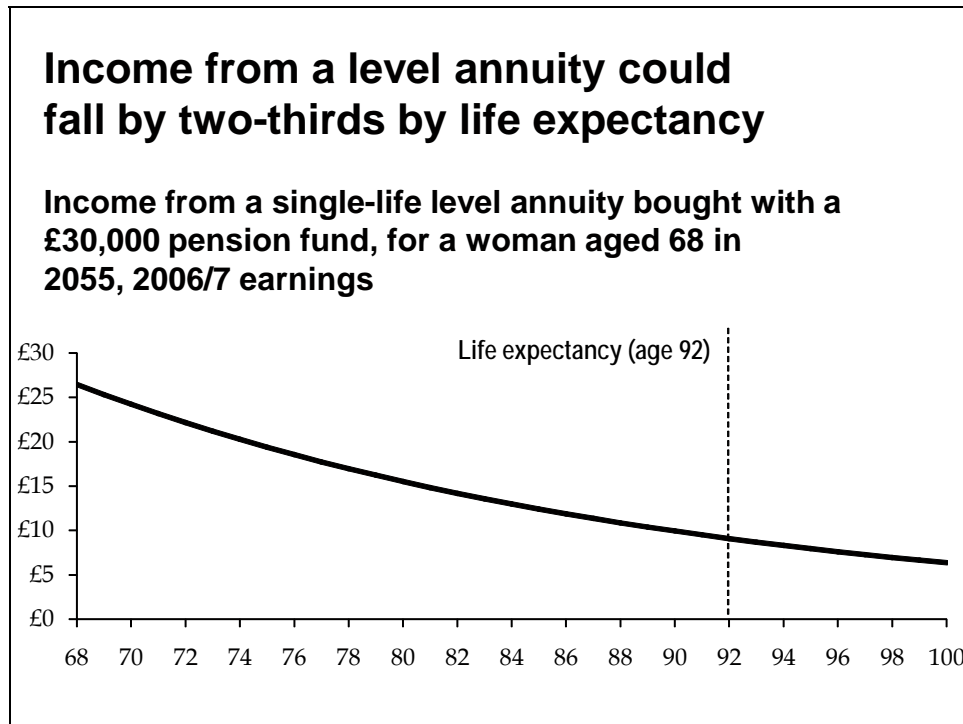
⁸² HMT (2007) paragraph 5.73.

⁸³ IR (2002) page 12.

⁸⁴ Canon and Tonks (2006).

annuity income could have declined by two-thirds relative to average earnings, to £9 a week. By age 100, it could have declined further to £6 a week (Figure 11).

Figure 11⁸⁵ Income from a level annuity could fall by two-thirds by life expectancy



If the trivial commutation limit were increased to £30,000, and she trivially commuted, she would have taken a lump sum and so would not receive this annuity income, of £9 a week at age 92. However, she could receive an extra £4 in means-tested benefits as a result, so the overall financial impact could be considerably lower. Overall, she could be at most £5 a week less well-off at age 92 from the decision to trivially commute.⁸⁶

Being more dependent on means-tested benefits has a variety of risks:

- Not all pensioners claim the means-tested benefits to which they are entitled. Around 65% of people who are entitled to Pension Credit claim it.⁸⁷ For Housing Benefit the equivalent figure is 84% and for Council Tax Benefit it is 56%.
- The value of means-tested benefits can be changed by Government at short notice. Although the level of the Guarantee Credit will be set in legislation in the Pensions Bill that is currently going through parliament, this is not the case for

⁸⁵ PPI analysis using the Individual Model. See Appendix B for details of the assumptions used.

⁸⁶ PPI analysis for Jasmine.

⁸⁷ DWP (2006 IRB). Figures are for pensioners and are the middle of the range given.

other means-tested benefits. So there is a political risk involved with relying on means-tested benefits.

Some people may not like the process of claiming means-tested benefits, which can be very complicated.

Increased reliance on means-tested benefits may lead to increased cost to the Government, which may be perceived as unfair to other taxpayers. The primary aim of means-tested benefits such as Guarantee Credit is to ensure that individuals have a minimum level of income in retirement. However, recent changes such as the introduction of Savings Credit have been designed to help to avoid disincentives to save. The policy options modelled in this paper take this process a step further by altering the design of means-tested benefits to further increase returns from saving.

The costs of the reforms are set out in detail later in this chapter. The Government will have to decide whether the benefits of increasing the limits is worth the extra cost. As the following sections show, increasing the trivial commutation limit and capital disregard can improve individuals' returns from saving. This could mean that Personal Accounts are more successful in their aim to encourage more people to save for their retirement.

The Equal Opportunities Commission has commissioned the PPI to analyse three reform options which are considered in turn:

- A. **Increase the limits:** Double the trivial commutation limit to £30,000 and increase the capital disregards to £10,000.⁸⁸
- B. **Align the limits:** Increase both the trivial commutation limit and the capital disregard to £30,000.
- C. **New drawdown product:** As reform option A but in addition launch a new drawdown product. Individuals can choose to use capital in excess of £10,000 to buy a temporary annuity that would provide an income for ten years, which is not taken into account for Pension Credit. This combination may encourage individuals to voluntarily buy a temporary annuity with part of their lump sum.

All changes are assumed to be introduced in 2012, at the same time as the Government proposes to start to auto-enrol employees into Personal Accounts.

⁸⁸ Note that increasing the capital disregards for pensioner means-tested benefits from its current level of £6,000 may mean that they are no longer aligned with the capital disregards for working-age means-tested benefits.

In all of the reform options, it is assumed that the upper capital threshold for Council Tax Benefit and Housing Benefit would be increased along with any increase in the trivial commutation limit. Otherwise, the higher trivial commutation limit may worsen internal rates of return rather than improve them (see Box 3).

Box 3 The upper capital threshold

Households with capital greater than the 'upper capital threshold' (£16,000 in 2006/7) are not currently eligible for Council Tax Benefit or Housing Benefit, unless they are eligible for the Guarantee Credit component of Pension Credit.

It is assumed that the upper capital threshold would be increased along with any increase in the trivial commutation limit. This research assumes a level of £50,000, in line with the recommendation made in the Lyons Report.⁸⁹ The change is assumed to be made in 2012 for consistency with the other reforms considered, after which the upper capital threshold is assumed to be increased in line with the growth in average earnings.

If the upper capital threshold were not increased, then the higher trivial commutation limit may worsen internal rates of return rather than improve them. As an illustration, Kate is a 40-year old woman with modest caring and part-time work. Her pension fund could amount to around £22,500 at age 67, so she would not be able to trivially commute under the current limits.

If the trivial commutation limit were increased to £30,000, then Kate could trivially commute. However, the £22,500 that she could receive from trivial commutation would be above the current upper capital threshold of £16,000. She would therefore lose her entitlement to Council Tax Benefit (worth £11 a week at state pension age).

Under the current trivial commutation limit, she could have an internal rate of return of 5.2%. For this to be increased as a result of increasing the trivial commutation limit, the upper capital threshold would also need to be increased:

- Without increasing the upper capital threshold, the loss of her entitlement to Council Tax Benefit could reduce her internal rate of return from 5.2% to 4.2%.
- If the upper capital threshold were increased at the same time as the trivial commutation limit, then she could still receive some Council Tax Benefit. This means that her internal rate of return could be increased to 5.8% (putting her in the low-risk category used in this paper).

