

ACHIEVING SIMPLICITY, SECURITY AND
CHOICE IN RETIREMENT?
AN ASSESSMENT OF THE GOVERNMENT'S PROPOSED PENSION
REFORMS

Carl Emmerson
Matthew Wakefield

Achieving Simplicity, Security and Choice in Retirement?

An Assessment of the Government's Proposed Pension Reforms

Carl Emmerson and Matthew Wakefield*

Institute for Fiscal Studies

April 2003

1. Introduction

On 17 December 2002, the government published a Department for Work and Pensions Green Paper about 'working and saving for retirement'¹ and a set of Inland Revenue proposals for reforms to the tax treatment of private pensions.² Of the options explored in the two papers, it is claimed that 'these 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' (DWP Green Paper, Summary, 66, 10).

The perceived need for yet more reforms to the UK pension system seems to stem from the government's belief that 'perhaps 3 million people are seriously under-saving (or planning to retire too soon)' and that 'a further group of between 5 and 10 million people may want to consider saving more or working longer' (DWP Green Paper, 3, 16, 36). In this Briefing Note, we discuss whether or not the proposed reforms are likely to help individuals to make choices about how to provide for their retirement that are appropriate to their circumstances. We focus particularly on whether or not the proposals might prompt those individuals who are not thought to be providing sufficiently for their retirement to save more each year or to retire at an older age than might otherwise have been the case. This would help alleviate concerns about underprovision.

The structure of our discussion is as follows. Section 2 describes the main proposed reforms. Section 3 discusses whether they are likely help individuals to make saving

* *Address for correspondence:* Institute for Fiscal Studies, 7 Ridgmount Street, London, WC1E 7AE or email Carl_Emmerson@ifs.org.uk or Matthew_Wakefield@ifs.org.uk. This Briefing Note is a written submission to the Department for Work and Pensions and the Inland Revenue as part of their recent consultation process on pension reform. Financial support from the ESRC-funded Centre for the Microeconomic Analysis of Public Policy at IFS (grant number M535255111) is gratefully acknowledged. The authors would like to thank Robert Chote for useful comments. Any errors and all opinions expressed are those of the authors.

¹ Department for Work and Pensions, *Simplicity, Security and Choice: Working and Saving for Retirement*, Cm. 5677, The Stationery Office, London, 2002 (www.dwp.gov.uk/consultations/consult/2002/pensions/gp.pdf). Hereinafter, references to this document will be contained in the main text in the form: DWP Green Paper, chapter, paragraph(s), page(s). A technical paper was also published alongside the Green Paper: Department for Work and Pensions, *Simplicity, Security and Choice: Technical Paper*, Department for Work and Pensions, London, 2002 (www.dwp.gov.uk/consultations/consult/2002/pensions/tech.pdf).

² Inland Revenue, *Simplifying the Taxation of Pensions: Increasing Choice and Flexibility for All*, The Stationery Office, London, 2002 (www.inlandrevenue.gov.uk/consult_new/pensions_consult.pdf). Hereinafter, references to this document will be contained in the main text in the form: IR, chapter, paragraph(s), page(s).

decisions that are appropriate to their circumstances. Section 4 looks at how the reforms might affect retirement ages. Section 5 concludes.

2. The government's proposals

Both the Department for Work and Pensions and the Inland Revenue have put forward a number of proposed reforms. This section does not aim to provide an exhaustive description, but instead focuses on the main reforms intended to affect the retirement and saving decisions of individuals.

We split the reforms into two broad categories. First, we consider those that might make it easier for individuals to understand the implications of their current plans for saving and retirement. Subsequently, we will consider those reforms that will directly change the way that the current institutional system affects individuals and thereby alter the way that their saving and retirement behaviour generates income in retirement. There is overlap between these two broad categories. Reforms that simplify the current system will mainly be discussed under our first subheading, alongside those that are intended to improve information flows. We will point out where these simplifications will directly affect certain groups of the population. It turns out that the groups most likely to be directly affected are often not those for which the government believes the problem of underprovision is most serious.

2.1 Reforms primarily aimed at simplification and increased information

The Department for Work and Pensions Green Paper suggests a number of proposals aimed at providing individuals with greater information about the consequences of their retirement saving decisions. For example:

- Campaigns to increase financial literacy and understanding, including providing information via new electronic media such as the internet and interactive digital television (DWP Green Paper, 3, 39, 41–42).
- Providing individuals with regular statements of their expected retirement income from state pensions (DWP Green Paper, 3, 43, 43).
- The possibility of providing individuals with combined pension forecasts – that is, including projections of all sources of state and private pension income (DWP Green Paper, 3, 45–49, 43–45).
- Rebranding tax relief. Instead of being described as 22p for every 78p a non-higher-rate taxpayer contributes, it will be phrased ‘for every £1 an individual contributes to a personal or stakeholder pension, the Government provides an additional 28p’ (DWP Green Paper, 3, 37, 41).
- Implementing many of the proposals from the Sandler Review,³ such as the creation of a suite of simple and highly regulated products. The intention is that consumer

³ HM Treasury, *Medium and Long-Term Retail Savings in the UK: A Review*, HM Treasury, London, 2002 (www.hm-treasury.gov.uk/documents/financial_services/savings/fin_sav_sand.cfm).

protection can be provided through high regulation of the products, allowing less-stringent regulation of the sales process (DWP Green Paper, 5, 37–52, 85–87).

