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# Pension and Saving Policy

**ELECTION BRIEFING 2005**

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## Summary

- State benefit spending on pensioners has remained roughly constant as a proportion of national income over the last quarter of a century, and is projected to remain flat over the next 50 years if Labour's current intentions and aspirations for raising the basic state pension and pension credit are realised.
- This is in spite of demographic changes that will mean that by 2040 there will only be around 2.3 workers for every pensioner, compared with around 3.3 today.
- With less expected to be spent on each pensioner, and increased targeting of benefits for pensioners, increasing numbers of individuals are likely to need private sources of income if they want to maintain their living standards into retirement. The Labour governments since 1997 have introduced some reforms that may help individuals to plan for their retirement, but others that reduce the reward from pension saving for many people.
- The two main UK opposition parties both plan to reduce the number of pensioners subject to means-testing below the levels implied by Labour's plans. The Conservatives would do this by increasing the basic state pension more generously than Labour intends to do (in line with earnings rather than prices); the Liberal Democrats' more radical proposal for a citizen's pension would mean a more sudden increase in the non-means-tested pension that would apply to those aged 75 and over, which would then be raised in line with average earnings.
- The Conservatives have also proposed extra financial support for some individual contributions to funded pensions, and a new matched savings account called the Lifetime Savings Account (LiSA), to provide new incentives for private saving. It is difficult to predict the overall effects of such policies on saving across the economy.
- The Liberal Democrats intend to extend free long-term care to those aged 65 and over who need it across the UK.
- There seems to be some consensus that a major issue is whether or not the UK pension system can deliver adequate incomes for individuals in retirement. Our analysis indicates that this does not currently translate into a consensus on what are the best policies to adopt.

## 1. Introduction

This Election Briefing Note aims to describe the key differences between the three main UK political parties on policies that might affect the ways in which individuals save and provide for the future, including the ways in which resources might be provided for retirement. Our main focus will be on policies that might affect future pensioners; IFS Election Briefing Note no. 11<sup>1</sup> explains how the different tax and benefit reform packages proposed by the different parties will affect people in the population in the short term, including current pensioners. We will also focus on areas in which the different parties have different policies.

Section 2 provides context to the policy debate by describing how the institutional set-up of pensions and saving in the UK has evolved over recent years, and how policy trends suggest that it will evolve in the coming years. Section 2.1 shows that following an increase in spending on state pensions as a proportion of national income between 1948 and the early 1980s, state spending on pensioner benefits has taken a roughly constant proportion of national income during the last 25 years. This is not an indication that pensions policy has been static over the past quarter of a century, and in the most recent years policy has tended increasingly to focus on targeting benefits towards those pensioners with lower incomes. Section 2.2 shows that if Labour's current plans and intentions are realised then an increasing proportion of future financial support for pensioners would be means-tested. Government projections also envisage total benefit payments to pensioners only increasing slightly as a proportion of national income despite considerable growth in the number of pensioners. Given these trends, increasing numbers of pensioners will need to rely on private sources of income to maintain their desired standards of living in retirement. Section 2.3 therefore looks at the policies implemented and proposed by Labour that affect individuals' saving decisions.

Both the Conservatives and the Liberal Democrats have proposed policies that would affect the way that people save and provide for their retirement, and we discuss the most important of these in Section 3. Both parties plan to make the means-tested pension credit less broad in scope than it would be under Labour's plans. The Conservatives would do this by indexing the basic state pension more generously than Labour intend; the Liberal Democrats' citizen's pension would imply a more sudden increase in the non-means-tested pension that would apply to those aged 75 and over. The Conservatives also have plans for extra financial support for some contributions to funded pensions, and for a Lifetime Savings Account, and we will outline some of the issues that will determine whether or not these would significantly increase private retirement provision. The Liberal Democrats intend to extend free long-term care to those aged 65 and over who need it (which is already provided in Scotland) across the UK, thus transferring to the state an important call on many pensioner households' incomes in retirement.

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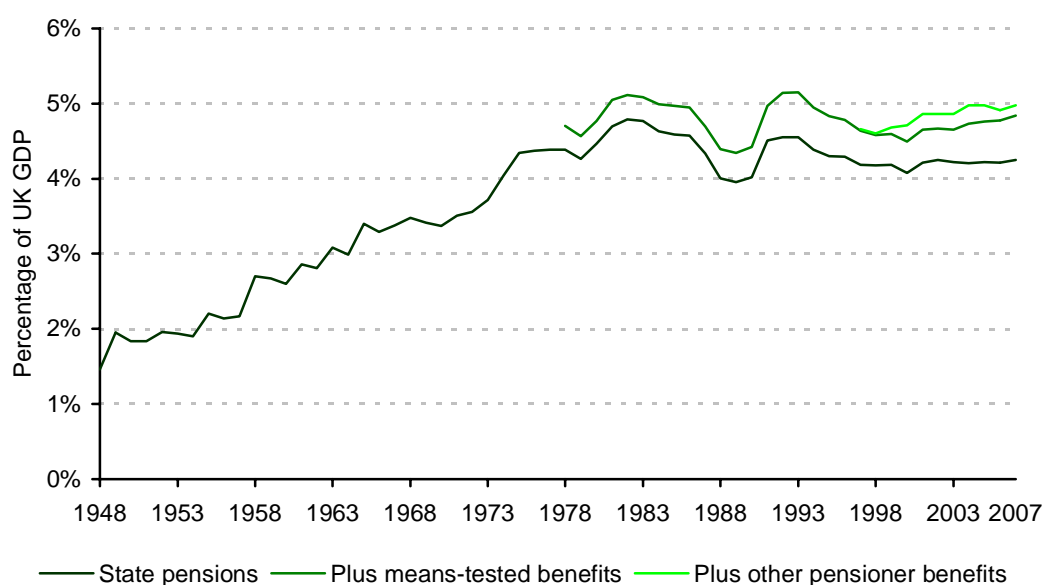
<sup>1</sup> S. Adam and M. Brewer, *Proposed Tax and Benefit Changes: Winners and Losers in the Next Term*, IFS Election Briefing Note no. 11, 2005 (<http://www.ifs.org.uk/bns/05ebn11.pdf>).

## 2. Trends in spending on transfers to pensioners

### 2.1 Past and current spending on benefits paid to pensioners

The basic state pension (BSP) was introduced in the UK in 1948, and in the three decades that followed, spending on state pensions rose almost continually as a proportion of national income. In contrast, as shown in Figure 1, since the early 1980s, spending on benefits paid to pensioners has been relatively flat, almost always remaining between 4% and 5% of national income. This subsection discusses some of the demographic and policy factors that have contributed to this recent stability.

Figure 1. State spending on financial transfers to pensioners in Great Britain



Notes: 'Other pensioner benefits' comprise winter fuel payments, TV licences for those aged 75 and over, and the over-70s payment. Figures for means-tested benefit spending on pensioners are not available prior to 1978. The figures in this graph refer to Great Britain rather than the UK and are therefore slightly lower than the ones shown in Figures 3 and 4.

Source: Department for Work and Pensions, *Benefit Expenditure Tables: Medium Term Forecast* ([www.dwp.gov.uk/asd/asd4/medium\\_term.asp](http://www.dwp.gov.uk/asd/asd4/medium_term.asp)).

Demographic trends have been helpful in holding down the cost of paying financial transfers to pensioners during the last 25 years. The size of the pensioner population relative to the size of the working-age population, which had been steadily increasing during the middle part of the twentieth century, has been almost constant since 1980 (see Table 1 and also figures 1.6 and 1.7 of Pensions Commission<sup>2</sup>). Such a slowdown in the relative growth of the pensioner population makes it easier to fund pension benefits from a constant fraction of national income.

<sup>2</sup> Pensions Commission, *Pensions: Challenges and Choices – The First Report of the Pensions Commission*, 2004 (<http://www.pensionscommission.org.uk/publications/2004/annrep/fullreport.pdf>).

Table 1. Pensioner population as a percentage of working-age population

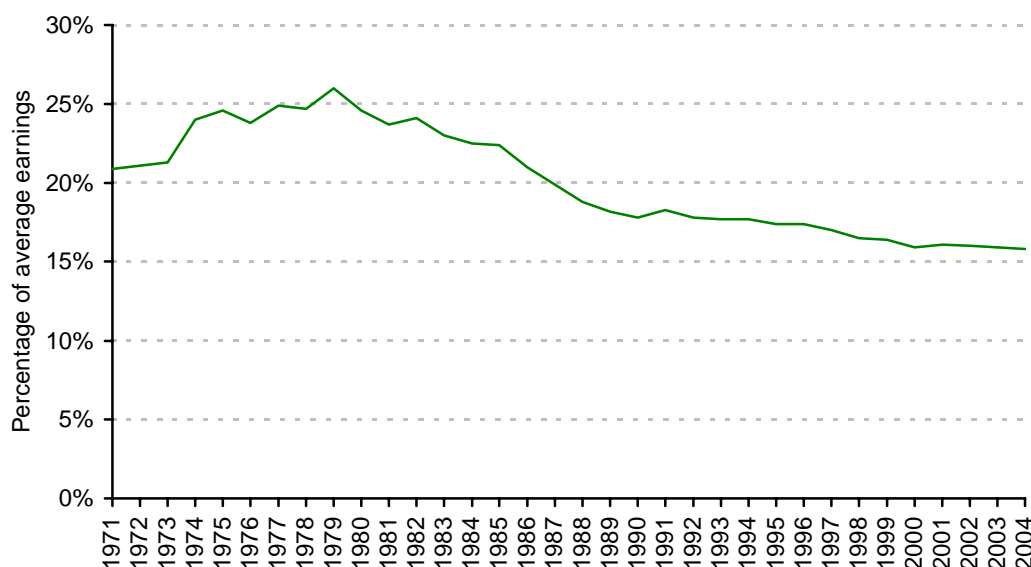
	1971	1981	1991	2001	2005	2011	2021	2031	2041
Percentage	28.0	29.7	30.0	29.8	30.2	32.0	31.8	39.0	43.1

Note: Takes account of change in pension age for women between 2010 and 2020.

Source: 1971 data – table 1.4 of ONS, *Population Trends*, no. 113, Autumn 2003; 1981–2001 data – table 1.4 of ONS, *Population Trends*, no. 119, Spring 2005. *Population Trends* is available via <http://www.statistics.gov.uk/STATBASE/Product.asp?vlnk=6303>. Projections for 2005+ are GAD 2003-based population projections (<http://www.gad.gov.uk/Population/2003/uk/wuk03cc.xls>).

Policy changes also contributed to the slowdown in the growth of the cost of pension benefits after 1980. When the BSP was first introduced, it was indexed on an ad hoc basis, but these discretionary increases were more than sufficient to keep pace with increases in average earnings on average until the early 1970s. From 1974 until 1979, the BSP was increased in line with the greater of earnings growth and price inflation. Since 1981, the BSP has been formally linked to price inflation.<sup>3</sup> During the period 1982–2005, average earnings have grown faster than prices and so the BSP is now less costly than it would have been had earnings indexation continued. For example, to keep the BSP at the same proportion of average earnings in 2004 as it was in 1981, it would have been worth about £111.50 a week in 2004 rather than its actual value of £79.60. Figure 2 shows how the value of the BSP has declined relative to average earnings since the early 1980s.

Figure 2. Basic state pension as a percentage of average earnings



Source: *Abstract of Statistics 2004* (<http://www.dwp.gov.uk/asd/asd1/abstract/Abstract2004.pdf>).

Part of the decrease in spending on pension benefits that would have occurred if price indexation of the BSP had been the only policy change in this period was offset by the introduction of the State Earnings-Related Pension Scheme (SERPS) in 1978. SERPS

<sup>3</sup> There have been exceptional larger increases, most recently in April 2001 and April 2002 (see the 2000 Pre-Budget Report). Subsequent to these increases, formal indexation has guaranteed that the BSP will increase in line with the retail price index or by 2.5% each April, whichever is larger.

provided additional pension income that was related to earnings over an individual's working life. It was reformed (in a way that will eventually make benefits substantially less generous than under the scheme originally envisaged for individuals reaching the state pension age after 1999) by legislation passed in 1986 and 1995 and was finally replaced by the state second pension (S2P) in 2002, which is rather more generous to low earners than the final SERPS system.<sup>4</sup> The combined effect of changes to the BSP and the introduction of and subsequent changes to SERPS is that state spending on these two benefits for pensioners has fluctuated as a share of national income since 1982 between 3.95% and 4.79% of national income. Some of these fluctuations have been due to movements in the business cycle affecting national income, rather than resulting from changes in the financial costs of these benefits.