⁸⁹ Lyons (2007) paragraph 172.

5.2 Reform A: Increase the limits

This section analyses the implications of doubling the trivial commutation limit from its current level of £15,000 to £30,000 and increasing the capital disregard from its current level of £6,000 to £10,000, in terms of:

- The returns from saving of the hypothetical individuals, as in Chapters 3 and 4.
- The additional number of men and women able to trivially commute their pension saving.
- Government spending on means-tested benefits and revenue from income tax.

The findings are summarised in Box 4 before being analysed in detail.

Box 4 Impact of Reform A

If the trivial commutation limit were doubled from its current level of £15,000 to £30,000 and the capital disregard were increased from its current level of £6,000 to £10,000, then returns from saving would be improved. For example, some people:

- With interrupted saving histories could be lifted from the medium-risk group to the low-risk group.
- Who are self-employed for their entire working life could be lifted from the high-risk group to the medium-risk group.
- Who rent in retirement could be lifted from the high-risk group to the medium-risk group.

Increases to the trivial commutation limit and capital disregard may increase the rate of return for some people who would already be in the low-risk group under current policy, such as some individuals in couples.

Increasing the trivial commutation limit may mean that around an additional 10% of retirees may be able to trivially commute in each year.

Taking into account their implications for means-tested benefits and income tax, the reforms could cost the Government around £500 million a year when they are introduced in 2012. This is an increase in spending on pensioner means-tested benefits by around 4%, or around 2% of the current fiscal cost of tax and National Insurance relief on private pension saving. The cost would grow over time, to around £1,400 million in 2050 (an increase of 20% on spending on pensioner means-tested benefits).

It is very important to realise that these cost estimates are subject to a very high degree of uncertainty and should only be considered illustrative. Estimates are based on current behaviour and the pattern of pension incomes observed today persisting into the future. They do not take into account any potential for increased saving if people see that returns from saving were increased by the reforms.

Returns from saving

Chapter 2 concluded that, even with the existing facility for trivial commutation, some hypothetical individuals may be at medium or high-risk of low returns from Personal Accounts.

High-risk people are those who are unlikely to receive back the value of their own individual contributions into Personal Accounts, after allowing for the effects of inflation. In other words, for every £1 they contribute, they would receive back less than £1 from Personal Accounts in total over the course of their retirement.⁹⁰ This corresponds to an internal rate of return of less than 2.5%.

Medium-risk people are those who are likely to receive back the value of their own individual contributions but who are unlikely to receive a full investment return on those contributions. This corresponds to an internal rate of return of between 2.5% and 5.5%.

Kate is an example of a single person with an interrupted saving history (see pages 26-29 above). She would be in the medium-risk category under the current limits, with an internal rate of return of 5.2%. This section will assume that individuals take and save any lump sums to which they are entitled, spending 5% of the balance each year.

If the trivial commutation limit were increased to £30,000 then she would be able to trivially commute, since her final fund value is estimated to be £22,500. Combined with an increase in the capital disregard to £10,000, this could increase her internal rate of return from 5.2% under the current limits to 5.8%. The reforms would therefore lift her from the medium-risk to the low-risk category (Figure 12).

Maya and Jasmine are both examples of young people who will spend time self-employed during their career (see pages 31-33 above). They can both trivially commute under the higher limit:

- Maya is self-employed for her entire working life. She would be lifted from the high-risk group to the medium-risk group.

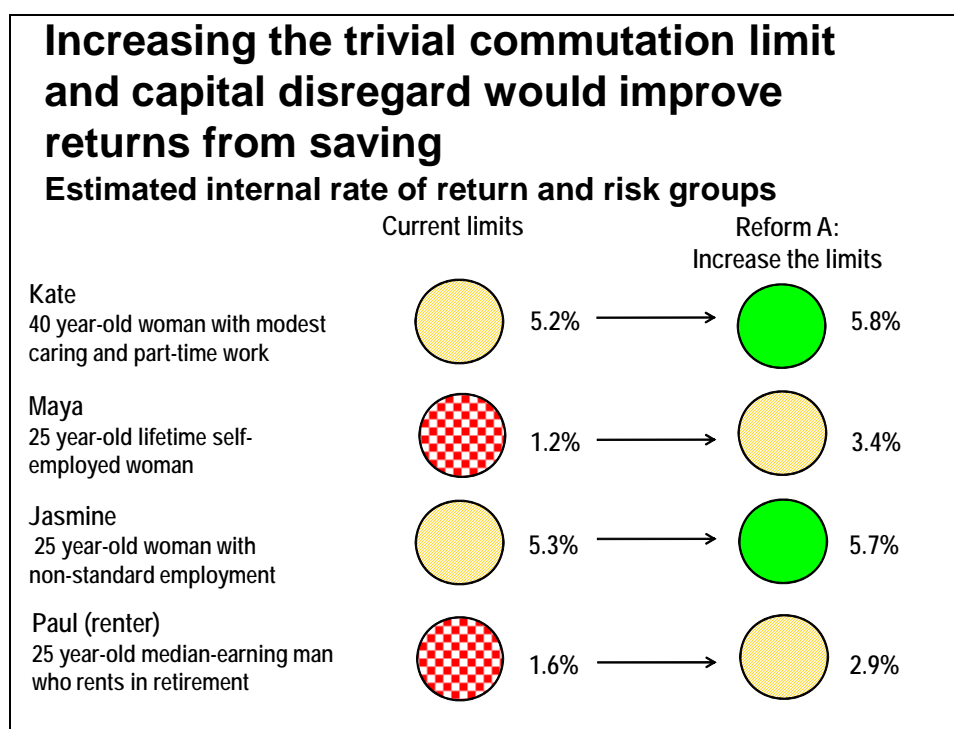
⁹⁰ On the assumptions made. See Chapter 1 and Appendix B for more details.

- Jasmine is self-employed for only 7 years in her forties.⁹¹ She would be lifted from the medium-risk group to the low-risk group.

Paul is a 25 year-old man who is in full-time employment for his entire working life. He has a low return from saving because he rents in retirement and so receives less in Housing Benefit than he would do if he did not save. He could be lifted from the high-risk group to the medium-risk group as a result of the higher limits.

Paul would not be able to trivially commute because his fund value is £65,500, which is much higher than the trivial commutation limit. However, he would benefit from the higher capital disregard, which would reduce the impact his 25% tax-free lump sum has on his entitlement to means-tested benefits.

Figure 12⁹² Increasing the trivial commutation limit and capital disregard would improve returns from saving



Increases to the trivial commutation limit and capital disregard may increase the rate of return for some people who would already be in the low-risk group under current policy. For couples, entitlement to means-tested benefits depends on the combined income of both partners, so one partner's income can take both partners out of means-tested benefits. Some individuals may be in the medium or high risk category if they are single throughout their retirement but be in the low risk category if they are

⁹¹ In comparison, a study in 2000 found that on average a spell of self-employment lasts almost 8 years, Knight and McKay (2000).

⁹² PPI analysis using the Individual Model. See Appendix B for details of the assumptions used.