In addition, the Inland Revenue proposals involve replacing the current eight different systems for the taxation of private pensions with one unified system (IR, 4, 4.1–4.33, 13–18). The intention will be to treat all schemes the same regardless of when they were first taken out and regardless of whether they operate on a defined benefit or a defined contribution basis. Many individuals might not benefit directly from this simplification – for example, they may not be aware of the current complexities or they may only be covered by one of the pension tax systems. On the other hand, many providers of pensions – for example, those offering occupational pension schemes that fall under different regimes – might be able to make administrative savings. Indeed, the government estimates that the proposed simplification could reduce ‘compliance costs by at least £80 million each year’ (DWP Green Paper, 3, 28, 39).

The existing earnings cap on pension contributions – which applies in personal and stakeholder pensions and in post-1989 occupational pensions and restricts annual contributions to be at most a given (age-related) proportion of earnings up to £97,200 (in 2002–03) – is to be significantly relaxed, as a new lifetime limit on the amount of tax-relieved pension funds that an individual can accumulate will be introduced. This will apply regardless of the kind of pension scheme that an individual has. It is proposed to set this lifetime cap, at least initially, at £1.4 million. Individuals will be allowed to accumulate pension funds that are larger than this, but will face a recovery charge which is intended to ‘neutralise the tax relief given initially on contributions and then on the growth of funds during investment’ (IR, 4, 4.13, 15).

Within this lifetime cap and in all kinds of pension schemes, there will also be a new annual limit on contributions set at the greater of £3,600 and 100% of earnings, up to some overall maximum. It is suggested that this maximum could initially be set at £200,000 a year. Individuals will be allowed to contribute more than this to a private pension in one year if they wish, but will face an income tax charge on the excess through the self-assessment system (IR, 4, 4.22, 16). It appears that the government hopes that this annual limit is only a temporary measure and that it will be removed if other mechanisms, such as mutual assistance arrangements with other countries, can restrict the possibilities for tax leakage.⁴

The DWP Green Paper states that this new £200,000 annual limit will apply to ‘increments of value to an individual’s pension fund’ (DWP Green Paper, 3, 27, 39). In its fullest explanation of the rule, the Inland Revenue document suggests that the annual limit ‘must take into account

- someone’s total contributions into defined contribution (DC) schemes; and
- the whole annual increase in the value of their defined benefit (DB) pension rights in any scheme sponsored by their employer’ (IR, 4, 4.20, 15).

⁴ Tax leakage might occur when, for example, funds flow through UK pensions from overseas and receive tax relief without the appropriate income tax ever being paid.

Hence the two documents seem to agree for the case of DB pension schemes, but seem to be inconsistent in the case of DC pension schemes. It would be helpful if this confusion could be cleared up.⁵

The objective of this new regime is to ensure ‘the same tax treatment for defined benefit (DB) and defined contribution (DC) pension schemes’ (IR, 4, 4.5, 13). In practice, it does not seem that the proposals, at least as they are described in the Inland Revenue document, will achieve this. An individual with a DC pension scheme could be allowed to contribute £200,000 a year tax-free to their scheme. This means that, after five years, the total value of their pension fund would be £1 million *plus* any return received on the fund. In a DB scheme, somebody could only accrue a maximum of £1 million tax-free over five years, as the £200,000 annual limit applies to the ‘whole annual increase’. Given the stated and sensible objective of not distorting the choice between DC and DB schemes, the government needs to ensure that the annual limit is of equal value in both kinds of scheme. If it does not do this, then individuals with high-value DB pensions would have an incentive to move their funds into DC schemes in order that the annual return on the fund no longer counts against their annual contribution limits.

The new limits will constrain some individuals: in particular, those who are currently contributing to pre-1989 occupational pension schemes will now face limits on the amount of tax-relieved pension saving that they can do, for the first time. Some individuals – primarily those who are approaching the lifetime fund cap – with personal or stakeholder pensions or post-1989 occupational pensions will also find that the new limits are less generous than the existing rules. However, for most individuals, the new annual limits will increase the amount that they are allowed to contribute to their pension fund in a particular year – indeed, the DWP estimates that ‘over 99 per cent of people saving in pensions would be able to save more in a tax-relieved pension’ (DWP Green Paper, 3, 28, 39).⁶ The £200,000 annual limit and the £1.4 million lifetime limit are set at such high levels that anybody who is constrained by them would be unlikely to be considered to be underproviding for their retirement. The government estimates that ‘only some 5,000 people have personal pension schemes worth more than £1.4 million’ (IR, 4, 4.31, 18). This excludes those who have occupational pensions or a combination of occupational pensions and personal pensions that are worth more than £1.4 million. Turning to the annual limit, the government estimates that ‘probably fewer than 1,000 will be affected’ (IR, 4, 4.31, 18).

2.2 Reforms that directly affect the way individuals are treated

The government’s proposals also include a number of measures that would directly affect the way that many individuals are treated by the current UK institutional arrangements. In many cases, the proposals do not affect the way retirement incomes are calculated, but

⁵ The press release issued by the Inland Revenue on 17 December 2002, ‘Simplifying the taxation of pensions’ (www.gnn.gov.uk/gnn/national.nsf/IR/27926DD29D09B22480256C930032C36A?opendocument), is also unclear, stating that the annual limit will apply to ‘inflows of value to an individual’s pension fund’.