However, the BSP and SERPS have not been the only state spending on cash transfers to pensioners. The main means-tested benefit paid specifically to pensioners<sup>5</sup> has, since October 2003, been the pension credit (PC). This is a reformed version of the minimum income guarantee (MIG), which had itself existed since income support (IS) payments to pensioners were rebranded in April 1999. IS had in turn existed since 1988, before which there had been supplementary benefit; data on how much of spending on these benefits was paid to pensioners are only available for the period since 1978. The MIG and then the PC have been made rather more generous in recent years, and spending on the PC now constitutes a slightly larger proportion of national income than was spent on the equivalent benefit in 1978 (0.5% of national income in 2004 as opposed to 0.3% in 1978). During Labour's two terms in office, the government has also introduced various additional payments to pensioners. These include free TV licences for everyone aged 75 and over, and winter fuel payments. The overall result of all changes to benefits for pensioners is that their cost has grown very slightly from 4.7% of national income in 1997 to 5.0% of national income in 2004.

This relative stability in the proportion of national income spent on pensioners masks the fact that the income available to the poorest pensioners has increased substantially under Labour's two terms in office. In 1997–98, single pensioners with no private income sources had a minimum income of £68.80 a week (in that year's prices), if they took up the benefits to which they were entitled. In contrast, the same type of pensioners in 2005–06 (again claiming all the benefits to which they are entitled) received at least £109.45 a week (in 2005–06 prices). This represents a nominal increase in income of 59.1% for the poorest pensioners who claimed the means-tested benefits to which they were entitled. This compares with growth in the retail price index of approximately 21.5% and in average earnings of approximately 40.5%.<sup>6</sup> Hence in real terms the benefits to which the poorest pensioners are entitled have grown by around 30% since Labour came to power, while relative to average earnings they have grown by approximately 13%.

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<sup>4</sup> A large part of the financial implications of these reforms will only be felt as the S2P system matures during this century; these effects underpin some of the discussion in the next subsection. For a fuller explanation of the impact of these changes, see R. Disney and C. Emmerson, 'Public pension reform in the United Kingdom: what effect on the financial well-being of current and future pensioners?', *Fiscal Studies*, 2005, vol. 26, pp. 55–81.

<sup>5</sup> People in benefit units containing at least one person aged over 60.

<sup>6</sup> Between 2004–05 and 2005–06, we have assumed growth in the RPI of 2½% and growth in average earnings of 4½%.

These large increases in benefits for the poorest pensioners mean that the (minimum) £109.45 a week to which the poorest single pensioners are now entitled is one-third more generous than the level of the BSP (£82.05). The equivalent gap (for younger pensioners) was 10% when Labour came to power in May 1997 and just 7% when IS was introduced in April 1988.

In spite of this increase in income amongst the poorest pensioners, the overall picture is still one of relative stability in the proportion of national income that is spent on pensioner benefits. It will be more difficult to maintain this stability as the retirement of the baby-boom generation after 2010 increases the size of the pensioner population relative to that of the working-age population (see Table 1). This major challenge for pensions policy, and its implications for the size and composition of state spending on benefits for pensioners, are the topic of the next subsection.

## 2.2 Future state spending on pensioners: Labour's policies

Projections for spending on pension benefits under Labour's current plans suggest that the recent stability in the proportion of national income devoted to these benefits is likely to continue. Figure 3 shows that the UK is one of the few EU15 countries that will not face a rapid increase in state pension spending over the next 50 years if current policy remains

Figure 3. Spending on public pensions as a percentage of national income, 2000 (actual) and 2050 (predicted)



Notes: For Denmark, the Netherlands, Sweden, France, Greece, Italy and Austria, the base year is 2005 rather than 2000. For the UK, the base year is 2003–04 and the second year used is 2053–54 rather than 2050. For France, the figures refer to 2040 rather than 2050. The figures for the UK include spending on the basic state pension, state second pension, pension credit, winter fuel payments, 75-and-over TV licences, and Christmas bonus.

Sources: Figures for the UK are from HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, 2004. Figures for Ireland and Luxembourg are from European Commission Economic Policy Committee, *Budgetary Challenges Posed by Ageing Populations*, Brussels, 2001 ([http://europa.eu.int/comm/economy\\_finance/epc/documents/ageing\\_en.pdf](http://europa.eu.int/comm/economy_finance/epc/documents/ageing_en.pdf)). Data for the remaining countries are from 2002–03 updates to stability and convergence programmes using revised national projections – European Commission Economic Policy Committee, *The Impact of Ageing Populations on Public Finances*, 2003 ([http://europa.eu.int/comm/economy\\_finance/epc/documents/2003/pensionmaster\\_en.pdf](http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf)).

unchanged: in 2000, the UK spent a relatively small 5.0% of national income on benefits for pensioners, and this is expected to rise only slightly to 5.6% by 2050.

There are several potential uncertainties that require caution when interpreting projections such as those shown in Figure 3.<sup>7</sup>

- First, these projections are based on population projections, which for the UK come from the Government Actuary's Department (GAD). Over recent years, GAD has consistently underestimated true improvements in mortality and thus has subsequently revised upwards its forecasts for future pensioner numbers.<sup>8</sup> If current GAD figures for future numbers of pensioners are lower than they turn out to be, actual spending on benefits for pensioners will be higher than suggested by Figure 3 (without any offsetting changes in policy).
- Second, demographic changes will mean that the age of the median voter will increase in future years. As a result, political pressure to spend more on pensioners may increase and so policy changes may be implemented in the next 50 years that increase state spending on benefits for pensioners. However, if older people also care about other policies (for example, taxes required to pay for higher pensions that could largely impact on their children) then increasing numbers of older voters might not result in extra pressure on the government to spend more on benefits for pensioners.
- Third, the figures for future state spending assume that private incomes of future pensioners will rise in line with average earnings. If they grow more quickly than this then eligibility for the means-tested pension credit will grow less quickly than projections (discussed below) suggest and so state spending will be lower than projected. Conversely, if incomes grow less quickly than expected – perhaps because of incentive effects created by the pension credit (see the penultimate paragraph in Section 2.3 and the references contained therein) – then more people will qualify for pension credit and so state spending will be higher. For example, if pensioner incomes grow only in line with prices in future years, state spending on the PC would be expected to be 2 percentage points of national income higher in 2050 than currently forecast.<sup>9</sup>

Even with these caveats, projected spending on benefits for pensioners over the next 50 years appears to be affordable, and some growth above central projections certainly would not make the UK system expensive by international standards. The stability in overall spending does, however, conceal some change in the expected composition of benefit spending on pensioners. Figure 4 again shows projections for benefit spending on pensioners in the UK, but now including spending on housing-related and disability benefits, which are not included in Figure 3, and also at more points in time than displayed in the previous graph. Figure 4 again shows a small rise in spending expected over the next 50 years; with the extra benefits included, this is from 6.2% of national income in 2004–05 to 6.6% in 2054–55. The

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<sup>7</sup> For a more detailed discussion of some of these uncertainties, see section 5 of R. Disney and M. Wakefield, *Solidarity and the Free Market in UK Pension Provision: How Much Risk-Sharing in a Multi-Pillar Programme?*, 2004 ([http://internationalezaken.szw.nl/index.cfm?fuseaction=dsp\\_rubriek&rubriek\\_id=13068&lijstm=0,322\\_9598,385\\_779\\_8#37381200](http://internationalezaken.szw.nl/index.cfm?fuseaction=dsp_rubriek&rubriek_id=13068&lijstm=0,322_9598,385_779_8#37381200)).

<sup>8</sup> In 2000, GAD estimated that there would be 16.1 million people aged 65 and over by 2051. Just two years later, it had increased this estimate to 16.8 million, and in the latest (2003) forecast it is expected to reach 17.1 million.

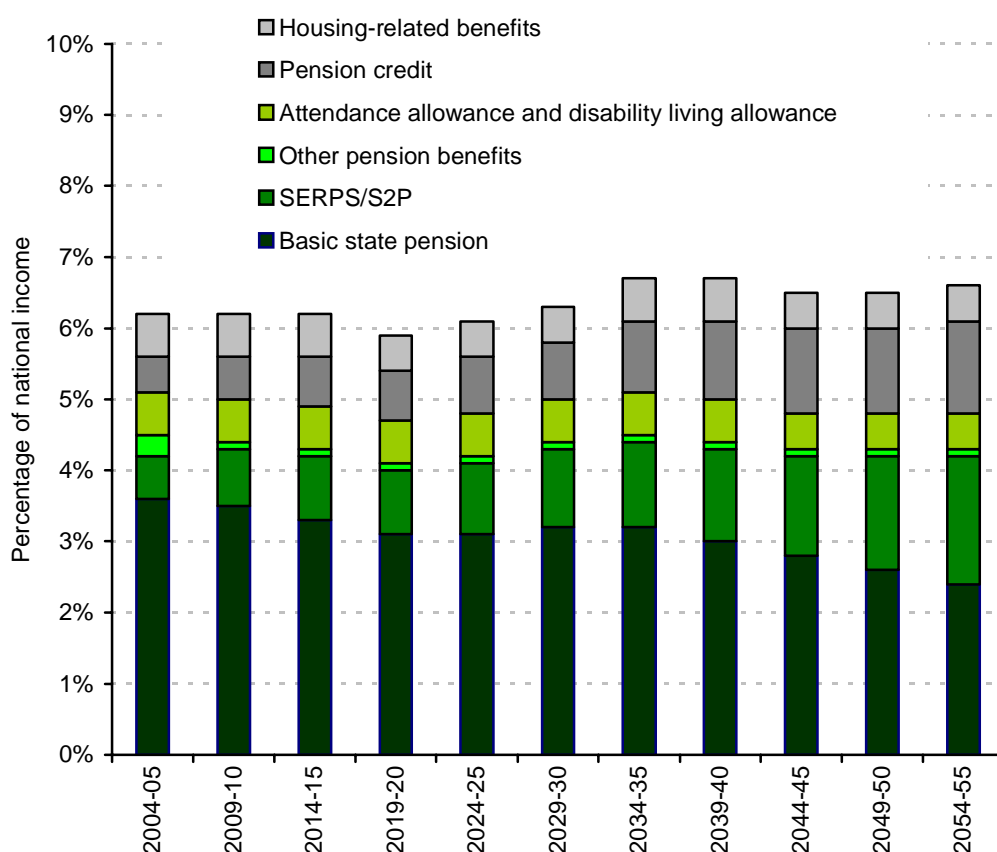
<sup>9</sup> Response to PQ from Mr David Willetts, House of Commons, *Hansard*, column 492W.



composition of this spending is expected to change under Labour’s plans to continue the current pattern of targeting benefit spending towards poorer pensioners.

The continued price indexation of the BSP is projected to result in spending on this benefit as a proportion of national income falling by a third, from 3.6% in 2004–05 to 2.4% in 2054–55. However, spending on SERPS/S2P, which is also non-means-tested, offsets this decline in spending on the BSP. Spending on SERPS/S2P is predicted to increase threefold from 0.6% of national income in 2004–05 to 1.8% in 2054–55. Although not means-tested, S2P is rather more generous to low earners than was the final SERPS system, and it is targeted towards low earners and carers in the sense that they accrue greater entitlement relative to their earnings than do higher earners.