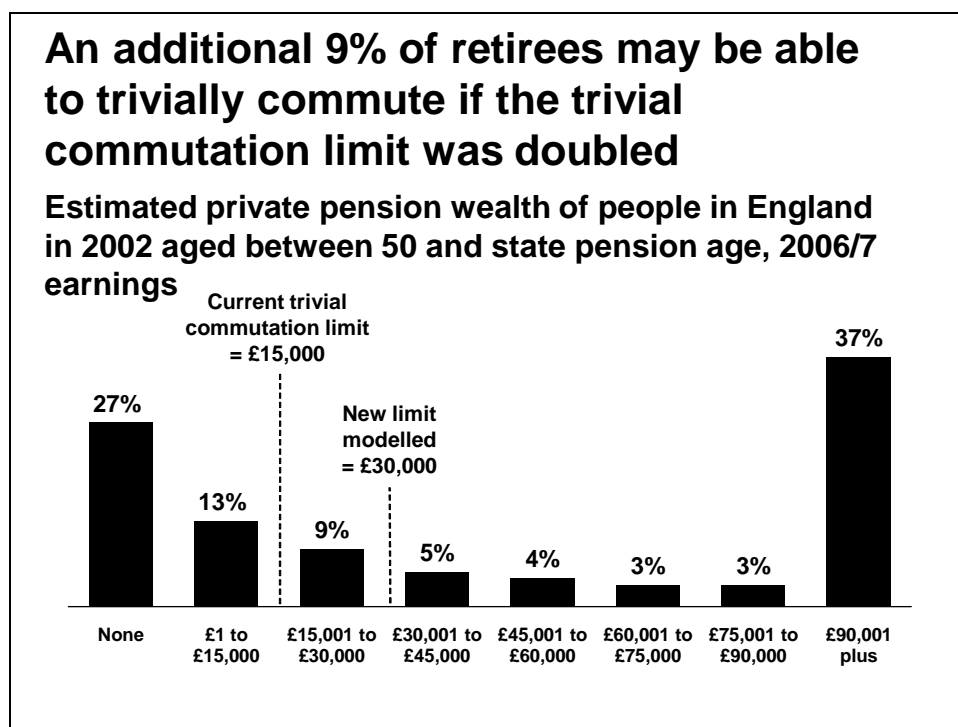
in a couple. Although the reforms to the trivial commutation limit and capital disregard would increase returns for these individuals in the event that they are single – which would help protect against the possible effects of divorce or widowhood – they could also increase returns in the event that they are in couples.

Numbers of people able to trivially commute

In 2002, around 13% of a sample of people in England aged between 50 and state pension age were on course to have a pension saving that is within the current trivial commutation limit of £15,000 when they retire.⁹³ Note that these estimates of the numbers of people able to trivially commute are subject to a high degree of uncertainty (see page 36).

If the trivial commutation limit was doubled to £30,000, then the proportion of retirees who are able to trivially commute may increase by around 9%, from 13% to 22% (Figure 13).

Figure 13⁹⁴ An additional 9% of retirees may be able to trivially commute if the limit was doubled



A substantial amount of retirees (37%) have large pension saving worth £90,000 or more. These people would be well above the new trivial commutation limit,

⁹³ PPI analysis of wave 1 of the English Longitudinal Study of Ageing. Marmot, M. et al. , English Longitudinal Study of Ageing: Wave 0 (1998, 1999 and 2001) and Waves 1-2 (2002-2005) [computer file]. 6th Edition. Colchester, Essex: UK Data Archive [distributor], January 2007. SN: 5050.

⁹⁴ See footnote 93.

suggesting that the private pension incomes of the wealthiest individuals would not be affected by increasing the trivial commutation limit.

Women are currently less likely to have any private saving than men. If this pattern continues, then fewer women than men may gain from increasing the trivial commutation limit (7% of woman retirees compared to 10% of male retirees). However, if only those people with private pension saving are considered, the same proportion of women and men would gain from the raised limit, an additional 12% (Table 6).

Table 6⁹⁵ Estimated proportion of people in England in 2002 aged between 50 and state pension age able to trivially commute

	Both men and women	Women	Men
Proportion of all retirees			
Under current limit	13%	16%	10%
Additional proportion under limit of £30,000	9%	7%	10%
Proportion of retirees with some private pension saving			
Under current limit	17%	27%	12%
Additional proportion under limit of £30,000	12%	12%	12%

The numbers of people affected by increasing the trivial commutation limit would increase over time. The reforms will affect new cohorts of retirees only, since people who have already bought an annuity when the reforms are implemented would not be able to change their position. As a result, the full effect of the reforms will build up over a period of time, perhaps 20 to 30 years.

Cost implications

Increasing the trivial commutation limit and capital disregard could have cost implications for Government, both in terms of increasing entitlements to means-tested benefits and reducing the amount of income tax raised by the Exchequer. A detailed costing exercise has been conducted for this paper.

It is very important to realise that the estimates are subject to a very high degree of uncertainty and should only be considered illustrative. Estimates are based on

⁹⁵ See footnote 93.

current behaviour and the pattern of pension incomes observed today persisting into the future.

The true cost will crucially depend on how individuals react to the reforms. For example, if the reforms made saving in pensions more attractive to individuals, then more people may save in pensions, which could increase the Government cost of providing tax relief on pension saving but decrease the future cost of means-tested benefits. Not all of this saving would be new. Some of it may replace saving in other tax-advantaged vehicles, such as Individual Savings Accounts (ISAs). How individuals react will, therefore, affect not just Government spending on pensions but other forms of Government spending as well.

The modelling uses the current distribution of private pension incomes as a starting point for the projections (the methodology is discussed in more detail in Appendix B). Adjustments are made at an aggregate level for possible future patterns, including a decline in Defined Benefit pension provision, continued increases in life expectancy and the introduction of Personal Accounts. These changes are uncertain and will alter the distribution of pensioner incomes as well as the aggregate amounts received over the whole pensioner population. It is not possible to take future distributional change fully into account.

The aim of the costings are therefore to give a broad illustrative estimate and an understanding of how the cost may change over time.

There are three main means-tested benefits for pensioners in Great Britain: Pension Credit, Council Tax Benefit and Housing Benefit (see page 7). State spending on all three would be affected by the reforms (Table 7):

- Increasing the capital limits (both the capital disregards and also the upper capital threshold for Council Tax Benefit and Housing Benefit) could account for the bulk of the costs of the reforms. It could have the more immediate impact on Government finances since it would affect everybody who is currently eligible for Pension Credit with more than £6,000 of capital. It may increase Government spending by £600 million in 2012.
- Increasing the trivial commutation limit would mean fewer older people would have regular income from private pensions. As a consequence, they may be eligible for larger amounts of means-tested benefits. This could increase state spending on means-tested benefits by £50 million or less in 2012. The cost would increase over time as more and more people retire under the higher trivial commutation limit, possibly to £500 million by 2050.

Overall, the reforms could increase spending on means-tested benefits in 2012 from a projected level of around £14,600 million to £15,200 million (an increase of 4%).

Official projections of total state spending on means-tested benefits show a decline over time as a result of projected future changes in state and private incomes, increases in the proportion of pensioners owning their own homes and the proposed squeezing of the range of eligibility for Savings Credit. Spending is projected to decrease from £14,600 million in 2012 to £6,900 million in 2050. Increasing the trivial commutation limit and capital disregard could increase spending in 2050 from £6,900 million to £8,300 million (an increase of 20% on the projected level of spending on pensioner means-tested benefits in 2050).