⁶ It should be remembered that this statistic is not measuring the percentage of pension savers who are constrained by current rules and who might save more each year under the new rules; hence it would not be correct to state that 99% of pension savers materially gain from the government’s proposals, as many are not constrained by the existing limits.

rather the ages at which people can take certain benefits or the incentives for older people to work. Proposals affecting people who are below state pension age tend to make the system less generous, while those affecting older people tend to make it more generous.

One benefit qualification age that the government has decided not to alter is the state pension age.⁷ The government has listed a number of possible arguments against this policy option (see DWP Green Paper, 6, 44–52, 102–104). For example, it highlights that increasing the pension age would not automatically increase the age at which people retire, as is indicated by the fact that ‘two-thirds of men have stopped working by the time of their sixty-fifth birthday’ (DWP Green Paper, 6, 46, 103). The government does suggest that it might consider the merits of replacing the universal pension age with an individual-specific pension age, perhaps linked to years of labour market participation (DWP Green Paper, 6, 50, 103).

There are firm proposals to increase the ages at which other benefits can be claimed. The age at which men and women can become eligible for the minimum income guarantee (which, from October 2003, will be rebranded the pension credit guarantee) is set to increase from 60 to 65 between 2010 and 2020.⁸ This will mean that, in the future, individuals in this age range and on low incomes can only be eligible for the less-generous income support, and will also be subject to the same job-search requirements as younger individuals in receipt of income support.

The generosity of pension schemes provided to public sector workers is to be reduced by raising the age at which an individual can receive an unreduced pension from 60 to 65, ‘initially for new members’ (DWP Green Paper, Summary, 50, 8). The statutory minimum age at which individuals can receive income from a private pension will be increased from 50 to 55 (DWP Green Paper, 6, 61, 105).⁹

The main proposal affecting people above state pension age is to increase the generosity of the incentives for individuals to defer receipt of their state pension. Currently, an individual’s initial benefit entitlement is increased by 1% for every seven weeks of deferral, and this is set to change to 1% for every five weeks. This change was to be introduced in 2010, but the government now expects to bring this forward to 2006 (DWP Green Paper, 6, 40, 101). It also proposes allowing individuals who defer their state pension to choose between receiving a permanently higher state pension and receiving an equivalently valued taxable lump sum (DWP Green Paper, 6, 41, 102).

⁷ The age from which the basic state pension, graduated pension, SERPS and the State Second Pension can be received. It is currently 65 for men, and for women it will increase from 60 to 65 between 2010 and 2020.

⁸ This is the meaning of DWP Green Paper, 6, 35, 101. The savings credit part of the pension credit will be introduced in October 2003 as a payment that is only available to families containing an individual aged 65 or above. For more details, see T. Clark, *Rewarding Saving and Alleviating Poverty? The Final Pension Credit Proposals*, IFS Briefing Note 22, London, 2002 (www.ifs.org.uk/pensions/bn22.pdf).

⁹ Currently, a small number of individuals in certain occupations – for example, models, professional footballers, skiers (downhill) and trapeze artists – can claim their private pension before 50 (at 35, 35, 30 and 40, respectively). This will no longer apply: in the new regime, all individuals (except for those with severe health problems) will have to be at least 55 before they can start to claim income from a private pension.

The government has also proposed increasing the amount of choice that individuals have over how to receive their pension benefits, as those who choose to save in a pension will no longer be required to purchase an annuity by age 75. It will still be the case that ‘once any lump sum has been drawn, the remainder of matured pension savings must be used to provide pension income’ (IR, 5, 5.24, 23). While individuals do not have to purchase an annuity, they will have to draw an income from their pension fund. On death, the fund cannot be bequeathed, but it can be used to pay survivors’ benefits. (See IR, Technical Appendix B, B71–B73, 47 for more details.) Another relaxation of the annuitisation rules is that trivial commutation is to be extended: individuals who reach age 65 with total private pension assets of no more than £10,000 will be allowed to take the full amount as a lump-sum payment, one-quarter of which will be tax-free (DWP Green Paper, 5, 67, 90).

Alongside changes to the ages at which individuals become eligible for certain types of pension or benefit income, the government has proposed other measures that might more directly affect the labour-supply decisions of older people. The Green Paper proposes introducing or piloting several schemes intended to help older individuals to return to work after periods of inactivity (DWP Green Paper, 6, 25–32, 99–100). As well as schemes targeted specifically at individuals aged 50 or over, the plans to reform incapacity benefit will also affect a large number of people near the top end of the working-age age range. A scheme will be piloted from around October 2003 that allows recipients of incapacity benefit who move into paid employment of more than 16 hours a week to keep £40 a week of benefit for the first year after their return to work. In fact, this is not a new proposal, but one that the DWP first put forward in November 2002.¹⁰ The original proposal was that the back-to-work bonus would be means-tested, whereas the new Green Paper describes the ‘introduction of a 52 week return-to-work payment of £40 a week to all those moving back from Incapacity Benefit to work’ (DWP Green Paper, 6, 31, 100), which suggests that the means test has now been dropped.

Other reforms are aimed at people who stay in, rather than return to, work. A proposed reform that should give some individuals more flexibility in how they move from employment and into retirement is to allow individuals ‘to continue working for the sponsoring employer while drawing their occupational pension’ (DWP Green Paper, 6, 60, 105). This is intended to help to ensure that ‘final salary schemes treat fairly those who go part-time or step down in responsibility near the end of their careers’ (DWP Green Paper, 6, 63, 106).