Figure 4. Projections of transfer payments to pensioners in the UK as a proportion of national income by benefit type



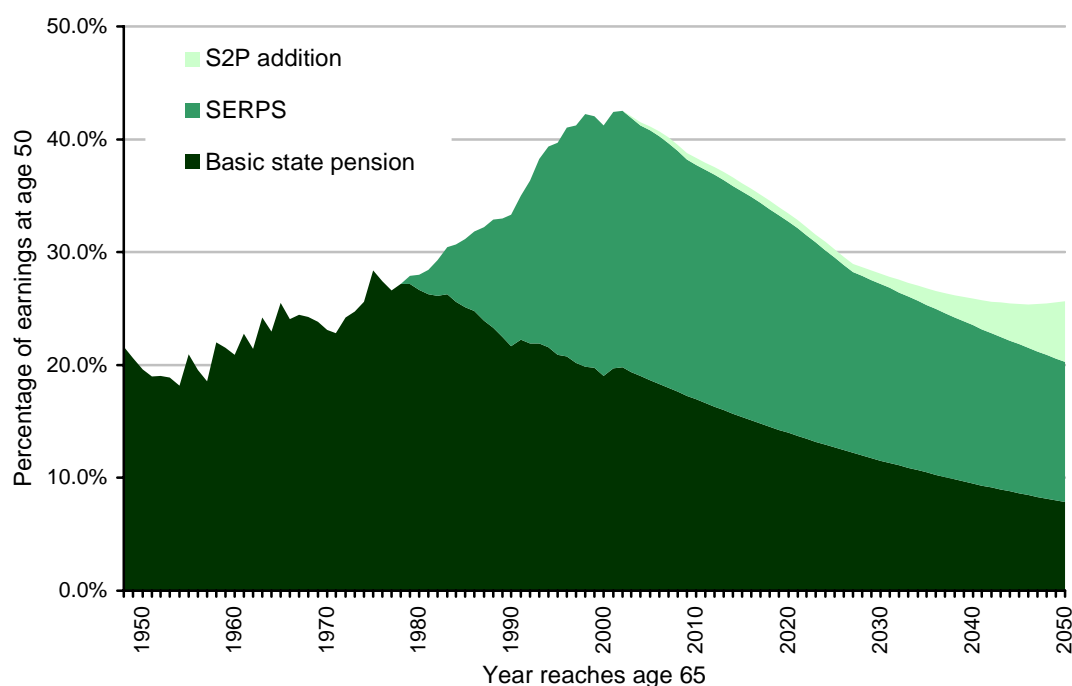
Notes: ‘Other pension benefits’ comprise winter fuel payments, over-75s’ TV licences, and Christmas bonus; ‘Housing-related benefits’ comprise housing benefit, council tax benefit in Great Britain, rate rebate in Northern Ireland and discretionary housing payments.

Source: Department for Work and Pensions, *Benefit Expenditure Tables* (<http://www.dwp.gov.uk/asd/asd4/expenditure.asp>).

To indicate how past and planned changes to the BSP and SERPS/S2P have affected and could affect the state pension incomes of individuals, Figure 5 shows how the generosity of the combination of these benefits will vary with the date at which state pension age is reached. The graph is drawn for a man with a full contribution history for these benefits and who earned age-specific median male earnings during every year of his working life (age 16

to 65). It shows the value of his pension benefit relative to his income at age 50. The assumption that he earns median male income every year of a full working life implies that he is relatively well off. The graph clearly shows how the declining generosity of the BSP in the 1980s and 1990s was offset by the growing maturity of the second-tier SERPS system. For individuals retiring after the early 2000s, the generosity of the benefits relative to age-50 earnings begins to decline as the reforms of 1986 and 1995 that reduced the generosity of the second-tier pension begin to take effect. The top, light-green segment of the graph (labelled S2P addition) shows how the effect of the element of the S2P that Labour introduced on top of the level of SERPS benefits will begin to arrest the decline in value of BSP and SERPS relative to age-50 earnings for individuals reaching pension age in the later part of the period considered. The effect of the S2P addition would appear sooner and be stronger for an individual with a lower income than the man considered in the graph (see other examples contained in Disney and Emmerson<sup>10</sup>).

Figure 5. State pension at 65 for male with median (age-specific) earnings, full employment history, and no private income



Source: Authors' calculations based on R. Disney and C. Emmerson, 'Public pension reform in the United Kingdom: what effect on the financial well-being of current and future pensioners?', *Fiscal Studies*, 2005, vol. 26, pp. 55–81.

Aside from the changes in the BSP and SERPS/S2P, the other major change in state spending on benefits for pensioners that is projected to occur over the next 50 years under Labour's plans is the rise of means-tested support. In particular, spending on the pension credit is expected to rise dramatically. Whilst 17.7% of state benefit spending on pensioners is currently in the form of means-tested benefits, such benefits will make up 27.3% of state benefit spending on pensioners by 2054–55. This increase arises from the growth of

<sup>10</sup> R. Disney and C. Emmerson, 'Public pension reform in the United Kingdom: what effect on the financial well-being of current and future pensioners?', *Fiscal Studies*, 2005, vol. 26, pp. 55–81.

expenditure on the pension credit. This is largely due to how this benefit integrates with the BSP, and the stated aspirations and intentions for indexing these two benefits.

As mentioned in the previous subsection, in October 2003 Labour replaced the minimum income guarantee with pension credit. This is described as having two elements. The pension credit guarantee (PCG) represents a direct replacement for the MIG and guarantees at least a certain level in income<sup>11</sup> for all pensioners who are prepared to claim this benefit. The pension credit savings credit, which is available to families containing an individual aged 65 or older, is effectively a 40% taper on the PCG for incomes over and above the level of the BSP. This means that unlike in the MIG, which was withdrawn pound-for-pound with other income, eligible individuals now keep 60p of each pound of non-PCG income that they have in excess of the full BSP, until their PC entitlement is exhausted.<sup>12</sup>

Large increases in the generosity of means-tested support for pensioners since April 1999 have contributed to the fact that some measures indicate that, for the first time since the mid-1980s, the proportion of pensioners living in poverty is no higher than the proportion of non-pensioners.<sup>13</sup> The introduction of the PC was a further increase in the generosity of means-tested support for pensioners that made many better off in financial terms. The structure and generosity of the PC also resulted in many new individuals becoming eligible for payments. In August 2003 (just before the PC replaced the MIG), approximately 2.1 million people received some MIG; a year later, the equivalent figure for the pension credit was approximately 3.2 million people.<sup>14</sup> Furthermore, since Labour aspires to index the PCG more generously than the BSP (to earnings rather than prices), the gap between the levels of the BSP and the PCG is set to increase in future years.<sup>15</sup> This will have the knock-on effect of pushing up the highest income level at which some PC is received and so is likely to mean that the proportion of pensioners eligible for means-tested benefits will continue to grow and that spending on the PC will become somewhat less precisely targeted on the poorest pensioners. Increases in the generosity of the PC relative to the BSP, and the fact that these would be likely to extend the PC to a larger proportion of an expanding pensioner population, together explain why the cost of this programme is expected to grow under Labour's plans. However, as mentioned above, political pressure may cause policy changes to be introduced in future years, so this spread of means-testing may not be realised.

The projected expansion of the pension credit is part of a continuing trend for greater targeting of state benefits for pensioners towards those with lower incomes. This targeting is a major part of the reason why spending on benefits for pensioners is expected barely to

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<sup>11</sup> In 2005–06, the weekly PCG rate is £109.45 for a single person aged over 60 and £167.05 for a couple containing at least one person aged over 60; this compares with BSP rates of £82.05 and £131.20.

<sup>12</sup> If a pensioner is also entitled to housing benefit and council tax benefit, the marginal withdrawal rate is 91% on income in excess of the BSP because of the interaction of withdrawal of these two benefits with the pension credit.

<sup>13</sup> See section 3.1.3 of M. Brewer, A. Goodman, J. Shaw and A. Shephard, *Poverty and Inequality in Britain: 2005*, Commentary no. 99, IFS, London, 2005 (<http://www.ifs.org.uk/comms/comm99.pdf>).

<sup>14</sup> Figures for numbers receiving the MIG in August 2003 come from DWP, *Income Support Quarterly Statistical Enquiry: November 2003* ([www.dwp.gov.uk/asd/asd1/is/is\\_quarterly\\_nov03.asp](http://www.dwp.gov.uk/asd/asd1/is/is_quarterly_nov03.asp)); figures for numbers receiving the pension credit in August 2004 come from DWP, *Pension Credit Quarterly Statistical Enquiry: November 2004*, ([www.dwp.gov.uk/asd/asd1/pc/pc\\_quarterly\\_nov04.asp](http://www.dwp.gov.uk/asd/asd1/pc/pc_quarterly_nov04.asp)).

<sup>15</sup> For a detailed discussion of the pension credit and the implication of indexation plans for the BSP and the PC, see section III of R. Disney and C. Emmerson, 'Public pension reform in the United Kingdom: what effect on the financial well-being of current and future pensioners?', *Fiscal Studies*, 2005, vol. 26, pp. 55–81.

increase as a proportion of national income during the next 50 years even in the face of a growing number and proportion of pensioners in the population. Indeed, these combined demographic and spending projections imply that the proportion of national income spent per pensioner on benefits paid to pensioners will fall to around two-thirds of its current level by 2054.<sup>16</sup> If this change is realised then pensioners will increasingly require extra incomes from other sources in order to achieve the living standards that they desire during retirement. The following section looks at the various policies Labour has proposed and introduced to encourage individuals to save, and especially to save more for their retirement.

## 2.3 Labour policies to encourage private pension saving

In order that individuals might achieve the standards of living that they desire in retirement, Labour has stated an aim of increasing the proportion of income that pensioners receive from private sources. Currently, about 60% of pensioner income is provided by the state and 40% comes from private sources. Labour aspires to reverse this – so that 60% of pensioner income will come from private sources and only 40% from the state by the middle of this century.<sup>17</sup>

Certain recent trends may be acting against such an aim. Figure 6 shows recent trends in pension coverage at the second tier (i.e. supplementary to the BSP/PC) of the UK pension system. The large increase in SERPS/S2P membership in 2002 is as a result of people with certain caring responsibilities, who did not accrue any entitlement under the rules of SERPS, accruing entitlement under the rules of S2P. There is no similar sudden shift in eligibility conditions to explain the steady downward drift in coverage by private defined benefit (DB) pensions. (DB schemes offer pension benefits that depend on a measure of a member's earnings (often final salary) and the number of years during which he/she has built up an entitlement within the scheme.) Private DB membership has declined as a form of 'second-tier' pension provision in the UK since the early 1990s, even whilst the overall number of pension scheme memberships has expanded due to increases in coverage by earnings-related state pensions, public DB schemes and (to a lesser extent) individual defined contribution (DC) schemes. (DC schemes pay pensions that depend on the amount of funds accumulated by the time a scheme member begins to draw their pension and on the annuity rate available at that time.) For some employees, the shift away from DB employer pensions may also mean a reduction in employer contributions to a pension.<sup>18</sup> Falls in the stock market in the early 2000s, and well-publicised problems with some company pension schemes, may also have dented public confidence in private pensions. All of these factors have increased concerns that individuals should be made more aware of what income they are likely to receive from public

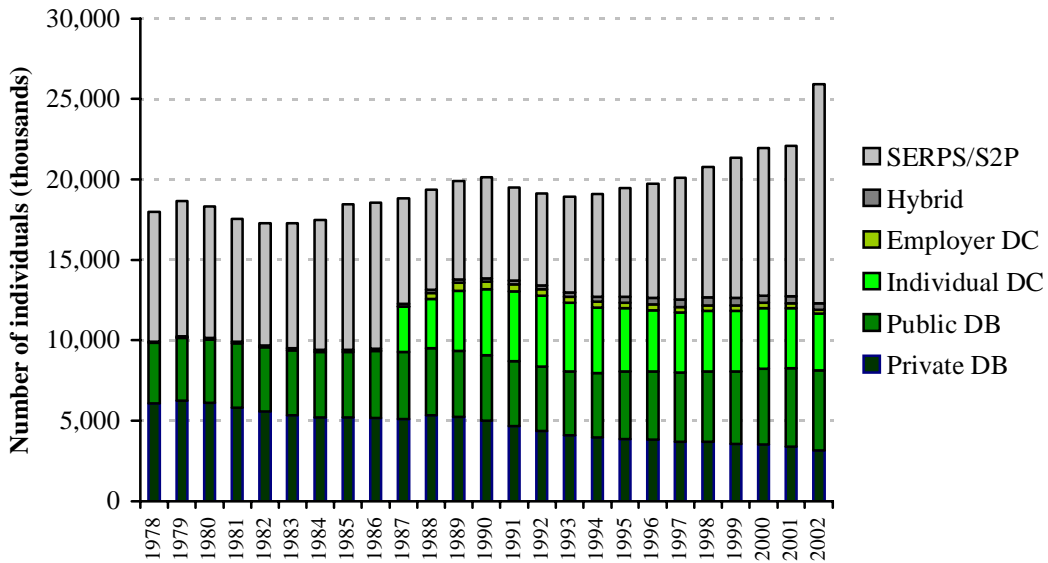
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<sup>16</sup> The pensioner population projections used to calculate this number are GAD 2003-based population projections ([www.gad.gov.uk/population/2003/uk/wuk035y.xls](http://www.gad.gov.uk/population/2003/uk/wuk035y.xls)), which do take account of the rise in the state pension age for women between 2010 and 2020.

<sup>17</sup> Department for Work and Pensions, *Autumn Performance Report 2004* (<http://www.dwp.gov.uk/publications/dwp/2004/autumnreport/oustanding-csr98/home.asp>).