Table 7⁹⁶ Illustrative projections of the impact on Government spending on pensioner means-tested benefits of increasing the trivial commutation limit to £30,000, the capital disregard to £10,000 and the upper capital threshold to £50,000, in £ million, 2006/7 earnings

	Spending on pensioner means-tested benefits under White Paper reforms ⁹⁷	Increase in spending on pensioner means-tested benefits from increasing trivial commutation and capital limits			% increase on total spending
		Capital limits	Trivial commutation limit	Total	
2012	14,600	600	*	600	4%
2020	10,600	700	100	800	8%
2030	8,600	800	200	1,000	12%
2040	7,100	900	400	1,300	18%
2050	6,900	900	500	1,400	20%

Increasing the trivial commutation limit could affect the amount of income tax collected by the Exchequer. Increasing the capital disregard is unlikely to significantly affect the amount of income tax raised by the Exchequer.⁹⁸

⁹⁶ Projections for Pension Credit are produced using the PPI's Distributional Model. The cost of increasing the capital limits for Council Tax Benefit and Housing Benefit are taken from modelled produced using the DWP's Policy Simulation Model for the Lyon's report and are assumed to remain constant over time relative to average earnings, Lyons (2007) Table C17. The Lyons report makes different assumptions to the PPI models so overall figures should be treated with caution. Figures are rounded to the nearest £100 million. * denotes a figures of less than £50 million.

⁹⁷ DWP long-term expenditure projections as at May 2007. Figures have been converted from 2006 prices to 2006 earnings terms assuming real earnings growth of 2% a year. Figures marked as 2012 actually relate to 2010 as figures for 2012 are not available.

⁹⁸ Increasing the capital disregard may lead to increased entitlements to Pension Credit, Council Tax Benefit and Housing Benefit. However, these benefits are not taxable.

Increasing the trivial commutation limit would mean that less income tax is collected from pensioners, since fewer older people would have a regular income from private pensions.

However, more income tax may be collected on trivial commutation lump sums (since three-quarters of trivial commutation lump sums are taxable, with the remaining one-quarter being tax free). Tax is collected at an individual's marginal rate. Marginal tax rates can decline during the course of an individual's retirement, partly because of the higher personal allowances for older people. Therefore, the amount of income tax collected on lump sums may outweigh the loss of income tax on private pension incomes.

Under the assumptions used in this paper, the overall impact of increasing the trivial commutation limit on the amount of income tax revenue collected by the Exchequer is projected to be small relative to the impact on means-tested benefits: with possibly £100 million extra being collected in 2012 and smaller amounts in subsequent years.

As with all long-term projections, the cost estimates in this paper are subject to a large degree of uncertainty. Assumptions are made on future private pension incomes, which will depend on future levels of saving in Defined Benefit and Defined Contribution schemes as well as Personal Accounts. In addition, assumptions are made on the future level of investment returns and mortality.

As an illustration of the potential uncertainty, the cost in 2050 could be in the range of £1,200 to £1,500 million (Table 8). This range has been derived using different scenarios for future growth in private pension incomes and capital.

Table 8 Illustrative projections of the impact of Reform A on Government spending in 2050, including the impacts on means-tested benefits and income tax revenue

	Projected cost in 2050 (£m, 2006/7 earnings)
Total private pension income in 2050 (% of GDP)	
Low scenario: 3.9%	1,500
Central scenario: 4.9%	1,300
High scenario: 6.3%	1,200
Annual real growth in capital	
Low scenario: 1%	1,200
Central scenario: 2% (Earnings growth)	1,300
High scenario: 3%	1,300

The cost of the reforms could be compared to the cost of the existing system of incentives for saving in private pensions, such as tax and National Insurance relief. This comparison seems valid, since the reforms would aim to increase returns from saving in pensions, which is a similar policy intention to the existing system of tax and National Insurance relief.

In 2005/6, the cost of tax and National Insurance relief was around £22.2 billion.⁹⁹ The cost is likely to remain significant in future despite large uncertainties.¹⁰⁰ In comparison, the central estimate of the cost in 2012 of increasing the trivial commutation limit to £30,000 and the capital disregard to £10,000 would be around £500 million, or 2% of the total.¹⁰¹

The system of tax and National Insurance relief applies to all forms of approved pensions, including existing occupational and personal pensions, and not just Personal Accounts. The tax relief on employee and employer contributions to Personal Accounts is estimated to amount to between £1.9 and £2.2 billion, not including cost of National Insurance relief on employer contributions.¹⁰² However, the reforms to the trivial commutation limit and capital disregard would not be restricted to savings in Personal Accounts either but could improve returns from saving in all forms of pensions.

5.3 Reform B: Align the limits

The above section analysed increasing the trivial commutation limit to £30,000 and the capital disregard to £10,000. If the capital disregard were increased further to £30,000, then returns could be further improved. Although Kate, Maya, Jasmine and Paul would not move risk categories as a result of the extra increase in the capital disregard, they could all see significant improvements in their internal rate of return (Table 9).

⁹⁹ HMRC (2006). The cost includes tax relief on employee and employer contributions, National Insurance relief on employer contributions and is net of the amount of income tax collected on private pensions in payment. Note that not all of this 'cost' could ever be recovered fully, even if the tax and National Insurance relief were completely abolished, because some individuals may change their behaviour and save more in alternative tax advantaged savings vehicles, such as ISAs.

¹⁰⁰ See the PPI's projections of the future cost of tax relief in Steventon (2005) Chapter 2.

¹⁰¹ This calculation is approximate as it compares the cost of tax and National Insurance relief on private pensions in 2005/6 with the cost of the policies in a later year, 2012/3. It implicitly assumes that the cost of tax and National Insurance relief on private pensions grows with national average earnings in the period between 2005/6 and 2012/3.

¹⁰² DWP (2006 PA RIA) paragraph 1.11.

Table 9¹⁰³ Estimated internal rates of return and risk categories

	Current policy	Reform A: Increase the limits	Reform B: Align the limits
Kate	5.2% (Medium)	5.8% (Low)	7.1% (Low)
Maya	1.2% (High)	3.4% (Medium)	5.2% (Medium)
Jasmine	5.3% (Medium)	5.7% (Low)	6.3% (Low)
Paul (renter)	1.6% (High)	2.9% (Medium)	3.5% (Medium)

In Reform A, the bulk of the Government cost came from increases in the capital disregard rather than from increases in the trivial commutation limit (see Table 7). Further increasing the capital disregard under Reform B would therefore lead to additional cost. In 2012, Reform B could increase Government spending by around £1.5 billion in addition to the cost of Reform A, taking the total cost up to £2 billion on top of the cost of the current system.

5.4 Reform C: A new drawdown product

The Equal Opportunities Commission (EOC) also asked the PPI to analyse a third option for reform, consisting of:

- Doubling the trivial commutation limit from its current level to £30,000 and increasing the capital disregard to £10,000, as in Reform A, and
- Introducing a new drawdown product. This would allow individuals to choose to take their trivial commutation lump sum and use it to buy a special type of ten-year annuity, which would not count in the calculation of entitlement to means-tested benefits.

The advantage of the ten-year annuity is that it pays a higher amount at retirement than a lifetime annuity, although it may result in a lower income later in life.