Measures outlawing ‘age discrimination in employment and vocational training’ (DWP Green Paper, 6, 54, 105) will also affect older people who want to work. Under the proposed measures, ‘compulsory retirement ages are likely to be made unlawful unless employers can show that they are objectively justified’ (DWP Green Paper, 6, 55, 105). Measures on age discrimination are set to be introduced in order to comply with the EU employment directive on equal treatment, and should be in place by December 2006 (DWP Green Paper, 6, 54, 105).

¹⁰ See Department for Work and Pensions, *Pathways to Work: Helping People into Employment*, Cm. 5690, The Stationery Office, London, 2002 (www.dwp.gov.uk/consultations/consult/2002/pathways/pathways.pdf).

Some proposed measures might affect younger workers as much as or more than their older counterparts. With regard to the self-employed, the government has suggested that ‘one option would be to allow the self-employed to opt to pay higher National Insurance contributions and accrue rights to the State Second Pension on a voluntary basis’ (DWP Green Paper, 3, 52, 46). With regard to the employed, the government has stated that it will also consider allowing employers to make membership of their pension scheme compulsory for all new recruits (DWP Green Paper, 4, 120, 75). Paradoxically, the very next paragraph states that individuals ‘should be able to opt out of their employer’s scheme where, for example, they are already contributing to a stakeholder pension’ (DWP Green Paper, 4, 121, 75). Clarification from the government about whether or not it actually agrees with the recommendation of the Pickering Report that ‘employers should be allowed to make membership of their pension scheme a condition of employment if they so wish’¹¹ would be welcomed. The government has proposed, in agreement with the Pickering Report, that employees should be vested into pension schemes as soon as they join; under the current rules, employees may have to be members for two years before they are able to have any secured rights (DWP Green Paper, 4, 116, 74).

In the Green Paper, there is an emphasis on the fact that the government is pursuing a ‘voluntary system’ within which individuals choose how to provide for their retirement (DWP Green Paper, Summary, 62–65, 9–10). It is intended that an ‘independent pensions commission’ will be set up to monitor ‘how effectively the current voluntarist approach is developing’ (DWP Green Paper, Summary, 64, 10). This will examine carefully whether the current environment is leading to appropriate saving decisions. In particular, it is to analyse the level of occupational pension provision, the level of personal pension savings and the level of other saving (including housing wealth) (DWP Green Paper, 2, 68, 31).

In the remainder of this Briefing Note, we offer some thoughts on whether or not the proposals just outlined would in fact help people with the task of providing for their retirement. In Section 3, we discuss how the reforms might affect the saving choices of individuals, and in Section 4, we discuss whether or not the changes might encourage individuals to retire later than would otherwise be the case.

3. Will individuals choose to save more for their retirement?

For some individuals, certain of the government’s proposals will affect the rewards from saving in a private pension. For some, the new lifetime limit on the size of a pension fund will act as a constraint on the amount of tax-relieved savings that they can have in this form. But those with funds worth more than £1.4 million, or whose pension fund is increasing by more than £200,000 in any one year, are unlikely to be thought to be those who are underproviding for their retirement.

¹¹ Page xi of A. Pickering, *A Simpler Way to Better Pensions*, Department for Work and Pensions, London, 2002 (www.dwp.gov.uk/publications/dwp/2002/pickering/report.pdf).

For the vast majority of employees, the relaxation of annual limits on pension saving will increase the amount of tax-relieved saving that they could put into their pension in any year (see Section 2.1 above, and especially footnote 6). Some individuals might respond to this by saving more in a pension, but many others might simply alter the point in their lifetime at which they contribute to a private pension. For example, the change will increase the opportunity to save in a more accessible form, such as in an Individual Savings Account, when one is young and still receive the tax relief that a pension provides by transferring the funds into a pension later in life when one is reasonably certain that the funds will not be needed for a ‘rainy day’.¹² Many could benefit from this increased flexibility and it might lead to some individuals choosing to save more. Those who are near retirement might, however, choose not to move their savings into a private pension if, for example, they experience an adverse shock, and this could reduce pension saving. Overall saving might be reduced if some feel that since they are now able to hold their retirement and precautionary savings in one easily accessible pot, they do not need to hold such a high combined balance during their working life as was required when the two assets were not fungible.

The £1.4 million and £200,000 limits on lifetime and annual contributions are designed to achieve a large-scale simplification while restricting the amount of tax relief that people can receive. After the reform, pension providers will still need to check that individuals who are contributing more than £3,600 (gross) a year into a pension are not exceeding the 100% of earnings limit. An alternative, which would simplify the system further, would be to remove the test against earnings completely, and therefore let individuals contribute whatever they want into a pension up to the overall lifetime and annual limits. This would have the administrative advantage that providers would no longer need to keep details of individuals’ earnings. The government should consider whether this change would have any undesirable consequences not considered here. Providers would, however, still need to check any other pension arrangements that the individual had, as the annual limit applies to all of an individual’s private pension schemes considered together.¹³

Instead of the £1.4 million lifetime cap, the government could consider a cap on the amount of tax-free lump sum that an individual could take from a private pension. Setting this at £350,000 (i.e. 25% of £1.4 million) would be more costly to the exchequer than the proposed system, as high-wealth individuals could receive tax-free returns on their pension saving above the proposed overall ceiling. If the government wanted to offset this additional burden on the exchequer, then it could simply set the cap on the tax-free lump sum at a lower level. Switching to the lump-sum cap would have the advantage of removing the need for the recovery charge and therefore simplify the system further. In addition, for individuals with pension funds that are approaching the proposed lifetime fund limit, this limit and the associated recovery charge would distort

¹² The tax advantages are only the same with individual, not employer, contributions due to no employer or employee National Insurance being levied on the latter. For a discussion of this retirement saving strategy, see T. Clark and C. Emmerson, *The Tax and Benefit System and the Decision to Invest in a Stakeholder Pension*, IFS Briefing Note 28, London, 2002 (www.ifs.org.uk/public/bn28.pdf).