<sup>18</sup> Some people point to evidence that employer contributions to DC pension schemes are, on average, lower than those to DB schemes. This is not conclusive since it fails to focus on those employers who have converted their schemes from DB to DC. However, in the medium run, in the absence of other adjustments, the shift towards DC schemes will mean that employer contributions will be lower than they would have been had the schemes been DB. In a DB scheme, the default adjustment to increases in longevity is increased contributions (to cover existing pension

Figure 6. Composition of second-tier pension membership



Source: Department for Work and Pensions, Second Tier Pension Provision statistics ([http://www.dwp.gov.uk/asd/asd1/dsu/second\\_tier/2002\\_03/STPP\\_Tables\\_2002\\_03.xls](http://www.dwp.gov.uk/asd/asd1/dsu/second_tier/2002_03/STPP_Tables_2002_03.xls)).

and private sources in retirement (as some could be overestimating it) and that they should be able to save additional amounts as easily as possible.

In the remainder of this subsection, we consider whether some specific recent policies are likely to have encouraged private savings. Initially, we consider some of the new saving instruments that Labour has introduced with an aim of making saving more easily available or attractive to some individuals. Subsequently, we consider the important move of introducing a Pension Protection Fund in an attempt to bolster DB occupational pension provision. Lastly, we consider some of the policy developments that have been identified as important in determining whether or not the current largely voluntarist approach to private pension saving can provide adequate incomes to retirees.

### New savings instruments

In an attempt to make private pension saving appropriate for more individuals, Labour introduced stakeholder pensions in its first parliament and increased the maximum tax-free contributions to pension funds for low earners and non-earners.<sup>19</sup> Labour has also reformed the institutional framework for individuals wishing to save in tax-advantaged non-pension assets. Individual Savings Accounts (ISAs) replaced TESSAs and PEPs from April 1999 and are tax-privileged savings vehicles for cash deposits, or for holdings of stocks and shares

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commitments). In contrast, in DC schemes, the default adjustment is that annual pension income in retirement will decrease (since, all else remaining unchanged, annuity rates will decline with rising longevity).

<sup>19</sup> There is some evidence that these changes increased pension coverage amongst some groups of people, though not necessarily amongst the groups that stakeholder pensions were originally targeted at. See W. Chung, R. Disney, C. Emmerson and M. Wakefield, 'Public policy and saving for retirement: evidence from the introduction of stakeholder pensions in the UK', mimeo, 2005 (<http://www.lse.ac.uk/ubs/events/conf/Disney.pdf>).

either directly or in trust, or for both cash and equities.<sup>20</sup> None of the three main parties has outlined plans for significant reforms of stakeholder pensions or ISAs.

Just before the 2001 election, Labour proposed two ‘asset-based welfare’ policies. The Child Trust Fund is now a national programme through which the government provides an asset to each newborn child by paying in a means-tested initial endowment of either £250 or £500. The process of paying endowments to families with children born since September 2002 began in January this year. Further state contributions will also be paid as children grow up. Concerns have been raised about design features of the Child Trust Fund – such as whether a means-tested structure can be justified when conventional benefit payments seem better instruments for pursuing distributional aims – and about the general question of whether the Child Trust Fund represents the best use of public funds to promote the ends it is intended to achieve.<sup>21</sup> The Liberal Democrats feel that the scheme does not represent the best-value use of public funds and, were they to be elected, they would abolish it in order to free the resources to spend elsewhere. For example, they intend to spend money on extra teachers in order to reduce primary-school class sizes.

The Saving Gateway is a savings account that would be available only to individuals with lower incomes. Eligible individuals would have a strong incentive to place funds into accounts because their deposits would be matched (at some rate) by the government. There are concerns that the strong incentives created by matching might lead individuals to respond in ways that do not create the new savers and savings that this policy is intended to generate. Some eligible individuals might, for example, be able to reshuffle existing savings, or funds that they would have saved even in the absence of the policy, into their Saving Gateway. Other individuals might realise that they could profitably borrow to ‘save’ in a Saving Gateway account and so also not have to find savings by consuming less than their income.<sup>22</sup> The practical importance of these potential problems should be better understood after a second pilot of the Saving Gateway, which is currently in its early stages and which will trial different match rates; researchers at IFS will be involved in evaluating this pilot.<sup>23</sup> None of the three main parties has stated its intentions for the Saving Gateway beyond the current pilot.

### Support for employer pensions

To increase confidence in private sector occupational pensions, the Pensions Act 2004 set up the Pension Protection Fund (PPF). This came into being on 6 April 2005 and has been established to increase the protection available to members of eligible DB pension schemes. The intention is that the PPF will pay compensation to individuals whose employer becomes

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<sup>20</sup> In common with stakeholder pensions, it was hoped that the features of ISAs would make them more attractive to individuals in income groups with relatively low propensities to save. Descriptive evidence in O. Attanasio, J. Banks and M. Wakefield, ‘Effectiveness of tax incentives to boost (retirement) saving: theoretical motivation and empirical evidence’, forthcoming in *OECD Economic Studies* 39 and currently available as IFS Working Paper no. W04/33 (<http://www.ifs.org.uk/wps/wp0433.pdf>), suggests relatively small effects.

<sup>21</sup> For our own concerns on these issues, see C. Emmerson and M. Wakefield, *The Saving Gateway and the Child Trust Fund: Is Asset-Based Welfare ‘Well Fair’?*, Commentary no. 85, IFS, London, 2001 (<http://www.ifs.org.uk/comms/comm85.pdf>).

<sup>22</sup> For a fuller explanation, see C. Emmerson and M. Wakefield, ‘Increasing support for those on lower incomes: is the Saving Gateway the best policy response?’, *Fiscal Studies*, 2003, vol. 24, pp. 167–95.

<sup>23</sup> Further details on the second pilot are available at [http://www.hm-treasury.gov.uk/documents/financial\\_services/savings/topics\\_savings\\_gateway.cfm](http://www.hm-treasury.gov.uk/documents/financial_services/savings/topics_savings_gateway.cfm).



bankrupt and leaves a shortfall in their pension fund. In broad terms, the scheme has been designed in the expectation that it will be able to pay a full pension to those already drawing their pension and 90% of full pension to those not yet eligible to draw their pension (subject to a cap of £25,000 per year).<sup>24</sup> The scheme is to be financed through a levy on pension funds, which currently only varies by the number of members in the scheme but will eventually also be positively related to an assessment of the risk of the scheme defaulting.

In the event of the PPF not having sufficient funds to pay out, it would be able to increase the levy and 'in extreme circumstances'<sup>25</sup> could also reduce the amounts that it pays out. Hence the PPF does not offer a firm guarantee to those covered, and the government has said that it would not guarantee providing taxpayer support for the PPF. Nonetheless, since the PPF will offer some support to individuals affected by the collapse of a firm with a shortfall in its pension scheme, Andrew Smith, when Secretary of State for Work and Pensions, argued that 'We will make sure that in future individuals in final salary schemes will never again face the injustice of saving throughout their lives only to have their hard-earned pension slashed just before they retire. The Pension Protection Fund will allow individuals to save with confidence'.<sup>26</sup>

A recent analysis by McCarthy and Neuberger showed that the PPF 'is likely to face many years of low claims interspersed irregularly with periods of very large claims'.<sup>27</sup> This suggests that the PPF will either need to build up large surpluses in order to cover the liabilities in these bad years; or it will need to raise premiums at times when pension schemes are most likely to be in financial difficulties; or it will need to reduce the amount of compensation offered when the periods of large claims arrive; or alternatively (despite the government's claims) taxpayer support would at times be needed to bail out the PPF.<sup>28</sup> A recent study by Standard and Poor's also questions whether the current levy will be sufficient to meet the PPF's likely outgoings.<sup>29</sup>

### **Bolstering the voluntarist system?**

Many of Labour's most recent pensions proposals were outlined in a DWP Green Paper<sup>30</sup> and accompanying Treasury and Inland Revenue document<sup>31</sup> published in December 2002. This

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<sup>24</sup> Further details of the Pension Protection Fund can be found at [http://www.dwp.gov.uk/lifeevent/penret/penreform/4\\_ppf.asp](http://www.dwp.gov.uk/lifeevent/penret/penreform/4_ppf.asp) and <http://www.pensionprotectionfund.org.uk/>.

<sup>25</sup> Source: <http://www.pensionprotectionfund.org.uk/index/main-functions/compensation.htm>.

<sup>26</sup> 12 February 2004, quoted on [http://www.dwp.gov.uk/lifeevent/penret/penreform/4\\_ppf.asp#a1a](http://www.dwp.gov.uk/lifeevent/penret/penreform/4_ppf.asp#a1a). In addition, Department for Work and Pensions, *Working and Saving for Retirement: Action on Occupational Pensions*, London, 2004 (<http://www.dwp.gov.uk/consultations/consult/2002/pensions/actionplanfull.pdf>), states that the government will be 'introducing a Pensions Protection Fund to guarantee members a specified minimum level of pension when the sponsoring employer becomes insolvent'.

<sup>27</sup> D. McCarthy and A. Neuberger, *The Pension Protection Fund*, mimeo, 2004 (<http://www.lse.ac.uk/ubs/pdf/McCarthyNeuberger28-05-2004.pdf>).

<sup>28</sup> McCarthy and Neuberger argue that of these four possibilities, the last is the most likely.

<sup>29</sup> Standard and Poor's, *Study of Potential Claims on the PPF*, 18 April 2005, London.

<sup>30</sup> Department for Work and Pensions, *Simplicity, Security and Choice: Working and Saving for Retirement*, Cm. 5677, TSO, London, 2002 ([www.dwp.gov.uk/consultations/consult/2002/pensions/gp.pdf](http://www.dwp.gov.uk/consultations/consult/2002/pensions/gp.pdf)). A technical paper was also published alongside the Green Paper: Department for Work and Pensions, *Simplicity, Security and Choice: Technical Paper*, London, 2002 ([www.dwp.gov.uk/consultations/consult/2002/pensions/tech.pdf](http://www.dwp.gov.uk/consultations/consult/2002/pensions/tech.pdf)).

<sup>31</sup> HM Treasury and Inland Revenue, *Simplifying the Taxation of Pensions: Increasing Choice and Flexibility for All*, TSO, London, 2002 ([www.inlandrevenue.gov.uk/consult\\_new/pensions\\_consult.pdf](http://www.inlandrevenue.gov.uk/consult_new/pensions_consult.pdf)).

Green Paper established a Pensions Commission to review the regime for UK private pensions and long-term savings.<sup>32</sup> Taking into consideration the other proposals made in the consultation papers, the Commission's recommendations (which will be published in the autumn of this year) will consider whether there is a case for moving beyond the current voluntarist approach to private pension saving – in other words, whether people should be compelled to save more towards a pension. Labour seems to have ruled this out for the time being. Speaking on BBC Radio 2's *Jeremy Vine* show on 15 April, the Prime Minister said, 'If you were to move to additional compulsion, that is something that will have to be worked out and put to people at a future election. But actually I don't think it is the answer to the problem we face'.

Many of the DWP and Inland Revenue proposals were designed to improve the functioning of a system based on the voluntarist approach, by facilitating better 'informed choice' about how to provide for retirement. Indeed the Green Paper argued that the 'proposals for better information, simpler pensions, simplified tax treatment, better protection and more flexible retirement are designed to enable people to make their own choices for retirement'.<sup>33</sup>

Perhaps the most significant proposal was a plan to reduce the multiplicity of rules governing tax-free pension saving into a single regime, or as near as possible to a single regime given the differences in structure between DC and DB pension schemes. This plan is due to be implemented beginning from the tax year 2006. Within the plan, the existing age- and earnings-related maximum limits on tax-exempt pension saving will be replaced by rules that allow almost all individuals to contribute up to the larger of £3,600 or 100% of their earnings each year (up to a cap of £215,000), as long as their total pension fund value does not exceed a specified 'lifetime allowance', which would initially be set at £1.5 million.<sup>34</sup> This will allow individuals greater flexibility to save in accessible forms (such as ISAs) when they are young, and only to transfer balances into less-accessible pension accounts as they approach retirement.

Another measure contained in the Green Paper that would allow individuals greater flexibility is allowing people to take their occupational pension while continuing to work (perhaps part-time) for the employer who is providing the pension. With respect to state pensions, proposals to increase incentives to defer receipt included the idea of allowing individuals greater choice about how they receive the extra benefits that they are due if they defer receipt. Yet further measures involved encouraging better information flows – for example, by distributing state pension forecasts to make people better informed about what they are likely to get from the state in retirement and producing combined state and private pension forecasts.