Although the draw-down product could add an extra layer of complexity to individual's decision making, it may encourage individuals to buy voluntarily a ten-year annuity with part of their lump sum. For example, Kate has a fund value of £22,500. She could:

- Keep the first £10,000 of her trivial commutation lump sum in a bank account and either not spend it or spend it gradually. This sum would not reduce her

¹⁰³ PPI analysis using the Individual Model. See Appendix B for details of the assumptions used.

entitlement to means-tested benefits if the capital disregard were set at £10,000.¹⁰⁴

- Put the remaining £12,500 into the new drawdown product, without it affecting her entitlement to means-tested benefits. She may prefer this to keeping all of her lump sum in a bank account which would mean that she is above the level of the capital disregard, with implications for her means-tested benefits.

If Kate uses the drawdown product, she could have an internal rate of return of 7.7% on her saving in Personal Accounts, assuming that she spends 5% each year of the £10,000 that she saved in her bank account. This is higher than the 5.8% she could receive by gradually spending down her lump sum under Reform A. The higher internal rate of return could potentially act as an incentive to take out the drawdown product, although other factors may also be relevant to her decision.

If Kate did not take out the drawdown product, she may choose to spend all of her trivial commutation lump sum immediately. This could lead to an uneven profile of income in retirement (Figure 14):

- If she spent her lump sum immediately, then she could receive an initial weekly income of £579 when she retires. However, her income could be lower in subsequent years.
- If Kate used the drawdown product, then her total weekly income could be around £186 when she retires. This option would provide Kate with a higher stream of income for the first ten years of her retirement than spending her lump sum immediately.

Using the drawdown product could mean that Kate receives a higher weekly income for the first ten years of her retirement than she would from buying a lifetime annuity under the current system.

Overall, Reform C could increase rates of return further than Reform A or B, so that Kate, Maya and Jasmine are all in the low-risk group (Table 10). Paul's rate of return would be the same under Reform A and Reform C because he would not be able to trivially commute under either and would not be able to use the drawdown product with his tax-free lump sum.

¹⁰⁴ Provided that the investment returns from her bank account do not take her above the capital disregard. In the calculations that follow, her bank account is assumed to earn interest of 1% a year in excess of prices. However, the capital disregard is assumed to be indexed with national average earnings, which is assumed to be 2% a year in excess of prices. Therefore, the value of her bank account never exceeds the capital disregard.

Reform C could lead to a higher Government cost than Reform A, depending on how many individuals decide to use the drawdown product.

Figure 14¹⁰⁵ The drawdown product could result in a more even stream of income than spending a lump sum immediately

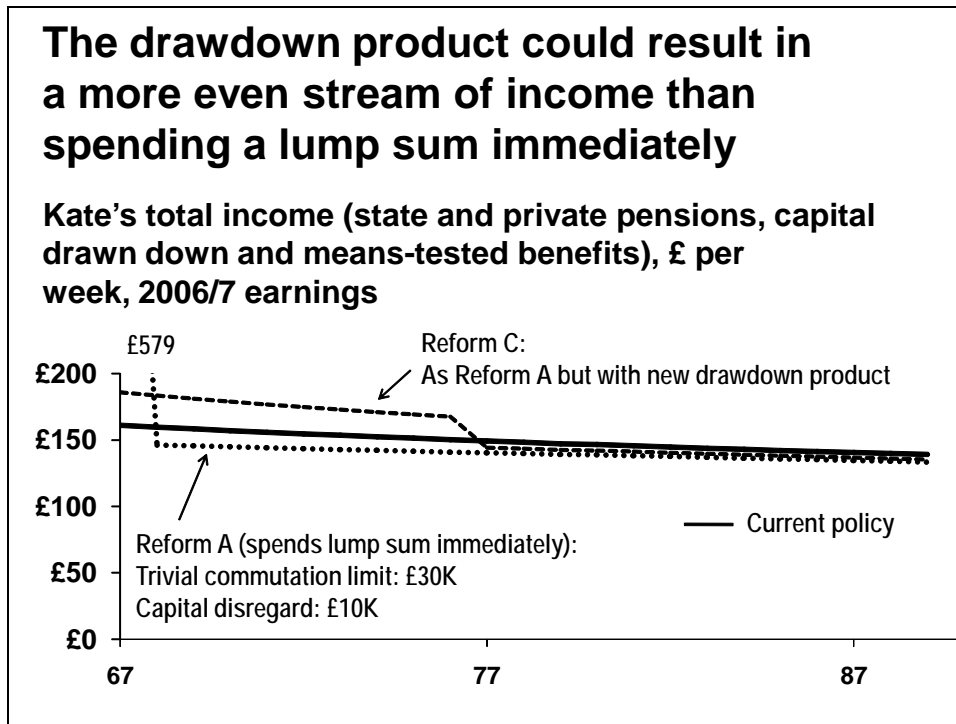


Table 10¹⁰⁶ Estimated internal rates of return and risk categories

	Current policy	Reform A: Increase the limits	Reform B: Align the limits	Reform C: New drawdown product
Kate	5.2% (Medium)	5.8% (Low)	7.1% (Low)	7.7% (Low)
Maya	1.2% (High)	3.4% (Medium)	5.2% (Medium)	5.5% (Low)
Jasmine	5.3% (Medium)	5.7% (Low)	6.3% (Low)	6.7% (Low)
Paul (renter)	1.6% (High)	2.9% (Medium)	3.5% (Medium)	3.5% (Medium)

¹⁰⁵ PPI analysis using the Individual Model. See Appendix B for details of the assumptions used.

¹⁰⁶ See footnote 105.

6 CONCLUSION

Taking a lump sum can lead to a higher return from saving in a Personal Account and higher entitlements to means-tested benefits. There is some scope under the current limits for people to use both tax-free lump sums and trivial commutation lump sums to improve their returns from saving in Personal Accounts. However, some people may still be at risk of low returns, which may mean Personal Accounts are not suitable for them.

This paper analyses extending the scope of trivial commutation by increasing the limit from £15,000 to £30,000, while at the same time increasing the capital disregard from £6,000 to £10,000. The upper capital threshold, which marks the cut-off point for eligibility to Council Tax Benefit and Housing Benefit, is also assumed to be increased to £50,000.

This policy could improve returns from saving for both men and women. For example, under the current limits:

- People who rent in retirement or who are self-employed for their entire working lives may be at high risk of Personal Accounts being unsuitable for them. Under the higher limits, they could be at medium risk.
- People with interrupted saving histories may be at medium risk of Personal Accounts being unsuitable for them. Under the higher limits, they could be at low risk.

Increases to the trivial commutation limit and capital disregard may increase the rate of return for some people who would already be in the low-risk group under current policy, such as some individuals in couples.

In addition, it may be possible to introduce a special type of annuity, which would not count in the calculation of entitlement to means-tested benefits, in order to encourage individuals who trivially commute to use part of their lump sum to provide a limited-term annuity. This has the potential to improve an individual's rate of return even further.

The reforms to increase the trivial commutation limit to £30,000 and the capital disregard to £10,000, could initially cost the Government around £500 million a year if they were introduced in 2012. The bulk of the cost would result from higher entitlements to means-tested benefits. To put these figures in context, £500 million is around 4% of the current cost of pensioner means-tested benefits, or around 2% of the current fiscal cost of tax and National Insurance relief on private pension saving.

The cost of the reforms would grow over time, to around £1,400 million by 2050. This would represent an increase of 20% on the projected level of spending on pensioner means-tested benefits in 2050.

Clearly, policy makers will have to decide whether or not the costs of the policy are justified by the potential benefits. There are several reforms options which could be considered, either singly or in combination.