¹³ This requirement will only exist as long as the annual limit is in place. For more details, see IR, 4, 4.23, 16.

investment decisions towards lower-risk, lower-expected-return assets. A simple cap on the size of the tax-free lump sum would remove this distortion. Again, the government should consider whether this change would have any undesirable consequences not considered here.

Saving in a private pension will become less attractive to some individuals when the minimum age at which they can receive income from their pension increases from 50 to 55. This will mean that those wanting to retire before 55 might well need either to reconsider their retirement decision or, perhaps more likely, to consider holding some of their retirement savings in a more accessible form to cover the period from retirement until they can first access the private pension, at age 55. The majority of people wanting to retire before 55 and to start drawing income from a private pension will be high-wealth individuals who will be unlikely to be considered to be undersaving for their retirement. For those on middle and lower incomes, the increase in the age at which a private pension can be drawn is likely to be less relevant.

Reforms to contribution limits, or to the age at which a private pension can be drawn, will affect the opportunities to save, and attractiveness of saving, in a private pension only for those individuals who are, or who expect to be, constrained by such limits. As we have mentioned, these are unlikely to be individuals who could be thought to be underproviding for their retirement.

It is possible that those who are currently not saving in a pension because they can only accumulate a very small pension fund will be encouraged to save in a pension as a result of trivial commutation being extended, but there is a possible pitfall of allowing individuals with pension funds of under £10,000 to withdraw these funds as a lump sum at age 65. An individual earning £10,000 or more (gross) a year with no pension savings who is one day from their 65th birthday would be able to contribute £7,800 (net) to a pension fund. After tax relief at the basic rate, this would be worth £10,000 (and therefore the individual will have contributed no more than 100% of their gross earnings). The following day, they could withdraw the fund, taking a quarter tax-free and paying basic-rate tax on the remaining three-quarters of the fund. This would leave them £550 better off than if they had not cycled the funds through a pension.¹⁴ It remains to be seen how many individuals respond to this incentive. People who have not themselves built up a pension fund because they have chosen to rely on the provision of a relatively wealthy spouse or partner might be well placed to take advantage of the opportunity, although their contribution would be restricted to a maximum of £3,600 if they were not in paid employment. Those who have been contracted into the state second-tier pension (the State Earnings-Related Pension Scheme – SERPS – or the State Second Pension – S2P) throughout their working life will have an incentive to build up a pension fund rapidly at the very end of their career if they have access to sufficient funds.

If the government were to extend the opportunity to contract into S2P to the self-employed, then this should be welfare-improving for the individuals concerned, since those who would not benefit could choose to remain outside the scheme. It is not a

¹⁴ $(1-0.22) \times \frac{3}{4} \times £10,000 + \frac{1}{4} \times £10,000 = £8,350$, compared with the £7,800 they would have had.

proposal that would be likely to increase the pension saving of the self-employed. Individuals who opted in would presumably be taking advantage of the fact that those with low qualifying incomes accrue S2P rights that are generous in relation to their National Insurance contributions. Hence, the proposal would give the self-employed the opportunity to boost their lifetime resources by contributing to S2P during years when their income from profits is low. This would reduce the need to save for a pension either from this low income or during years of high income when there would be less need to save to cover for low saving during lean years. The proposal would be of benefit not only to those self-employed people with consistently modest income, but also to those with volatile profits who could contract into S2P during low-profit years. If those with volatile incomes have lifetime resources that are high relative to the population at large, then it might be thought that helping them does not accord with the redistributive spirit of S2P. On the other hand, the proposal would give greater assistance to those with consistently low incomes who would contract in most frequently.

To help the voluntary approach to pension provision to function more effectively, proposals such as those just mentioned give greater flexibility and choice to individuals. It would sit oddly with this approach to allow employers to make membership of their occupational pension schemes a condition of employment. While some individuals might benefit from this proposal, those who would choose not to join their employer's pension scheme for appropriate reasons (e.g. that they have more pressing calls on their income such as repaying debts, or that they plan to change employer soon) will lose out. Such a measure might also impair labour market mobility.¹⁵

The main tool that the government uses to alter the financial returns to saving in a pension is tax relief, and there are no proposals to alter the rates at which relief is given: for a basic-rate taxpayer, it will still be the case that 78p saved out of net income into a pension fund will attract 22p of tax relief. While this will not be changed, the government is proposing to rebrand it so that individuals start to think of this as a 28p government contribution to match every pound that they personally contribute.¹⁶ This rebranding is part of the efforts to simplify the pension system and to help individuals to make more informed decisions about their pension saving. Given that there is presumably no legislation stopping private pension providers from promoting tax relief in this way, it seems unlikely to have any large effect, either positive or negative.