All else remaining equal, simplifications of the complex UK pension system are welcome.<sup>35</sup> Measures to promote better information flows are also likely to help people to make better

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<sup>32</sup> Details of the Pensions Commission and its published findings to date can be found at [www.pensionscommission.org.uk](http://www.pensionscommission.org.uk).

<sup>33</sup> Summary, paragraph 66, page 10 of Department for Work and Pensions, *Simplicity, Security and Choice: Working and Saving for Retirement*, Cm. 5677, TSO, London, 2002 ([www.dwp.gov.uk/consultations/consult/2002/pensions/gp.pdf](http://www.dwp.gov.uk/consultations/consult/2002/pensions/gp.pdf)).

<sup>34</sup> Finance Bill 2004; see table A on page 3 of [http://www.hm-treasury.gov.uk/media/717/AB/fb04en139\\_270\\_.pdf](http://www.hm-treasury.gov.uk/media/717/AB/fb04en139_270_.pdf).

<sup>35</sup> For more discussion of the particular simplifications and other measures from the 2002 Green Paper considered here, see C. Emmerson and M. Wakefield, *Achieving Simplicity, Security and Choice in Retirement? An Assessment of the Government's Proposed Pension Reforms*, IFS Briefing Note no. 36 (<http://www.ifs.org.uk/bns/bn36.pdf>).



decisions about how to provide for their retirement, although the cost-effectiveness of measures must always be borne in mind. Opposition parties have not proposed large reversals of the measures that we have discussed briefly here. However, the measures proposed in 2002 have not been the only recent measures that are likely to have had an effect on the smooth operation of a pension system based on a voluntarist approach, and some other recent reforms are generating more lively debate between the political parties.

Not all of Labour's measures have been aimed at strengthening pension saving. Early on in Labour's term in office, at a time when many private pension schemes had large surpluses, Labour scrapped repayment of the tax credit on dividends from shares held by pension funds (the dividend tax credit). This was announced in July 1997 and, for pension funds at least, implemented immediately. The Treasury estimates that by 2001–02, this change raised £5.1 billion a year.<sup>36</sup> There has been some debate about the likely consequences of this tax change for pension providers and for companies deciding how much to pay in dividends for shares. Box 1 explains why a large part of the revenues raised by the reform are likely to represent an increase in the cost of providing private pensions. The first-round effects of this will most likely have been felt by members of DC pension schemes and employers providing DB schemes. In the absence of other changes, members of DC pension schemes would have experienced reduced accruals in their schemes, while employers providing DB schemes would have had to increase contributions to their pension schemes in order to achieve the fund size they required. None of the main political parties has plans to reinstate repayment of the dividend tax credit for pension providers, although the Conservatives plan to increase support for some pension contributions at a cost of £1.7 billion a year (see Section 3.1 and the Appendix).

#### **Box 1. Dividend tax credits for pension funds<sup>a</sup>**

Before July 1997, UK pension funds and insurance companies providing pension plans could reclaim a tax credit on dividends received from UK companies. Gordon Brown abolished this tax break for pension providers in his first Budget, raising an estimated £5 billion per annum for the exchequer.<sup>b</sup>

Before their abolition, these refundable dividend tax credits added 25 pence to the value of every £1 received by pension providers in cash dividends from UK companies.<sup>c</sup> The value of this tax break to pension funds was increased if firms adopted high dividend payout policies, retaining a smaller proportion of their profits to finance investment spending, and relying more on external sources of funding from borrowing and new equity issues. In his first Budget Speech, Gordon Brown suggested that this tax treatment distorted firms' dividend policies, and that the abolition of refundable dividend tax credits would encourage corporate investment.<sup>d</sup> Michael Howard has argued that this tax increase has hit share prices and increased pressures on pension funds and insurance companies.<sup>e</sup>

The Notes appear at the bottom of the continuation of this box on the next page.

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<sup>36</sup> Source: HM Treasury, *Financial Statement and Budget Report 1997*, London, 1997 (<http://archive.treasury.gov.uk/budget/1997/report/fsbr.htm>).

**Box 1 continued**

It is unlikely that this tax change had any significant impact on the UK stock market. There was no sharp fall in the UK stock market when it was announced, unexpectedly, in July 1997. Although UK pension providers owned at least one-third of the equity in listed UK companies at that time, their wealth is small in relation to the world capital market as a whole. UK shares are traded internationally and valued at what they are worth to foreign investors, which was essentially unchanged by the abolition of repayable dividend tax credits for UK pension providers.

Given that stock market valuations were largely unaffected, there is little reason to suppose that changes to the taxation of UK pension funds would have major effects on company dividend or investment policies. It is possible that UK pension funds were so influential that some finance directors used to eschew value-maximisation in favour of paying excessively high dividends, but we know of no solid evidence that this was the case. Nor have we seen any evidence that company investment was significantly affected by this tax change.

On the assumption that these effects on share prices and company behaviour were minor, the main impact of the abolition of refundable dividend tax credits was simply to reduce the post-tax value of dividend income from UK companies for UK pension providers. By reducing the post-tax return on pension assets, this measure has increased the cost of providing private pensions.

The cost of this tax reform to pension providers is somewhat overstated by the headline figure of £5 billion per annum raised from the abolition of credits. Part of this was used to finance a cut in the corporation tax rate from 33% to 31% in July 1997, at a cost to the exchequer of around £2 billion per annum. Pension providers benefit as shareholders from this reduction in corporate income tax, although this gain is shared with all other shareholders. If we also factor in the further cut in the corporation tax rate from 31% to 30% in April 1999, the total offsetting gain to pension providers may have been as high as £1 billion per annum.<sup>f</sup>

Nevertheless, the net cost to UK pension providers from these changes to the tax system remains substantial, in the region of £4 billion per annum. Gordon Brown argued in his 1997 Budget Speech that 'many pension funds are in substantial surplus and at present many companies are enjoying pension holidays, so this is the right time to undertake a long-needed reform'.<sup>g</sup> Whilst the abolition of refundable dividend tax credits is not the only reason why pension providers now find themselves in very different circumstances, it has surely been a contributory factor.

<sup>a</sup> The authors thank Steve Bond for providing the analysis in this box.

<sup>b</sup> Inland Revenue Press Release 2, 2 July 1997.

<sup>c</sup> From 1973–74 to 1992–93, the value of these refundable tax credits was linked to the basic rate of income tax, and so had fallen in line with the basic rate under Conservative governments after 1979. Norman Lamont broke this link when he reduced the credit rate to 20% (expressed as a proportion of the cash dividend plus the credit, i.e.  $25/125 = 20\%$  immediately prior to abolition).

<sup>d</sup> <http://archive.treasury.gov.uk/pub/html/budget97/speech.html>.

<sup>e</sup> For example, [http://www.conservatives.com/tile.do?def=news.story.page&obj\\_id=48142&speeches=1](http://www.conservatives.com/tile.do?def=news.story.page&obj_id=48142&speeches=1).

<sup>f</sup> This is calculated by assuming that all of the tax saving is passed on to shareholders as higher dividends, and that pension providers own one-third of UK equity.

<sup>g</sup> <http://archive.treasury.gov.uk/pub/html/budget97/speech.html>.

The expansion of means-tested benefits for pensioners since April 1999 has helped reduce pensioner poverty, but it has also had a complicated impact on incentives for workers to save to provide for retirement. While the Pensions Commission generally avoided discussing

specific policies in its first report, it did devote some space to the incentive implications of the pension credit and why this is likely to have reduced incentives to save for those who are now likely to receive its tapered element once they retire, but who would not have been eligible for the MIG.<sup>37</sup> As we noted in Section 2.2, the people who fall into this group are likely to be drawn from ever higher points in the income distribution if Labour's current plans to price index the BSP, but earnings index the PCG, are realised. Labour intends to persist with these indexation strategies into the next parliament, and will wait for the considered thoughts of the Pensions Commission before it decides what action, if any, needs to be taken over incentives to save for retirement. Ed Balls, Labour's parliamentary candidate for Normanton and former Chief Economic Adviser to the Treasury, said on 11 April, 'When you are talking about something as delicate and difficult and important as pensions policy, it's quite important to take the time to build the consensus. There would be future general elections before those changes come into effect'.<sup>38</sup>

The two main UK opposition parties seem to be calling for more immediate action on this specific issue. To see exactly where the Conservatives and the Liberal Democrats differ from Labour, in the next few pages we consider the main plans of these parties for policies that affect incentives to save and provide for retirement.

### 3. Conservative and Liberal Democrat proposals

The Conservatives and the Liberal Democrats both plan to introduce measures that would reduce the number of pensioners eligible for means-tested benefits relative to Labour's plans. The Conservatives plan to index the BSP to average earnings growth rather than to prices, which will have the effect of limiting the growth in the reach of the pension credit savings credit. The Liberal Democrats, on the other hand, plan to introduce a citizen's pension for all pensioners aged 75 and over, which would remove a large number of older pensioners from means-tested benefits.

In addition to these policies, the Conservatives plan to introduce a new Lifetime Savings Account (LiSA) as well as extra financial support for some contributions to funded pensions, two measures that are intended to encourage private saving. The Liberal Democrats would increase state assistance to some older people by providing free personal care to those aged 65 and over who need it throughout the UK (which is a more generous promise on long-term care than either of the other parties has proposed).

As we mentioned in the Introduction, our focus is on measures that may affect the decisions of future pensioners who are currently deciding how to provide for the future. Measures such as reforms proposed to local taxation will undoubtedly have large effects on current pensioners; distributional analyses of how different groups in the population will be affected

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<sup>37</sup> Chapter 6, and especially pages 226–9, of Pensions Commission, *Pensions: Challenges and Choices: The First Report of the Pensions Commission*, 2004 (<http://www.pensionscommission.org.uk/publications/2004/annrep/fullreport.pdf>). See also section III of R. Disney and C. Emmerson, 'Public pension reform in the United Kingdom: what effect on the financial well-being of current and future pensioners?', *Fiscal Studies*, 2005, vol. 26, pp. 55–81.

<sup>38</sup> See, for example, <http://www.bloomberg.com/apps/news?pid=10000102&sid=aFXEoa0UV0e4&refer=uk>.

financially by the overall tax and benefit reform packages proposed by the different parties are contained in IFS Election Briefing Note no. 11.<sup>39</sup>

### 3.1 Conservative pension and saving policy

#### *Earnings indexation of the basic state pension*

The Conservatives propose increasing the BSP in line with average earnings during the next parliament. This compares with Labour's intention to index the BSP to prices over the same period. Indexing to earnings rather than prices will have two effects. First, incomes of many pensioners, including anyone who gets a full BSP, would be higher under the Conservatives than under Labour. (A small number of pensioners with low or no entitlement to the BSP would have lost under the Conservatives' policy relative to Labour plans, but the Conservatives have said that they would be compensated.)<sup>40</sup> Second, indexing to earnings rather than prices would slow the rise of means-testing because the pension credit guarantee (which is means-tested) is also indexed to average earnings growth until 2007–08. Therefore, the number of people on the PC taper (who face low returns from their pension saving) would be lower under Conservative plans than under Labour plans. Under Labour commitments for indexation (PCG indexed in line with earnings until 2007–08, BSP and savings credit threshold indexed in line with prices), the number of pension families we estimate to be in receipt of the PC in 2007–08 would be 3.0 million, compared with 2.6 million in November 2004. Under the Conservatives' proposed indexation (see below), our estimates suggest there would be 2.9 million families receiving the PC in 2007–08.<sup>41</sup>

Figure 7 shows the Conservative and Labour intentions for future BSP and PCG indexation. Labour has committed to price indexation, the Conservatives to earnings indexation of the BSP during the next parliament. The Conservatives have stated an aspiration to continue this earnings indexation for more than four years in order to close the gap between the level of the BSP and the PCG. In a speech to the Centre for Social Justice on 6 January 2005, David Willetts, Shadow Secretary of State for Work and Pensions, stated that 'Conservatives are committed to restoration of the earnings link [for the basic state pension] until the means test is completely abolished'. However, moves towards this 'abolition' will initially be slow since, like Labour, the Conservatives have committed to earnings index the PCG until 2007–08.

Beyond 2008, there is a difference between the parties over how the PCG should be indexed in that Labour has a long-standing aspiration to earnings index the PCG. This earnings indexation has not been costed beyond 2008 by Labour.