One option would be to do nothing on top of the extensive reforms that are already going through parliament and are already proposed for Personal Accounts. Even in this scenario, many people would be at low-risk of low returns from saving in Personal Accounts, as a result of the state pension reforms and the employer and state contributions proposed. However, there are concerns about specific groups of people who may be at medium or high risk of low returns. People in the at-risk groups are more likely to be women than men.

If it was decided that returns should be increased, then one option would be to increase the trivial commutation limit and the capital disregards, as considered in this paper. Other options (not considered in this paper) would be to:

- Make pension saving fully or partially invisible in the calculation of means-tested benefits,
- Provide advice to help individuals to make the right decision about whether to stay in or opt out of Personal Accounts, or
- Not auto-enrol some groups of people who are more likely to be at risk of low returns, such as low earners and today's older people.
- Significantly cutting back the generosity of means-tested benefits.

In any case, the cost of the reform options should be set against the potential cost of no reform.

The lower the risk that people are auto-enrolled into a product that is not suitable for them, the lower the risk that they later discover that Personal Accounts did not deliver for them, which may have repercussions for future Governments. It is very difficult to quantify this risk. Although individual examples can be found of people for whom Personal Accounts may or may not be suitable, it is not currently possible to put a figure on the total number of people in each group.

Estimating the number of women and men who fall into the different risk categories can only be carried out by use of dynamic modelling such as the Pensim2 model used by the Department for Work and Pensions. Ideally, the Government should

project the number of individuals in each group who are likely to be affected by Personal Accounts, and the possible range of outcomes from a policy of auto-enrolment.

The Government has highlighted that an estimated 7 million people are currently not saving enough to give them an income in retirement that they are likely to consider adequate. It has proposed Personal Accounts as a response. The clearer the Government can be about the value of saving in Personal Accounts, the more likely Personal Accounts are to meet their aim of encouraging more people to save.

APPENDIX A

Characteristics of the individuals modelled

The appendix sets out the characteristics of the hypothetical individuals that are modelled in this paper. Appendix B describes the methodology and assumptions used in the modelling.

All individuals are assumed to pay Council Tax during retirement, of £15 a week.¹⁰⁷ Council Tax rates are assumed to increase in line with the growth in earnings in future.

Jane: 50-year old woman with caring and part-time work

Jane is a single woman, aged 50 in 2012, who has taken time out of work to care for her child and for elderly relatives:

- She had her only child at age 21 and stayed at home caring until her child was aged 18.
- She then started full-time work, for 20 years until she is aged 58. During this time, she earns at the 3rd decile of earnings for women of her age.
- She cares for her mother and aunt from age 59 until state pension age, for 8 hours a week each, combined with some part-time earning below the Lower Earnings Limit. She would receive no state pension credits during this time.¹⁰⁸
- She and her employer will contribute the minimum amount to a Personal Account from 2012, while she is working (i.e. for 9 years, for ages 50 to 58 inclusive). She takes her Personal Account at state pension age, at age 66 in 2028.

Kate: 40-year old woman with modest caring and part-time work

Kate is a single woman, aged 40 in 2012, with a combination of full-time work, caring and 5 years of part-time work:

- She started work at the age of 21, working full-time until age 28.
- She then had a career break to care for a child for 6 years. She qualified for state pension credits during this period.
- She returned to part time work for 5 years.
- She then worked full-time until she took another career break for 5 years in her 50s to care for an elderly relative, for which she received no carer benefits or credits.

¹⁰⁷ This is the average amount of Council Tax paid by today's Council Tax Benefit claimants, DWP (2006 HB) Table HB2.2

¹⁰⁸ Note however that if she cared for more than 20 hours a week, then she could receive state pension credits under the proposals currently being scrutinised in Parliament

- She returned to full-time work again, until reaching state pension age.
- When in full-time work, she earned a median earnings for women.
- She and her employer contribute the minimum amount to a Personal Account from 2012, while she is working. She takes her Personal Account at state pension age, at age 67 in 2039.

Maya: 25-year old lifetime self-employed woman

Maya is a single woman, aged 25 in 2012, who is self-employed for her entire working life, from age 18 until retiring at age 65:

- She earns at the 3rd decile of earnings for women of her age.
- Although the self-employed would not be auto-enrolled into Personal Accounts, she voluntarily opts-in from their introduction in 2012 until retiring at her state pension age (age 68).

Jasmine: 25-year old woman with periods of employment and self-employment

Jasmine is a single woman, aged 25 in 2012, who has a combination of employment, self-employment and unemployment.

- She is employed from age 21.
- Self-employed for 7 years, from age 40 to age 47.¹⁰⁹
- Employed from age 47 to age 55.
- In receipt of Incapacity Benefit from age 56 to age 60.
- She then returns to part-time work from age 61 to retiring at state pension age (68).
- When in work, she earns at the 3rd decile of earnings for women of her age.
- She and her employer contribute the minimum amount to a Personal Account from 2012, while she is employed and working full-time. She does not save in a Personal Account when she is working part-time because she decides she cannot afford the contributions. The self-employed would not be auto-enrolled into Personal Accounts and she does not voluntarily opt-in when she is self-employed. She does not contribute when she is receiving Incapacity Benefit.

¹⁰⁹ In comparison, a study found that on average a spell of self-employment lasts almost 8 years, Knight and McKay (2000).

Paul: 25 year-old median-earning man

Paul is a single man, aged 25 in 2012, who works mainly full time but with some unemployment and part-time work.

- He starts working full-time from age 21, but was unemployed for two years in his twenties and worked part-time between age 55 and age 60.
- When in full-time work, he earned at median age-specific earnings for men.
- He and his employer contribute the minimum amount to a Personal Account from 2012, while he is working. He takes his Personal Account at state pension age, at age 68 in 2055.

Two alternative scenarios are modelled for Paul: if he owned his own home in retirement and if he rented. In this scenario, he is assumed to pay rent of £70 a week.¹¹⁰ Rents are assumed to increase in line with the growth in average earnings in future.

¹¹⁰ This is the average amount of rent for today's Housing Benefit claimants, DWP (2006 HB) Table HB1.5.

APPENDIX B

Modelling assumptions and methodology

Recent policy analysis of returns from saving has only partly allowed for the possible impact of lump sums.¹¹¹ It typically assumes that individuals take a tax-free lump sum but then use it to buy a voluntary annuity which is mostly non-taxable.¹¹² This means that the value of tax relief is taken into account but ignores the impact of the capital disregards.

This paper fully analyses the impact lump sums could have on returns from saving in Personal Accounts both in terms of the tax-relief and the interaction with means-tested benefits. To enable the calculations to be made, the PPI's Individual Model has been extended to model the trivial commutation option and the interaction between capital and the tax and means-tested benefits systems.¹¹³

Baseline policy assumptions

This paper is based on the proposals contained in the May 2006 White Paper¹¹⁴ being introduced in full, with the Basic State Pension being indexed to average earnings from 2012.

The PPI models have not yet been updated for the changes proposed in the 2007 Budget to income tax rates and thresholds. Initial analysis suggests that the changes would have a marginal effect on the internal rates of return illustrated in this paper.¹¹⁵

The Lifetime Allowance is set at £1.5 million for 2006/7 and is scheduled to gradually increase broadly in line with the expected future growth in average earnings to £1.8 million by 2010/1. The modelling requires an assumption about how the Lifetime Allowance increases after 2010/1, since this will directly impact the level of the trivial commutation limit. It is assumed that the Lifetime Allowance continues to increase in line with average earnings from 2010/1.