The government has also stated that it is considering the proposals from the Sandler Review that, among other things, recommend a suite of simple, highly regulated products. Providers and individuals respectively will be free to choose whether to offer or purchase these products. If the simplicity of these products means that individuals become better informed about them than they currently are about existing products, then these proposals could lead to better saving decisions, at least in the medium term. While

¹⁵ Those who choose not to join their employer's pension scheme are subsequently more likely to change employer. For more details, see R. Disney and C. Emmerson, 'Choice of pension scheme and job mobility in Britain', IFS Working Paper 02/09, 2002 (www.ifs.org.uk/workingpapers/wp0209.pdf).

¹⁶ The figure is not 28p but $22/(1-0.22)$, which to one decimal place is 28.2p. For higher-rate taxpayers, the equivalent figure is $40/(1-0.40)$, which to one decimal place is 66.7p.

the government and the Sandler Report suggest that a simpler savings environment will lead to individuals choosing to save more, it is possible that some will respond by saving less. The groups that are likely to gain the most from the provision of simpler products might not be those that are thought to be undersaving for retirement. Evidence from the British Household Panel Survey shows that, among middle earners who do not currently contribute to a private pension, median gross financial wealth in 1995 was just £300.¹⁷ Many will also have some debts.¹⁸ Therefore an appropriate lifetime income management strategy for these individuals might be to consider paying off debts and then saving in a mini cash ISA, before going on to consider products such as equity ISAs and stakeholder pensions.¹⁹ All of these financial products are already relatively simple. Introducing new products, even if they are also simple, can create increased complexity in the short run, as individuals take time to understand them.

Turning to the government's other proposals to increase financial awareness: if individuals who are currently underproviding for their retirement have not realised the extent to which the reforms of the last twenty or so years have reduced the generosity of state pensions, then regular state pension statements might well encourage them to revise their retirement saving decisions. Supplementing these with combined statements of likely state and private pension entitlements could also help individuals to make informed decisions about how they provide for their retirement.

However, extra and clearer information will only encourage those currently 'underproviding' to save more or work for longer if their behaviour is a result of poor information or understanding. It may be that individuals are making choices with full knowledge of what they can expect and that are sensible given their expectations of the pension system and their preferences for present and future consumption. Many might have noted that the system of provision for older people is tending to place a greater emphasis on means-tested benefits. The pension credit will extend means-tested benefits further up the pensioner income distribution. It is estimated that when it is introduced in October 2003, 52% of those aged 65 or over will be eligible for the pension credit. By 2025, assuming that the government's aspirations for price indexation of the basic state pension and earnings indexation of the pension credit are met, it is estimated that this could rise to 73%.²⁰

Means-tested benefits for the elderly reduce the incentive to save for retirement not only because they increase the replacement rate that people can achieve without relying on their own assets (an 'income effect'), but also because, for individuals who will be on the benefit taper in retirement, they reduce the amount of extra retirement income that will

¹⁷ See table 5.2 of J. Banks, R. Blundell, R. Disney and C. Emmerson, *Retirement, Pensions and the Adequacy of Saving: A Guide to the Debate*, IFS Briefing Note 29, 2002 (www.ifs.org.uk/pensions/bn29.pdf).

¹⁸ For details of the distribution of financial assets and debts, see J. Banks, Z. Smith and M. Wakefield, 'The distribution of financial wealth in the UK: evidence from 2000 BHPS data', IFS Working Paper 02/21, 2002 (www.ifs.org.uk/workingpapers/wp0221.pdf).

¹⁹ See, for example, paragraph 3.2, page 9 of HM Treasury, *Saving and Assets for All*, The Modernisation of Britain's Tax and Benefit System 8, HM Treasury, London, 2001 (www.hm-treasury.gov.uk/media//71C90/36.pdf).

²⁰ T. Clark and C. Emmerson, *The Tax and Benefit System and the Decision to Invest in a Stakeholder Pension*, IFS Briefing Note 28, 2002 (www.ifs.org.uk/public/bn28.pdf).

be provided by each extra pound accumulated in a pension fund (a 'price' or 'substitution' effect). It seems likely that many of those whom the government identifies as potentially underproviding for their retirement will have lifetime resources that will put them in the middle part of the income distribution once they retire. These are precisely those people who could be floated into entitlement for means-tested retirement benefits as the pension credit system evolves, and the choice to devote relatively few resources to retirement saving may be a response to the expectation of this eligibility.

Although not necessarily an effective method to tackle all the reasons why people might provide 'too little' for their retirement, it is very difficult to argue that providing information and financial education to help individuals make more informed choices about saving and retirement is a bad proposal. The government might want to consider a full-scale evaluation of the different kinds of information and education offered, to try to establish what the most cost-effective policy is. As part of such an evaluation, it would be interesting to observe how individuals respond to the proposed reforms that could simplify the pension system and improve the information on the basis of which they make their saving decisions. For example, it is possible that some individuals currently use the pension contribution limits as a guide to what they should contribute to deliver a good retirement income, and it would be interesting to see how such individuals respond once contribution limits are no longer measured as a percentage of earnings. If the impact of such factors could be identified, then this would be informative about how people are making their saving decisions and about what policies help people to make sensible decisions about how to provide for their retirement. Any new 'pensions commission' should consider any such evaluations and analyses in order to aid its deliberations on whether or not the various incentives provided by the system of financial support for pensioners can be compatible with a largely voluntary system as a means of providing adequate incomes to the retired population.

4. Will individuals work longer?

As described in Section 2, the DWP Green Paper contains a number of measures aimed at extending individuals' working lives. The focus on labour market issues alongside saving behaviour is very welcome, as individuals could boost their retirement incomes either by saving more while in work or by delaying retirement and spending longer in the workforce, or through a combination of both.