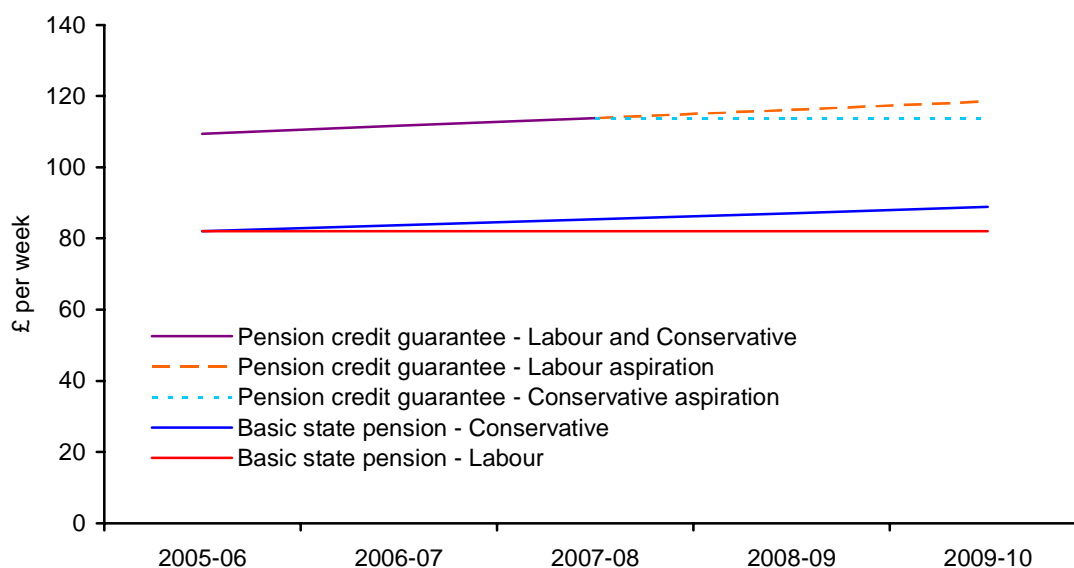
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<sup>39</sup> S. Adam and M. Brewer, *Proposed Tax and Benefit Changes: Winners and Losers in the Next Term*, IFS Election Briefing Note no. 11, 2005 (<http://www.ifs.org.uk/bns/05ebn11.pdf>).

<sup>40</sup> This problem occurs due to the link between the savings credit threshold and the BSP. The Conservatives have said that 'No-one will lose under this policy' (page 35 of D. Willetts and S. Yeo, *A Fair Deal for Everyone on Pensions*, London, 2003 (<http://www.conservatives.com/getfile.cfm?file=Pensions-full-Oct2003&ref=POLICYDOCUMENT/1664&type=pdf>)).

<sup>41</sup> Our estimates are based on a linear interpolation from government figures for the levels in 2009–10 under current indexation rules from *Hansard*, 7 April 2005, c.1694W.

Figure 7. Basic state pension and pension credit guarantee under Labour and Conservative aspirations in real terms (2005–06 prices)



Note: Assumes real earnings growth of 2% a year. No account is made for each year's rounding of pension benefits; normally, benefits would be rounded to the nearest 5 pence per week.

Source: 2005–06 rates for the basic state pension and pension credit guarantee are from DWP Press Release, [www.dwp.gov.uk/mediacentre/pressreleases/2005/feb/fraud2202-need.asp](http://www.dwp.gov.uk/mediacentre/pressreleases/2005/feb/fraud2202-need.asp).

Table 2. Funding the earnings indexation of the basic state pension

£ million	2005/06	2006/07	2007/08	2008/09	Total
Gross cost of earnings link	+510	+1,400	+2,200	+2,900	
Offset of means-tested benefits	-180	-500	-800	-1,000	
Reduction in new pension credit claims	-25	-50	-75	-100	
Higher tax revenues	-50	-140	-220	-290	
<b>Net cost of new earnings link</b>	<b>+255</b>	<b>+710</b>	<b>+1,105</b>	<b>+1,510</b>	<b>+3,580</b>
<i>Reforming welfare</i>	-700	-800	-900	-1,000	-3,400
<b>Net effect</b>	<b>-445</b>	<b>-90</b>	<b>+205</b>	<b>+510</b>	<b>+180</b>

Note: This costing assumes 2% average annual real earnings growth, which has been the average over recent years in the UK.

Source: D. Willetts and S. Yeo, *A Fair Deal for Everyone on Pensions*, London, 2003

(<http://www.conservatives.com/getfile.cfm?file=Pensions-full-Oct2003&ref=POLICYDOCUMENT/1664&type=pdf>).

The Conservatives' costings show that they believe they have found sufficient money to fund the earnings indexation of the BSP during the next parliament but not beyond that, as shown in Table 2.<sup>42</sup> Some of the cost of the policy will be offset by the reduction in the number of pensioners eligible for means-tested benefits and by the tax some pensioners will pay on their additional state pension income. The Conservatives plan to fund the remaining cost of the

<sup>42</sup> The Conservatives have costed this policy on the basis of 1.5% real earnings growth (though ignoring the increased receipts from higher income tax revenues). However, we feel that assuming 2% real earnings growth gives a more prudent estimate of the cost of this policy. Estimated costs on the basis of 1.5% real earning growth can also be found in D. Willetts and S. Yeo, *A Fair Deal for Everyone on Pensions*, London, 2003 (<http://www.conservatives.com/getfile.cfm?file=Pensions-full-Oct2003&ref=POLICYDOCUMENT/1664&type=pdf>).

policy by abolishing the New Deals for young people and lone parents. However, as Table 2 shows, their plans mean that the policy is only funded on average over the next Parliament – surpluses in the first two years will be used to fund deficits in the final two years. By 2009–10, they would need to find around £½ billion a year to keep the BSP at the level it will be at the end of 2008–09. In order to continue earnings indexation, they would need to find even more.

### ***Increased financial support for pension contributions***

The Conservatives plan to increase support for individual contributions to funded pension schemes where such contributions attract relief at the basic rate of income tax. Currently, when a non-higher-rate taxpaying individual makes a personal contribution to a pension that attracts tax relief, they receive 22p of relief for every 78p of individual contribution. The Conservatives' proposal would add another 10p government contribution, but only when such contributions are made to funded pension schemes. Individuals who qualify for this support would gain from this policy and there would be no losers. The Conservatives estimate that the policy would cost £1.7 billion a year.

Basic-rate taxpayers should fairly easily understand that they would receive additional support worth an extra 10% (of their personal gross contribution) under this Conservative policy. However, there would be various administrative complexities that pension providers would face as a result of this policy in terms of identifying those contributions that attract basic-rate tax relief. (For example, with final salary schemes, the pension entitlement accrued in a year depends on pension tenure and final salary, neither of which will be known when contributions are made.) This issue (and other issues surrounding this policy) are discussed in more detail in the Appendix.

One of the aims of this policy could be to increase total saving in the economy to address the perceived under-saving problem in the UK. The total amount of money in funded pensions would almost certainly increase if this policy were implemented: the net effect of the additional government support and changes in individual contributions would be to increase the amount of money in these schemes. However, not all of this could be considered as new national saving. First, some of the additional funds would represent state financial contributions, which (if they had not been used for this policy) could have been used to reduce national debt. Second, even the new individual contributions would not all be new national saving because (in the absence of this policy) they may have been saved in other assets.

The purpose of encouraging pension saving is to help people to provide adequate pensions for themselves in retirement. Even if this policy does not add much to national saving, it might increase total pension saving. It could therefore help some individuals to ensure that they have adequate provision for their retirement, but certain provisos must be noted. First, if the policy were not introduced and instead national debt were reduced, then this could free extra resources for future spending on state pensions to ensure adequate provision. Extra provision through saving now may be preferred if this offers a better guarantee of future pension incomes than current policy promises. On the other hand, future policy changes could erode the value of future pension incomes even if these are derived from savings in funded pension schemes; pensioners' incomes could, for example, be taxed more heavily than is currently expected. Second, it may be that many of the individuals who would end up with a little extra



pension provision because of this policy would have ensured themselves reasonably good retirement incomes even in the absence of the policy. This deadweight cost of increased support going to those who would have provided adequately for retirement will have been reduced by not giving support to employer contributions or to contributions that currently attract higher-rate tax relief, but it will not have been eliminated completely.

### **Lifetime Savings Accounts (LiSAs)**

In an attempt to encourage private saving, particularly amongst lower income groups (who typically save very little), the Conservatives have proposed a new savings vehicle – Lifetime Savings Accounts (LiSAs). These are intended to encourage individuals to save not only for retirement but also to meet other possible needs throughout their lives. Whilst the accounts would provide an incentive to leave the funds until retirement, individuals would be able to withdraw their own contributions before retirement if they needed to.

The basic design of the policy that the Conservatives have outlined so far is as follows:

- Accounts would be available to anyone aged 18 or over.
- Individual contributions to the account would be matched by the government at some (as yet undetermined) rate up to an annual contribution cap.
- Own contributions (plus the interest earned on them) could be withdrawn at any time (subject to a three-month notice period), although upon withdrawal the government match would be withdrawn (and so cease to earn interest) until the funds were returned.
- Own contributions, plus the government match, plus all interest earned would be able to be withdrawn as a lump sum at the age of 65.<sup>43</sup>
- In addition, after 10 years (and every 10 years thereafter) an individual would be able to withdraw their own contributions (and the interest) plus the average government match put into the individual's account.

Various elements of this policy are still under consultation. Most importantly, the match rate and annual matched contribution cap have not yet been decided upon. Therefore it is not yet possible to estimate the cost of this proposal.

As we understand it, this policy introduces complex incentives for some individuals to withdraw money early and then re-deposit it in order to maximise the return on their funds. The perverse incentives towards early withdrawal are induced by the possibility of withdrawing not only your own contributions but also the average government match every 10 years. Anyone who wishes to contribute the maximum amount each month will have the greatest total stock of wealth by leaving their funds in the account until they reach age 65. However, an individual who plans to contribute less than the maximum amount each month could, in fact, increase their stock of wealth at the age of 65 if they withdrew their funds and the average match after 10 years and then re-deposited some or all of this money into their account, before withdrawing it all (own contributions and government match) at retirement.

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<sup>43</sup> Individuals would probably also be able to withdraw their own contributions plus the entire government match in the event of chronic illness.

**Box 2. LiSA example****Example LiSA rules**

Contributions matched at a rate = £1:£1  
 Maximum matched monthly contribution limit = £20  
 0% real interest rate

**Example individual**

Man, aged 45, anticipates being able to contribute £10 a month from his income to his LiSA for the next 20 years.

**Option 1:** Make £10 monthly contribution from income each month between ages 45 and 65, then withdraw all contributions and total government match at age 65.

Total own contributions after 20 years	= £2,400
Total government match after 20 years	= £2,400
Lump sum received at age 65	= £4,800
<b>Total available funds after 20 years</b>	<b>= £4,800</b>
(Total government subsidy	= £2,400)

**Option 2:** Make £10 monthly contributions from income each month between ages 45 and 55, then withdraw all contributions and average government match. Between ages 55 and 65, make £10 monthly contribution from income plus £10 monthly contribution out of funds withdrawn from the account at age 55. Withdraw all contributions and total government match at age 65.

Total own contributions during first 10 years	= £1,200	(re-deposited)
Average government match over first 10 years	= £ 600	(kept)
Total own contributions during second 10 years	= £2,400	
Total government match after second 10 years	= £2,400	
Lump sum received at age 65	= £4,800	
<b>Total available funds after 20 years</b>	<b>= £4,800 + £600 = £5,400</b>	
(Total government subsidy	= £3,000)	

These incentives are complex and Box 2 presents an example to clarify this point. It would be unwelcome for such complex incentives to be created within the already intricate retirement saving framework in the UK. The example also shows that the incentive towards early withdrawal (and hence the complexity in understanding how to get maximum benefit from the policy) will only occur for those people planning to contribute less than the maximum amount each month. Unfortunately, these are more likely to be the lower-income people that this policy is specifically aimed at. Further consultation on how to avoid the complicated incentives that the current design of this policy would seem to create would be welcome.

The Conservatives have also suggested that assets held in a LiSA could be ignored for the purposes of assessing PC entitlement, in order that the tapering of this benefit should not discourage saving in these accounts. However, such a policy would raise equity issues: two individuals with the same income and the same level of assets could be entitled to different



amounts of PC simply because these assets were held in different forms. The Conservatives would need to consider carefully whether this would be desirable.