¹¹¹ Pensions Commission (2005), DWP (2006 FISR), PPI (2007).

¹¹² Voluntary annuities are subject to a special tax treatment. The element which is assumed to be the return of capital to the individual is not liable for income tax and only the element which is assumed to be investment growth is taxable, Pensions Commission (2006) Appendices page 220. In this paper, the simplifying assumption is made that all income from the voluntary annuity is tax-free.

¹¹³ See Appendix B for details of the development made to the Individual Model for this paper.

¹¹⁴ DWP (2006 SR).

¹¹⁵ For more details on the possible effects of the 2007 Budget for pensions, see PPI Briefing Note 37.

Overall methodology

The Pensions Policy Institute (PPI) has developed a suite of three economic models to analyse long-term outcomes of the current UK pensions system and possible reforms. The development of the models has been funded by the Nuffield Foundation.

- The Individual Model estimates state and private pension income for hypothetical individuals.
- The Aggregate Model projects long-term government expenditure on pensions and contracted-out rebates, the private pensions system and the fiscal cost of tax relief.
- The Distributional Model projects forward the current distribution of pensioners' incomes consistently with the Aggregate Model.

The Aggregate and Distributional models have been validated against Government models. Using the same assumptions as Government projections in the PPI models results in similar projections. All of the models have been extensively used in PPI research.

Assumptions used in the individual modelling

The internal rate of return and net present value calculations are based on the following assumptions:

- Future annual price inflation of 2.5%.
- Future annual earnings growth of 2% in excess of prices.
- Expected investment returns of 3% in excess of prices, before charges, corresponding to a mixed equity/bond fund.¹¹⁶
- Annual charges in Personal Accounts of 0.5% of assets under management.
- Life expectancies are assumed to be in line with the most recent cohort life projections by the Government Actuary's Department.

All of the individuals analysed are assumed to use their Personal Account funds to buy a single-life, level annuity fixed in cash terms at retirement (unless they trivially commute their Personal Accounts saving). This means that their income from Personal Accounts would decline quickly during their retirement, especially when considered relative to average earnings.

Most annuities bought today are level annuities.¹¹⁷ If the individuals analysed in this paper were assumed to use their Personal Account fund to buy an annuity which

¹¹⁶ This corresponds to assumed equity returns of 7% a year, assumed bond returns of 4% a year, and a portfolio of 60% equities and 40% gilts, Curry (2003) page 25.

increased in line with the Retail Prices Index, rather than a level annuity, then the estimated internal rates of return could be lower. This is because a greater proportion of income from Personal Accounts would be taken later in life, when the individuals are likely to be in receipt of greater entitlements to means-tested benefits.¹¹⁸

Assumptions are made regarding future annuity rates. The assumptions used are:

- Mortality follows the PMA92/PFA92 mortality tables, adjusted for future mortality improvements using the “medium cohort” projection in CMIB (2002).
- Post-retirement investment returns are 1% in excess of prices.
- Calculated annuity rates are multiplied by a factor of 1.04 to allow for expense charges.

These assumptions are broadly similar to those required for the calculation of annuity rates for the purpose of Statutory Money Purchase Illustrations (SMPIs).¹¹⁹ As noted above, a level annuity is assumed to be bought for the purpose of the case studies rather than an RPI annuity as required for SMPIs.

As an illustration, on the assumptions used in the case studies, the rate for a single-life, level annuity is 6.5% for men at age 65 in 2006. Equivalent available market rates are currently between 6.5% and 7.4%.¹²⁰

This paper makes the simplifying assumption that rates are the same for both voluntary and compulsory annuities. In practice, providers may charge different rates.

Costing methodology

The reform options analysed in Chapter 3 are likely to have some impact on Government expenditure. Increasing the trivial commutation limits and capital disregards for Pension Credit is likely to impact on Government expenditure through:

- Extra expenditure on Pension Credit, Council Tax Benefit and Housing Benefit.
- Extra revenue from income tax paid on the lump sum.
- Lost revenue from income tax on the annuity that would be bought under current policy.

¹¹⁷ Canon and Tonks (2006).

¹¹⁸ PPI analysis using the Individual Model.

¹¹⁹ Actuarial Profession (2006) TM1 Version 1.2, coming into effect 1 November 2006. Note that TM1 requires annuities to be calculated using a market interest rate. This varies over time, and would be 1.2% real for illustrations dated between 6 April 2005 and 5 April 2006, and 0.8% real for illustrations dated between 6 April 2006 and 5 April 2007. The case studies use an assumption of 1.0% real.

¹²⁰ For a non-smoker with a pension fund of £75,000. Annuity rate information is taken from the FSA's Comparative Tables (www.fsa.gov.uk/tables) as at 23 May 2007, for rates with unrestricted availability and no guarantee. © The Financial Services Authority.

The costs have been projected using the Distributional Model.

- It is based on the current distribution of private pension incomes. However, the average amount of private pension received by each age and sex is assumed to change in line with projections of aggregate private pension income.
- The size of pension pots are derived by working backwards from the projection of private pension incomes. This requires a series of assumptions to be made, such as when people take their pension in future.

There are a number of uncertainties in the modelling. In particular, the distribution of private pension income could change in future, due to:

- Changes to contributions, which could result from a continued shift from DB to DC pension schemes or from changes to public sector pension schemes
- Changes to investment returns, demography, etc.

These cost projections have been produced making the most conservative assumption for how people spend the extra amount they receive in lump sums as a result of the higher trivial commutation limit. Lump sums are assumed to be spent immediately. In practice, the impact of increasing the trivial commutation limit on spending on means-tested benefits could be lower than shown in Table 7 in Chapter 5, because:

- Individuals may choose to save some of their lump sum. In this case, the remaining amount of lump sum would be counted in the calculation of eligibility for means-tested benefits. If an individual's capital exceeds the capital disregard, then entitlements could be reduced as a result.
- Even if individuals do spend all of their capital immediately, they may be treated as still having the capital that they have spent, as a result of the notional capital rules for means-tested benefits (see Box 2). Notional capital rules are assumed not to apply in the cost modelling in order to produce the most conservative cost estimates.

The individual analysis assumes that the capital disregards would be uprated from 2012 (see page 28). In contrast, and to be as conservative as possible, the cost projections assume that the capital disregard for Pension Credit would not be uprated under current policy. This is in line with what has happened to date since Pension Credit was introduced in October 2003. However, it means that the capital disregard would fall relative to pensioner incomes. If instead the capital disregard were uprated in line with average earnings over the long term, then net effect of the reforms on future means-tested benefits could be lower.

Extra spending on means-tested benefits has been calculated assuming that 100% of pensioners will take up the extra entitlement they have as a result of the reforms.

Administrative savings for pension schemes are not included in the costings. When the Government proposed that the trivial commutation limit should be increased from around £5,000 to £15,000 in April 2006, the Government estimated that the possible administrative saving could be around £8 million a year for Defined Benefit pension schemes.¹²¹ This was based on savings from no longer making small pension payments.

¹²¹ DWP (2004) paragraph 4.4.13.