Allowing individuals to continue to work for their sponsoring employer while drawing their occupational pension will in some cases remove a strong distortion in the labour market and is therefore very welcome. Currently, individuals might have to change employer in order to work and draw an occupational pension. Many might prefer not to change employer at the end of their career, or might find that the firm-specific skills that they have built up during a long tenure with a particular employer make it difficult for them to change jobs. For these individuals, final salary pension schemes give a very strong incentive either to work full-time or to stop work completely. The proposed change will therefore be of benefit to people who, for example, want to reduce their hours of work before fully exiting the labour market, but without changing employer or suffering a sudden drop in their standard of living. Therefore the effects of this measure

are likely to be an increase in the number of older individuals working part-time and an increase in the number of older workers. It is unclear whether this will mean that older workers (as a group) supply more hours of labour. While some might decide to delay retirement and work part-time as a result of the reform, others might decide to work part-time *instead* of working full-time. All of these individuals will be made better off by the reform in that they are able to choose options that were previously not available to them. Whether or not employers gain from the proposals will depend on how they are able to respond to the differing requirements of older individuals: those who can easily accommodate part-time working patterns might gain, while those who find it more difficult to do so might lose out.

The increase in the age at which individuals are entitled to the minimum income guarantee / pension credit guarantee will have an unambiguous positive impact on the incentive to supply labour for individuals aged 60 to 64. This is for three reasons. First, the amount of income that can be received by those out of work will be lower, and this reduced replacement rate increases the incentive to work. Secondly, the reduction in the generosity of means-tested benefits will mean that some will now face a reduced withdrawal rate because they are no longer eligible for any form of income support. This will increase the income they gain for each additional hour of paid employment. Thirdly, the likelihood that these individuals find work might be increased, since, while out of work, they will become subject to the same job-search requirements, enforced by possible benefit withdrawal for non-compliance, as younger individuals.

Increasing the age at which public sector workers can receive income from their occupational pension schemes should increase the incentive for these workers to stay in work for longer.²¹ The effect here is similar to the first identified with respect to the reform to the minimum income guarantee / pension credit guarantee qualification age, since, for those affected, the income available to them when out of work is reduced. In the short run, this effect will only be felt by a small number of people, as the proposed change is ‘initially for new members’ (DWP Green Paper, Summary, 50, 8). This phrasing leaves open the option of extending this to existing public sector workers at a later date. This would, however, involve reducing the generosity of public sector workers’ occupational pensions for those already under contract.

The reform to incapacity benefit that is to be piloted should also act to increase the labour supply of older workers. If, as the government argues, some recipients of incapacity benefit are able to work, then the proposed back-to-work bonus of £40 a week for one year will increase the incentive for individuals to try to find employment. The cost of the policy is that some individuals would have returned to work without the bonus. A full evaluation of the pilot schemes would be useful to shed light on the number of additional individuals who are induced into work by the £40-a-week payment. The government could also consider varying the £40 in different pilot areas to test whether this is the most cost-effective payment or whether, for example, £20 a week or £60 a week achieves better value for money.

²¹ Individuals who strongly want to retire before 65 might choose to save more to finance an earlier retirement, or alternatively seek employment with a private sector firm that offers a pension that pays benefits before age 65.

The proposal to increase the extra benefits paid in return for deferring receipt of state pension payments should mean that more people will choose to defer (and some will choose to defer for longer). It is not necessarily the case that all of these people will work for longer than they would have done if they had not deferred their state pension: individuals can retire before they start drawing state pensions or continue working after they have started to draw them. Some individuals might even choose to retire earlier, since the option of deferring will now allow them to build up a given stock of wealth to fund their retirement by saving less while they are in work (this is a 'lifetime income effect'). Individuals who are liquidity-constrained, and so can only retire if they receive their state pension, might be induced to retire later. They will do this if the earnings that they get for working beyond age 65 are sufficient to compensate them for the disutility of supplying this labour *only* when these earnings are combined with the newly generous reward for deferral. Another possible mechanism by which the increased deferral rate might affect retirement ages is if people see it as a signal that later receipt of pension *and* later retirement are now being regarded as more accepted options for older people.

The other major change that might affect the labour market behaviour of older individuals is the proposed introduction (by December 2006) of legislation outlawing age discrimination, including the outlawing of compulsory retirement ages unless these can be 'objectively justified' (DWP Green Paper, 6, 55, 105). It is hoped that such legislation will increase the opportunities for older individuals to enter, and to remain in, paid employment. The actual impact that it will have on the numbers of older individuals in work is difficult to judge. If employers are unjustly reluctant to hire older workers, then the introduction of age discrimination legislation could increase employment rates among older individuals by forcing employers to hire or retain them. In addition, the legislation could also play an important part in changing the attitudes of employers towards employing older individuals. This could lead to greater numbers of older individuals in paid employment. If, however, employers do not want to hire older workers because of genuine differences in their productivity on average,²² and if firms become concerned that it will be more difficult to terminate their employment subsequently, then the legislation might in practice discourage them from taking on older individuals. Empirical evidence on the impact of the introduction of age discrimination legislation in the USA (which introduced such legislation for those aged 40 to 65 as long ago as 1967) suggests that it may have had a positive impact on the employment rates of older workers.²³

5. Conclusions

Many of the proposals contained in the DWP Green Paper and the Inland Revenue consultation document are sensible. Previous pension reforms have tended to come at the cost of adding complexity to the already complex UK pension system. The latest set

²² If the productivity of each individual can be observed, then this will not be a problem. The difficulty will arise if some older workers are less productive but it is not possible for firms to identify which ones.