Abstracting from these issues with the exact design of the policy, would such an account (that provides a cash match to contributions rather than tax relief) increase saving? There are at least two elements of this policy that will affect an individual's decision as to whether or not to save in this account. First, matching could provide a strong – and arguably easy-to-understand – incentive to place funds into an account. Whether or not this would attract large amounts of funds into LiSA accounts would largely depend on the match rate that was chosen and how the value of matching payments would compare with the value of financial support or tax reliefs available for saving in other forms. All else being equal, positive matching contributions on a savings account would be more valuable to non-income-taxpayers than are the tax advantages that are available in ISAs. Second, the flexibility to withdraw contributions before retirement may make these accounts more attractive for some individuals than existing pension vehicles because their savings will not be tied up. On the other hand, there is currently an intention to have a three-month notice period for withdrawals from accounts, which could discourage individuals who feared that they may need to access their funds more quickly than this. This is particularly likely to affect those with little or no liquid financial assets. For many such individuals, existing savings vehicles, including some ISAs, which do not require notice for withdrawals, could remain more attractive than a LiSA as an accessible savings product.

For the LiSA account to have an impact on saving in the economy, its parameters would have to be set in such a way that some individuals would choose to save in this form. Funds that flowed into accounts would only be new national savings if they were individual contributions that, in the absence of the account, would not have been deposited in other savings instruments. Money spent paying state matching contributions would not represent new national saving since, in the absence of the policy, this money could have been used to reduce national debt (i.e. for public saving). The cost-effectiveness of the policy would also depend on the extent of reshuffling in LiSA accounts of assets that would have existed even without this policy. If individuals fund contributions to a LiSA from existing savings or from a flow of saving that they would have made anyway, this is a deadweight loss: the policy will have generated no new saving but will still have incurred a cost of matching payments. The deadweight loss from the policy would be likely to be highest in the first few years, when individuals have existing accessible savings that they could transfer into LiSA accounts. Once individuals had exhausted existing savings, the deadweight loss from the policy would decline. One way to attempt to reduce such dead weight would be to try to design accounts that would mainly attract individuals who, in the absence of the policy, would have saved very little.

Before finalising this policy, the Conservatives would need to consider carefully its design if they want to create a simple incentive structure that could encourage new private saving. This should include consideration of how this policy would interact with existing pension and saving policy and, indeed, with the enhanced support for some individual contributions to pensions that the Conservatives propose. For example, the existence of LiSAs and additional support for contributions to funded pensions attracting basic-rate tax relief could produce incentives for individuals to save in a LiSA until age 65 (thus receiving the government

match) and then deposit all their money in a pension (receiving the additional 10p of support for each 78p of contribution). This is a complex policy that would require further consultation to avoid any unintended effects.

### **Others**

- In common with the Liberal Democrats, the Conservatives have said that they would abolish regulations that compel people to annuitise their pension wealth (over and above any tax-free lump sum) by the age of 75. Since this would allow people new choices without closing off any options that are currently available, it should make individuals better off. Some care would be needed, though, in designing such a policy change, which could have implications in terms of forgone tax receipts and extra benefit expenditures.
- The Conservatives have promised that if an individual pays for the first three years of long-term care that they receive, then any further care would be state-financed without any means test. During the first three years, the current means test would continue to apply. This is somewhat less far-reaching than the Liberal Democrats' proposal to extend free long-term care to all those aged 65 and over who require it. Some potential implications of that policy for individuals' saving decisions are discussed in Section 3.2.
- The Conservatives have said that, if elected, they would allow firms to promote their own pension schemes, and also encourage firms to make schemes 'opt-out' rather than 'opt-in'. Allowing firms to promote their schemes amounts to a relaxation of rules about who can advertise pensions, and it might be argued that careful regulation would be needed. With respect to the second idea, if firms are currently making considered decisions about whether to default workers into or out of pension schemes, then it is possible that this will not have a large effect on behaviour of pension providers (and therefore savers) unless financial incentives are provided.
- The Conservatives would like to change the rules that stop those with only a low number of years of National Insurance Contributions from qualifying for a BSP, and they would also like to make it easier for carers and individuals who take career breaks to build up contributions records.<sup>44</sup> These measures would be advantageous to individuals who currently build up low contribution records, especially if these individuals are not eligible for or do not claim means-tested benefits that would be tapered away with pension income. It is likely that a high proportion of these individuals would be women.

## **3.2 Liberal Democrat pension and saving policy**

### ***A citizen's pension***

The Liberal Democrats intend to introduce a citizen's pension for those aged 75 and over, with eligibility based on residence rather than contributions. They propose to set the rate for a single pensioner at the current level of the PCG for a single pensioner, £109.45 in 2005–06. The rate for a pensioner couple would be £167.05 in 2005–06, the same as the PCG for pensioner couples. The current BSP would continue to apply to pensioners aged under 75,

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<sup>44</sup> This would build on changes made when S2P was introduced.

though the Liberal Democrats aspire to extend the citizen's pension eventually to all pensioners.

The Liberal Democrats have chosen to focus resources on the oldest pensioners because they tend to be the poorest, and targeting through means-tested benefits encounters the problem of incomplete take-up. Pensioners' incomes usually rise in line with inflation or are fixed in nominal terms. As a result, pensioners become poorer relative to average incomes as they get older. A very large proportion of the beneficiaries of the policy will be women, due to their longer life expectancies.

No single, non-disabled pensioner who meets the residency criteria could be made worse off by replacing the BSP and PC with a citizen's pension. However, some pensioners (notably those eligible for the disability premiums in the pension credit, those who do not meet the residency criteria and some pensioners in couples) could be made worse off if the PC were abolished for older pensioners. So in order to avoid creating losers from this policy, the Liberal Democrats would retain the PC (both guarantee and savings credit elements) for older pensioners. Therefore, means-testing (even beyond that resulting from council tax benefit and housing benefit) would continue amongst older pensioners, though the number of families aged 75 and over eligible for any PC would be greatly reduced under the Liberal Democrat proposal.

**Table 3. Cost of citizen's pension for older pensioners**

<i>£ million</i>	<b>2006–07</b>	<b>2007–08</b>	<b>2008–09</b>	<b>2009–10</b>	<b>Total</b>	<b>Average annual cost</b>
Spending	+3,100	+3,400	+3,700	+4,000	+14,200	+3,600
Tax revenues	–400	–400	–500	–500	–1,800	–500
<b>Net cost</b>	<b>+2,700</b>	<b>+3,000</b>	<b>+3,200</b>	<b>+3,500</b>	<b>+12,400</b>	<b>+3,100</b>

Note: Figures are in 2004–05 prices. Additional tax revenues are only estimated for 2006–07 and are assumed to be a constant proportion of the gross cost of the policy thereafter.

Source: *Hansard*, 4 May 2004, *Official Report*, c.1461–62W.

Table 3 shows an approximate costing of this policy. These figures are DWP estimates based on all older pensioners qualifying for the citizen's pension (i.e. no pensioners failing the residency test) but also assuming the PC savings credit is abolished for older pensioners. Therefore the Liberal Democrats' policy would be cheaper than this because not all older pensioners would meet the residency criteria, but offsetting this would be the additional cost of retaining the PC savings credit. Providing a citizen's pension based on residency to pensioners aged 75 or over would cost about £2.7 billion in 2006–07, rising to £3.5 billion in 2009–10. The Liberal Democrats hope to be able to extend the citizen's pension to all pensioners eventually. However, this would hugely increase the cost of the policy. For example, just to provide a citizen's pension at the level of the PCG to all individuals aged 70 and over (or couples where one individual is aged 70 or over) would cost £6.3 billion in 2006–07, rising to £6.7 billion by 2009–10.<sup>45</sup>

The effect of this policy on retirement saving by current workers is, initially at least, likely to be small. Were the citizen's pension to be extended to all pensioners, there would be a large reduction in the number of pensioners entitled to means-tested benefits. For many individuals,

<sup>45</sup> *Hansard*, 22 June 2004, *Official Report*, c.1309W

this would increase the reward to each pound saved for retirement and hence would increase incentives for these individuals to undertake such saving. However, working in the opposite direction is the fact that providing a citizen's pension to all pensioners would increase the amount of income provided by the state in retirement, which would serve to reduce the need for individuals to save for their retirement. Since, initially at least, the citizen's pension is only intended to be provided to pensioners aged 75 and over, any impact on retirement saving is likely to be small, as working-age individuals who expect to be shifted off means-tested benefits as a result of the reform might well expect to be eligible for means-tested benefits prior to reaching age 75.

### **Long-term care**

The Liberal Democrats propose providing free long-term care to those aged 65 and over who need it (which already exists in Scotland) and for disabled people across the UK. They estimate that this policy would benefit 70,000 individuals at an annual cost of £1.7 billion in 2007–08, rising to £2.0 billion in 2009–10. Although this policy would have some effect on the incentives for current workers to save, it is not clear that this would result in large changes in saving behaviour. The measure would mean that individuals would have less need of precautionary savings to guard against the contingency of needing residential care in old age. On the other hand, it represents a reduction in means-testing; however, it is only if individuals were saving less due to the possibility of being means-tested for personal care in old age that this could have a positive effect on saving.

### **Others**

- The Liberal Democrats have said that they would ‘make occupational schemes “opt out” schemes rather than “opt in” schemes and allow companies to make membership of their company scheme a condition of employment’.<sup>46</sup> They would also like to establish a ratings system for occupational schemes so that individuals deciding whether or not to join a scheme can easily see an indicator of the strength of the scheme. The idea of such measures would be to try to increase the number of people holding employer pensions, but there are potential drawbacks. For example, it is possible that making schemes ‘opt-out’ rather than ‘opt-in’ could increase the costs of providing an employer pension for companies that are currently choosing to have their scheme set up so that employees have to deliberately ‘opt in’. Allowing firms to make membership of schemes a condition of employment could make those who are currently choosing not to join their employer's pension scheme for a good reason worse off. If the employer schemes are final salary schemes, such a policy might reduce labour market mobility and hence reduce economic efficiency.<sup>47</sup>
- The Liberal Democrats would introduce a new National Savings Pension account if they were elected. This new no-frills pension account would probably have little aggregate effect on the overall take-up of private pensions. Nonetheless, if this account is more suitable or accessible to some individuals than current pension accounts, then its

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<sup>46</sup> Page 5 of Liberal Democrat 2005 Manifesto for Older People (<http://www.libdems.org.uk/media/documents/policies/OlderPeopleManifestoWord.doc>).

<sup>47</sup> The objective of increasing labour market mobility was a stated reason in the 1986 Social Security Act for allowing individuals to be able to choose not to join their employer's scheme.

existence could significantly improve the well-being of some people who would choose to save in this way.

- In common with the Conservatives, the Liberal Democrats have said that they would abolish regulations that compel people to annuitise their pension wealth (over and above any tax-free lump sum) by the age of 75. For a brief discussion of this, see the subsection *Others* in Section 3.1.

## 4. Conclusion

There has not been a consensus between the main parties over the broad direction of state pension reform since the Social Security Act of 1975. That is not to say that the parties' positions have not changed. It was a Conservative government that, in 1981, linked increases in the basic state pension to growth in prices rather than to the greater of growth in prices or earnings. The opposition Labour Party remained in favour of linking increases in the BSP to growth in earnings right through until the General Election of 1992. In government, Labour has pursued the strategy of price indexing the BSP, while the now opposition Conservative Party is proposing that the earnings link be restored.

During the 1980s and 1990s, the Conservatives were concerned with ensuring that the state pension system was financially sustainable. The concern has now switched to whether the UK pension system will provide individuals with adequate incomes in retirement. To date, Labour believes that the current system can achieve this as long as individuals are armed with greater information about the consequences of their saving choices. Substantial additional resources have also been targeted on low-income pensioners who take up the benefits to which they are entitled. In contrast, both the Conservatives and (to an even greater extent) the Liberal Democrats believe that a large increase in non-means-tested support for pensioners is required to boost pensioner incomes and limit the scope of future means-testing. This would increase the reward to saving for many individuals, as would the Conservatives' policy to provide additional support to some funded pension saving.

## Appendix. Conservative proposal to increase support for pension saving

The Conservatives have announced that, if elected, they would cut taxes by £4.0 billion in 2007–08. Of this, they have allocated £1.7 billion to increasing support for individual contributions to funded pension schemes where these contributions attract relief at the basic rate of income tax. Currently when a non-higher-rate taxpaying individual makes a personal contribution to a pension that attracts tax relief, they receive 22p of relief for every 78p they contribute. The Conservatives' proposal would add another 10p government contribution, but only when such contributions are made to funded pension schemes.

Under the Conservatives' proposal, contributions made on individuals' behalf by employers, those that attract higher-rate relief and those made to unfunded public sector pension schemes would not qualify for the additional support.