GLOSSARY

Alternatively Secured Pension

ASPs were created in 2006 and they work in a similar way to **unsecured pensions**, but have different rules. An ASP allows individuals to keep their pension invested with the option to draw an income worth a certain proportion of that paid by an annuity. They are available to people reaching age 75 and are intended for those who have a principled religious objection to the pooling of mortality risk in annuities.

Annuity

In this paper, 'annuity' refers to an immediate life annuity, unless otherwise stated. An immediate life annuity is an insurance product that pays an income from the date of purchase until the date of death. An annuity insures against an individual's money running out because he or she lives longer than expected.

Auto-enrolment

Pension scheme enrolment technique proposed to be used in Personal Accounts, whereby employees are automatically enrolled into the scheme without the employees having to make a separate application for membership. Employees are able to opt out of the scheme if they prefer, whether to make alternative provision or otherwise. The self-employed can also opt-in to Personal Accounts but will not benefit from an employer contribution.

Basic State Pension

The BSP is the first-tier of state pension benefits in the UK. The final pension paid to an individual depends on the number of National Insurance contributions made and the number of credits received before reaching state pension age. The BSP is a flat-rate pension so that, subject to having made the same number of contributions, individuals will receive the same level of benefit, irrespective of the size of the contributions. The full BSP is set at £87.30 per week for 2007/8.

Capital disregard

In 2006/7, the capital disregard limit was £6,000 (or £10,000 for people living in care homes). This means that the first £6,000 (or £10,000) of a pensioners' eligible capital is not taken into account when calculating their entitlement to means-tested benefits, such as Pension Credit.

Council Tax Benefit

A means-tested social security benefit provided by local authorities. It is a rebate scheme providing help with up to 100% of people's council tax. Qualification criteria include income, savings and personal circumstances.

Drawdown product or Income drawdown

This is an alternative to buying an annuity, where the pension fund remains with the pensioner, as long as certain amounts of income are taken each year. This allows pensioners to retain some control over the investment of the fund and take flexible income amounts. Under current legislation, the pension fund must be converted to an annuity before age 75.

Housing Benefit

A means-tested benefit paid by local authorities designed to help with housing costs. This includes rent and some accommodation related service charges, such as living in a hotel, guest house, hostel or somewhere similar. Qualification criteria include income, savings and personal circumstances.

Incapacity Benefit

This is a social security benefit for people who have an illness or disability. A person may be eligible if they have an illness or disability and are either unemployed or self-employed or work for an employer but cannot receive Statutory Sick Pay or have been receiving SSP and this has now stopped.

Internal rate of return

The internal rate of return is the nominal interest rate that an individual receives on his or her individual contributions, after allowing for the effects of tax relief, employer contributions, investment returns, charges, income tax and means-tested benefits.

Level annuity

A level annuity pays out the same amount each year without being increased to protect against inflation. This means that the real purchasing power of a level annuity decreases from year to year. A level annuity is different to an **RPI annuity**, which increases by the Retail Price Index each year.

Lifetime Allowance

Existing pension rules set a limit on the total amount of pension savings (including any pension life cover) that can be used to provide benefits when a person retires or dies. If a person's benefits exceed the limit then the amount over this limit could be taxed by up to 55%. This limit is called the Lifetime Allowance and for the 2006/07 tax year is set at £1.5 million.

National Insurance

This is a national scheme where people in work and employers make payments towards state benefits. The payments are called national insurance contributions and certain benefits are only payable if a person meets the National Insurance contribution conditions.

Net present value

The net present value of an individual saving £1 in a Personal Account is the total expected amount received in pension income during retirement as a result of that saving, in today's prices. The net present value calculation allows for the factors that affect the returns from saving in Personal Accounts: employer contributions, tax relief, expected investment returns, charges, tax and means-tested benefits.

Occupational pension

A pension scheme organised by an employer on behalf of its employees. Only employees of the organising employer(s) can join the scheme, and active membership ends when the employee no longer works for the employer.

Pension Credit

Pension Credit is a means-tested benefit introduced in October 2003. PC combines a Guarantee Credit for those aged 60 and above, with a Savings Credit for those aged 65 and above. Guarantee Credit aims to ensure that the poorest people over age 60 have a minimum level of income. Savings Credit is an additional amount that aims to reward saving for some low-income pensioners.

Pensioner benefit unit

A single (non-cohabiting) person over State Pension Age or a couple (married or cohabiting) where the man is over SPA.

Personal Accounts

Personal Accounts is a new, low-cost national pension savings scheme that the Government proposes to introduce from 2012. Personal Accounts will combine auto-enrolment for some employees with the opportunity to opt out, with a minimum contribution of 4% of band earnings from the individual, a minimum 1% contribution of band earnings from the Government and a compulsory 3% contribution of band earnings from the individual's employer, for as long as they remain in the scheme.

Personal pensions

Unlike occupational pensions, which are organised via an employer, personal pensions are individual accounts organised directly via the individual and a pension provider.

RPI Annuity

An RPI annuity pays out an income each year that increases inline with prices. This means that the real purchasing power of an RPI annuity does not fall from year to year. An RPI annuity is different to a **level annuity**, which pays the same cash amount from year to year. However, the starting amount from an RPI annuity will be significantly lower than that from a level annuity.

State Second Pension

Along with its predecessor SERPS, S2P is an earnings-related pension and forms part of the UK's second-tier state pension provision. S2P is a separate state pension, paid in addition to the Basic State Pension, with the amount received by an individual dependent on how much they earned or were credited during their working life.

Tax-free lump sum

Between the ages of 55 and 75 an individual can take out 25% of the value of their combined pension savings as a one-off tax-free cash lump sum. With the remainder, an individual has to purchase an annuity or take out an unsecured pension.

Tax relief

Tax relief is available to everyone who pays into a pension, even those who do not pay tax. Individuals making contributions to tax approved pension schemes receive tax relief at their marginal rate (e.g. a standard rate taxpayer will receive tax relief at 22%). Individuals with very low or no tax liabilities can also receive 'tax relief' at 22% on contributions of up to £2,808 per year. Employers' contributions are made from gross profit and are therefore, tax and **National Insurance** privileged. Pensions also attract tax relief on some types of investment returns. Income from pensions in retirement is taxable.

Trivial commutation

People with pension savings worth no more than the trivial commutation limit (1% of the Lifetime Allowance or £15,000 in 2006/7) can chose to take all of their saving as a one-off lump sum. Trivial commutation therefore, is when somebody takes their entire pension saving as a cash lump sum.

Unsecured pension

An unsecured pension is an alternative to buying an annuity. It allows individuals to draw an income from their pension fund while leaving their fund invested. A person under 75 can take out an unsecured pension and either draw an income by using income withdrawal (also known as pension fund withdrawal or pension drawdown), or by using a 'short-term annuity'. An unsecured pension will stop at age 75. By that

time, individuals must secure an income from their pension funds, which generally means buying a lifetime annuity, or an **Alternatively Secured Pension**.

Upper capital threshold

Households with capital greater than the 'upper capital threshold' (£16,000 in 2006/7) are not currently eligible for Council Tax Benefit or Housing Benefit, unless they are eligible for the Guarantee Credit component of Pension Credit.

Voluntary annuity

Voluntary annuities can be purchased by individuals who want to annuitise some of their savings (i.e. part of a pension lump sum payment or ISA). Also, voluntary annuities are subject to a special tax treatment; the element which is assumed to be the return of capital to the individual is not liable for income tax and only the element which is assumed to be investment growth is taxable.

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