²³ For more details, see D. Neumark, 'Age discrimination legislation in the United States', NBER Working Paper 8152, 2001 (<http://papers.nber.org/papers/w8152>). Empirical evidence cited is from D. Neumark and W. A. Stock, 'Age discrimination laws and labor market efficiency', *Journal of Political Economy*, 1999, 107(5), 1081–1125.

of proposals achieves some simplification of the current rules and regulations, including the removal of some undesirable distortions. This is welcome.

The government's analysis suggests that some 8–13 million people might need to revise their plans to provide for their retirement. In this Briefing Note, we have looked in turn at whether or not the proposals outlined in the Green Paper might help people to make more appropriate saving decisions and at whether or not they might encourage them to work for longer, in order to provide adequately for their retirement.

In Section 3, we discussed the reforms aimed at encouraging individuals to save more for their retirement. The proposals to provide individuals with more information about the likely consequences of their current retirement saving decisions should aid more-informed choices. The government might want to consider a full-scale evaluation of different ways of providing information and education to try to establish what the most cost-effective policy is.

Turning to the proposed simplification of the tax treatment of pension saving, complexities arise in trying to design a single tax system for both defined contribution and defined benefit schemes. In practice, the single tax regime might look more like two different regimes – one for defined contribution pension schemes and one for defined benefit pension schemes – that are designed to be of equal generosity. Further attention needs to be paid to the proposals to ensure that they are equally generous in both kinds of scheme. The proposed simplification would lead to some people losing out: for example, some high-wealth individuals who have a pre-1989 occupational pension scheme will find themselves constrained for the first time by limits on how much they can contribute to a private pension. These are not individuals whom the government considers likely to be underproviding for their retirement. It is not clear how many of those who might be undersaving for retirement would be directly affected by this simplification, especially since they are unlikely to be constrained by the current contribution limits. In any case, many of the features of the proposed single system are welcome in their own right. The government should consider whether further simplification could be achieved – for example, by allowing everyone to contribute up to £200,000 a year to a private pension rather than just very high earners.

As acknowledged by the government, the proposals extend the scope for individuals to move funds from more-accessible forms of saving, such as Individual Savings Accounts, into private pensions as they near retirement. This would potentially benefit those individuals who value holding the funds in a more-accessible way. It also means that the incentive provided by the tax-free lump sum to put funds into a private pension looks increasingly as if it is not being used to encourage people to lock away their savings for a long time period (i.e. until retirement), but rather as if it is being provided in order to ensure that people convert their assets into an income stream once they retire.

Section 4 of this Briefing Note considered the measures aimed at increasing retirement ages. The focus on labour market issues alongside saving behaviour is very welcome, as individuals could boost their retirement incomes either by saving more while in work or by delaying retirement and spending longer in the workforce, or through a combination of both. Many of the proposals, such as allowing individuals to remain in employment while drawing an occupational pension from their current employer, are expected to lead

to an increase in the number of older people in employment. A key issue is the demand from employers to hire older individuals. Further research into the consumption patterns of older individuals would be useful to shed light on what changes in product demand and therefore labour demand might arise as a result of the ageing population.

A general point evident in our discussion is that while the government has proposed some reforms that could help individuals planning their retirement, these reforms often assume that the general policy approach implied by the current pension system is correct. Many of the reforms are intended to simplify the means by which the system is delivered or to improve information flows within the system. There are no new plans to alter the basic structure, which involves increasing reliance on voluntary participation in private pensions to supplement a decreasingly generous state pension system, combined with widespread targeting of state benefits to assist lower-income pensioners. From this point of view, the plans outlined in the Green Paper are not especially radical, but it is surely welcome that the government has chosen to consult on them in order to minimise the risk that there might be unintended adverse consequences from apparently small reforms. We have pointed out some areas where more detailed thought might be needed to iron out such consequences.

In order to prevent dwindling state provision from resulting in lower relative retirement incomes, future generations will need to save more or work for longer, or a combination of both. The inevitable pressures on resources created by an ageing population might have resulted in these outcomes even without the reforms intended to aid appropriate decision-making that are contained in the DWP Green Paper, although, as we have stated, the reforms suggested might often help individual decision-making. The new independent ‘pensions commission’ will have the job of assessing whether the incentives provided within the system as it stands after the reforms are enacted can make for the provision of adequate incomes to pensioners. If it cannot, then the incentive structure might need to be altered or the system might need to move ‘beyond the current voluntarist approach’ (DWP Green Paper, Foreword, page v). Any move towards increased compulsion should be carefully considered, since, while it could make some people better off, it would also be likely to make worse off some who, in the absence of compulsion, would, for sensible reasons, choose only to save small amounts. Additionally, those compelled to put more into a pension might respond, not by reducing their current consumption, but by saving less in more-accessible forms or by increasing their debts, neither of which seems desirable.

If the establishment of a pensions commission leads to an ongoing and thorough debate about whether larger reforms to the pensions system are needed, then this must be welcome. Any reforms affecting a forward-looking activity such as retirement saving should be thoroughly thought out before they are enacted. One large problem that the commission will encounter is the current paucity of information on household assets and debts in the UK. The distribution of family total wealth (including financial assets, pensions and housing) in the UK is simply not known. The collection and analysis of further data would aid policy-making considerably.