### **Q1. Who would win from this policy?**

Individuals who contribute to pensions that qualify for this support, and who are not higher-rate income taxpayers, would be gainers from this policy. The Conservatives estimate that around 10 million individuals are in this position. These individuals would receive more financial support for their personal contributions to their pension than they would under current arrangements for tax relief. This means that the same amount of pension saving would achieve a larger amount of pension wealth.

Some of the individuals who receive this support might not have contributed as much, or at all, to a qualifying pension in the absence of the policy. The fact that these individuals would have chosen to change their behaviour suggests that they have only done so because they are made better off. Hence one can argue that all individuals who do not pay income tax at the higher rate and who would contribute to qualifying pensions after the reform would be made better off by this policy change. (In addition, those higher-rate taxpayers who contribute more to a funded pension than the amount by which their income exceeds the higher-rate threshold also receive basic-rate relief on part of their pension contribution and therefore this part of their pension saving would be eligible for increased support.)

### **Q2. Who would lose from this policy?**

There would be no losers from this policy. One potential group of losers could have been higher-rate taxpayers making individual contributions to personal or stakeholder pensions. At present, the tax system operates in such a way that these individuals automatically receive basic-rate tax relief on their personal contributions to their pension, and claim back the balance of (higher-rate) relief that they are due at the year-end. Were this policy to operate in such a way that higher-rate taxpayers automatically received basic-rate tax relief plus 10% on their individual contributions, then these individuals would have less money to claim back at the year-end. Since the money that is claimed back at the year-end can be used as an individual chooses, but payments that are automatically credited are locked into a pension fund, this reduction in money claimed back would leave individuals with less resources to spend on buying goods and services. In order to free up extra resources to spend, some higher-rate taxpayers might in this situation choose to cut their pension contributions (and so qualify for less tax relief). The Conservatives have said that they will design the policy in a way that avoids these individuals losing. While no details have been released for how this might be achieved, designing the scheme in this way could lead to extra complexity in the administration of personal and stakeholder pensions.

### **Q3. How much would the policy cost?**

The Conservatives have allocated £1.7 billion to pay for this policy and believe that they have costed it ‘prudently’.

The policy is targeted on contributions made to funded pension schemes that attract relief at the basic rate of income tax. This targeting and the paucity of information available on pension contributions make it difficult to cost the policy accurately.



By making a number of assumptions, the Conservatives estimate that if individuals do not change their behaviour, the policy would cost £1.0 billion a year to implement. The assumptions made do not seem unreasonable. Rough calculations using figures from the Inland Revenue suggest that the total income of non-higher-rate taxpayers is around £440 billion. The Conservatives' £1.0 billion costing is consistent with around 2½% of this income being paid by individuals into funded pension schemes, which does not seem unreasonable.<sup>48</sup>

The cost would also depend on the extent to which those individuals affected by the policy would respond to the increased incentive to contribute to a qualifying pension. This is extremely difficult to estimate in advance, but the Conservatives have allocated an additional £0.7 billion, which, on the basis of the £1.0 billion estimate outlined above, would allow for a potential 20% increase in pension contributions. This would be a large increase in contributions; a smaller increase in contributions would reduce the cost of the policy (see Q5 below).

#### Q4. What would be the effect on defined benefit pensions?

The policy would make a given pension promise cheaper to deliver. Hence it would strengthen the position of funded defined benefit pension schemes, and hence could lead to some individuals receiving higher pension income in retirement than would be the case in the absence of the policy. This could also have the knock-on effect of reducing claims on the Pension Protection Fund.

The policy might also create some extra administrative burden on defined benefit pension scheme providers, since it would become necessary to measure the amount of contributions to a scheme that would qualify for the additional financial support. Providers of defined benefit schemes would presumably welcome the extra financial support provided through this policy, but would also favour attempts to minimise its administrative burden.

#### Q5. Would the policy lead to increased pension saving?

One aim of this proposed policy might be to increase the amount of funds flowing into funded pensions. The increased support to pension saving would have two effects on incentives to save in a pension which work in opposite directions. Were it to be introduced, the reform would increase the amount of pension wealth that could be bought by each pound of personal income allocated to pension saving; this substitution effect would increase the incentive to save in a funded pension. On the other hand, the reform would also mean that an individual could achieve the same final pension wealth by allocating less of their personal income to pension saving; this (lifetime) income effect would tend to decrease personal saving in funded

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<sup>48</sup> Table 2.5 of *Inland Revenue Statistics* ([http://www.inlandrevenue.gov.uk/stats/income\\_tax/table2-5.xls](http://www.inlandrevenue.gov.uk/stats/income_tax/table2-5.xls)) shows that individuals with incomes below £30,000 a year have a total income above the personal allowance of £366 billion. Adding in half of the income above the personal allowance of those with incomes between £30,000 and £50,000 (to approximate those with incomes below the higher-rate threshold) gives a total income above the personal allowance of those earning below the higher-rate threshold of £439 billion. To support all of this income by 10% would cost £44 billion. Hence for the Conservatives' costing to be correct  $\frac{1}{44}$  of this income must constitute individual contributions to funded pensions (i.e. 2.3%). Another problem with this estimate is that it includes contributions from higher-rate taxpayers which only attract relief at the basic rate of income tax.

pensions. While these competing effects mean that it is unclear how *individual* contributions to qualifying pensions would respond to this policy, the extra government contributions would mean that *total* contributions to qualifying pensions would almost certainly not be reduced, and would probably be increased, were this policy to be introduced.

The reform would also increase the attractiveness of contributing to a qualifying pension to non-higher-rate taxpayers who do not currently save in this way: the reform would make such contributions more attractive relative to spending on current consumption and also relative to other forms of saving. To the extent that the reform resulted in people shifting wealth that would otherwise have been saved in other assets, personal contributions that attract the support would not actually be new saving, although they could still represent new pension saving if the money would otherwise have flowed into non-pension assets. Although funds that were reshuffled in qualifying pensions rather than being saved elsewhere would not be new savings, they would still attract financial support and so – provided the government support is more costly than any reliefs that would have been due for other forms of saving – increase the cost of this policy. Furthermore, funds that were reshuffled from non-qualifying to qualifying pensions would not even be new pension savings – for example, a basic-rate taxpaying teacher who, instead of purchasing added years in her unfunded final salary scheme, chose to make a contribution to a stakeholder pension would simply be shuffling savings from one form of pension to another.

Table A1. Funds flowing into funded pensions under Conservative plans

Change in individual contributions to qualifying pensions	Amounts per year (£ billion)				
	New individual contributions	Financial support for new contributions (32p for each 78p of individual contribution)	New financial support for current contributions	Implied total cost of policy	Implied total new funds in qualifying pensions
-9.1%	-0.71	-0.29	1.00	0.71	0.00
0%	0.00	0.00	1.00	1.00	1.00
10%	0.78	0.32	1.00	1.32	2.10
<b>Conservatives' assumption ≈ 22%</b>	<b>1.71</b>	<b>0.70</b>	<b>1.00</b>	<b>1.70</b>	<b>3.41</b>
30%	2.34	0.96	1.00	1.96	4.30

The Conservatives have estimated that this policy would imply a £1.0 billion cost of extra support for existing contributions to funded pensions, which implies that there are currently around £7.8 billion of such contributions attracting £2.2 billion of tax relief. Under the assumption that this is correct, Table A1 illustrates the annual cost of this policy, and its impact on balances in funded pensions, for a range of scenarios concerning how the level of individual contributions would be affected by the new financial support. One way to summarise the information in the table is that under the policy envisaged, an extra £1 billion



of individual contributions to qualifying pensions would lead to an extra £410 million<sup>49</sup> of state support for these contributions and so an extra £1.41 billion of deposits into qualifying pensions to be added to the £1 billion of extra state financial support paid for current contributions.

In more detail, the first row of the table indicates that if no new savers were attracted to qualifying pensions, and if current savers aimed to keep their total pension contributions at the level they would have achieved without the new support, then this implies a cut of slightly more than 9% (from £7.8 billion to around £7.1 billion) in individual contributions to qualifying pensions. The fourth row of the table (highlighted in bold) corresponds to the Conservatives' main costing of the policy. This envisages a total of £1.7 billion of new individual contributions to qualifying pensions due to this policy, which may come from existing contributors increasing payments or from savers who are new to qualifying pensions. With such a response, the total cost of financial support to contributions to qualifying pensions would be increased by £1.7 billion, and there would be a total of £3.4 billion per annum of new funds flowing into qualifying pensions. This costing implies an increase in personal contributions of slightly over 20%. This seems quite a strong response, which suggests that the costing provided is quite cautious (i.e. high), although a lower costing would correspond to less success in attracting funds to funded pensions. Furthermore, the response could be quite strong if the policy generates the kind of reshuffling of assets discussed earlier. The possibility of a strong response explains why we have included a row in the table to show the implications if the policy were to increase individual contributions by 30%.

## Q6. Would the policy lead to increased national saving?

The last column of Table A1 indicates how much extra money might flow into qualifying pensions under different assumptions about the responses of private savers to this potential policy. However, not all of this could be considered as new national saving. Part of it represents state financial contributions. If this policy were not introduced, these contributions would not need to be paid and the funds could instead be used to reduce the national debt. Furthermore, even the new individual contributions could not all be seen as new national savings if some of these contributions would, in the absence of the policy, be saved in other assets. Since there exist assets that are quite close substitutes for pensions, this reshuffling could be quite strong and the contribution of the policy to national saving could be correspondingly small.

## Q7. What does all this mean for ensuring adequate pensions?

Even if the policy does not add a huge amount to national saving, it might add rather more to total pension saving. It could therefore help some individuals to ensure that they have adequate provision for their retirement, but certain provisos must be noted. First, if the policy were not introduced and instead national debt were reduced, then this could free extra resources for future spending on state pensions to ensure adequate provision. Extra provision through saving now may be preferred if this offers a better guarantee of future pension

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<sup>49</sup> This is £1 billion  $\times$  (32/78).

incomes than current policy promises. On the other hand, future policy changes could erode the value of future pension incomes even if these are derived from savings in funded pension schemes; pensioners' incomes could, for example, be taxed more heavily than is currently expected. Second, it may be that many of the individuals who would end up with a little extra pension provision because of this policy would have ensured themselves reasonably good retirement incomes even in the absence of the policy.

### **Q8. Would the policy create an incentive to convert employer contributions into employee contributions?**

At present, employer contributions to pensions are financially more favoured than employee contributions because they are exempt from employee National Insurance contributions (the main rate of which is 11%) and employer National Insurance contributions (the main rate of which is 12.8%).<sup>50</sup> Those individuals affected by the policy would see an increase in the attractiveness of making individual pension contributions relative to having contributions paid on their behalf by their employer (perhaps as part of a salary sacrifice arrangement). However, the new support would not completely offset the advantages of employer contributions that are due to the system of National Insurance contributions. Therefore we might not expect to see a big shift from employer contributions towards employee contributions due to this policy.

### **Q9. This is a very complicated policy – can we expect individuals to understand it and respond to it?**

Basic-rate taxpaying individuals would not need to understand all the complexities in order to understand that they would receive additional support worth an extra 10% (of their personal gross contribution) under the Conservatives' policy. Moreover, those advising individuals on their pension decisions should be able to understand the policy. An alternative, but very similar, policy that the Conservatives might want to consider would be to make individual contributions to funded pensions exempt from employee National Insurance contributions. This might have advantages in terms of greater simplicity, although the overall cost of this alternative policy could be somewhat different from the cost of the current proposal.<sup>51</sup>

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<sup>50</sup> Those individuals whose earnings are above the upper earnings limit (UEL) currently pay employee NI contributions at a rate of 1% on their earnings above the UEL, and employer contributions to a pension paid on their behalf receive relief at that rate. While this relief on employer contributions would not be worth as much as the 10% support available on individual contributions (to funded pension schemes which attract basic-rate relief) under the Conservatives' proposal, these employer contributions do also attract relief from employer NI contributions at a rate of 12.8%. Therefore the employer and the employee could still both be financially better off if the employer continued to make the contribution, as long as part of the saved employer NI was transferred to the employee.

<sup>51</sup> The main rate of employee NI is 11%, which is higher than the 10% support proposed by the Conservatives. Moreover, those higher earners who pay employee NI at a rate of 1% at the margin would also benefit from the change. This would be at least partially offset by the fact that those earning above the UEL but who receive basic-rate relief on some of their pension contributions would receive support of 1% instead of 10%. In addition, those earning below the lower earnings limit (LEL) and those not in paid work would not benefit from this alternative policy.