Saving for retirement: Implications of pensions reforms on financial incentives to save for retirement
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Foreword

All Governments need to strike a balance between protection from poverty on the one hand, and encouraging saving on the other.

Following the recommendations of the Pensions Commission, two Pension Acts in the last two years have set out a framework for the future. Automatic enrolment, compulsory employer contributions, tax relief, and the setting-up of personal accounts will allow millions of people to build private pension savings for the first time ever.

The reforms will improve both the incentives to save and the availability of pension saving, giving people the opportunity to provide more for themselves in retirement. Nevertheless, stakeholders asked whether there was any group who may fail to gain from saving because their private pension reduces their benefit entitlement.

At the heart of the reforms is a clear message: people need to take responsibility by saving for their retirement if they aim to live on an income above that provided by the State. Those choosing to rely on the benefit system will be protected from severe poverty but are unlikely to have an income to meet their aspirations.

This report makes clear that for virtually everybody, if the benefit system remains the same, saving will make them better off in retirement. For over 95%, on standard assumptions, the expected increase in income is greater than the cost of their contributions, even after taking inflation into account. Most will get far more than this – the large majority of savers can expect to get back more than twice what they put in. This reaffirms the Pensions Commission’s conclusions that auto-enrolment is the right approach to manage the unique challenges of demographic change. Incentives are improved by our reform, and other savings vehicles with no employer contributions are unlikely to give higher returns.
We are clear that the safety net provided by income-related benefits is vital to protect the poorest individuals. This report shows that, as our reforms mature, fewer pensioners will need this support, and that the safety net can and does work alongside good incentives to save for the vast majority. It does not find any readily identifiable group in the working-age population whose members would not, on average, gain back more than they put in to a pension.

The Government believes that its overall package of pensions reform already strikes the right balance between alleviating pensioner poverty, encouraging individuals to take personal responsibility and save for their retirement, and ensuring the long-term affordability of the system – on balance the package does not need to be changed. Significantly, the report highlights the trade-offs involved if any changes were made to the balance struck by the Pensions Commission package. While some changes could improve payback for some people, they could reduce incentives for other groups. They would also affect other Government objectives, such as simplifying the benefit system or protecting the poorest.

Importantly, none led to a significant simplification of the overall messages about the benefits of saving. The report makes clear that we need to ensure that high quality, appropriate and accessible information and guidance are available to help individuals make informed financial decisions.

The key message remains: most people aspire to maintain good living standards in retirement, they will need to save to achieve their aspirations, and the vast majority can expect saving to be worthwhile.

I would like to thank all those who have contributed to the exceptional consensus surrounding these reforms, and to those who have played their part producing this report. It sets out our understanding of the careful balance being struck between supporting personal responsibility and the most vulnerable whilst being fair across generations and to the taxpayer. It is a balance all Governments must strike, and I welcome the contribution this report has made.

Rt Hon James Purnell MP
Summary

This report sets out the results of a work programme undertaken by the Department for Work and Pensions (DWP) in close collaboration with key stakeholders to analyse the financial incentives to save in a pension. A central aim of the programme has been to establish what incentives will look like following the reforms in the 2007 and 2008 Pensions Acts.

The pensions reforms are based on the work of the Pensions Commission. The Commission concluded that millions of people today are not saving enough for their futures. The reforms aim to increase the number of people saving for retirement – largely by introducing automatic enrolment into workplace pension schemes for employees, and thus helping them generate more income in retirement than they will get from the State alone. They also aim to enhance financial incentives by mandating an employer contribution, enhancing State Pensions and reducing the spread of income-related benefits, building on the UK’s longstanding and generous tax incentives for saving.

Ensuring people have good financial incentives to save in this way is an important objective of the reforms, though of course it has to be balanced against other objectives, such as the need to protect the poorest from poverty and the need to create an affordable and sustainable settlement.

In this programme we have undertaken extensive analytical modelling of the impact of pension saving on net retirement income, making reasonable assumptions about what the world will look like in many years, or decades, time. We have not only generated case study information to help understand what will happen to typical people and households, we have also, for the first time, been able to analyse the distribution of outcomes from saving across the population as a whole, given reasonable assumptions about their future characteristics and the future tax and benefit system. Most innovative of all, and crucially for thinking about whether there is a need for further reforms, we have been able to assess the extent to which characteristics of groups during working life can tell us what their expected outcomes from saving (and thus their financial incentives) will look like.
The headline findings of this analysis are that, given these assumptions about the future benefit system and other factors, of those making savings into a defined contribution pension after 2012 with an employer contribution:

- virtually everybody modelled – over 99% – is better off in retirement by saving. In other words, they have more money available to them in retirement than if they hadn’t saved;
- for the vast majority – over 95% – the improvement is greater than the cost of their contributions, even after taking inflation into account;
- the large majority of savers get back more than twice what they put in, even after taking inflation into account; and
- there is no readily identifiable group in the working-age population whose members would not, on average, gain back more than they put in to a pension.

These results, and this report as a whole, focus on a particular interpretation of financial incentives to save: the amount that people will gain in retirement as a result of contributing to a pension during their working life and how this compares to the contributions they make. It is important to remember that this is just one of the factors that will influence individuals’ decisions, and may not be the most important: smoothing one’s income between work and retirement is generally considered to be the main aim of pension saving and may make it worth saving even in the absence of high expected returns.

The programme also looked at what the impact would be of making more changes to the tax and benefits system to try to improve incentives even further. We found that while some of these changes would further improve incentives to save for some groups of people, they could reduce incentives for other groups. They may also have negative impacts on other reform objectives, such as simplifying the benefit system and limiting the proportion of the population within the net of income-related benefits. Importantly, none led to a significant simplification of the overall messages.

The Department’s evolving information and communication strategy for the pension reforms will take account of the evidence generated by this work programme. While the analysis is too complex to be able to inform communications messages directly, and is based on a particular set of assumptions about the future, it is very helpful to have rigorous confirmation of the potential benefits of saving in a pension for the overwhelming majority of people.
The Savings Incentives Work Programme

This paper presents the evidence from a year-long work programme on financial incentives to save for retirement. The work was led by the DWP working in close collaboration with many prominent stakeholders including consumer, employer and pensions industry representatives, pensioner interest groups, analytical and academic experts and politicians from each of the main political parties.

The context of this work programme is the introduction of extensive reforms following the work of the Pensions Commission. The Commission was set up following the pensions Green Paper in December 2002 to review the adequacy of voluntary saving for retirement in the UK and recommend appropriate policy responses. The Commission judged that without change, many individuals would, in the future, face a retirement on a lower income than they would have wished, and than they would have been able to achieve had they saved appropriately. In response to this it made three main proposals:

• A fairer and more generous State Pensions system.

• Automatic enrolment into a pension for employees with an employer contribution.

• A national pensions saving scheme for those who would not otherwise have access to an employer scheme.

Automatic enrolment is a key plank of the pensions reform agenda initiated by the Pensions Commission and legislated for in the Pensions Acts 2007 and 2008. Automatic enrolment is designed to overcome one of the main barriers to pension saving, particularly amongst low-moderate earners, and so to reduce the number of ‘undersavers’ who could expect to face significantly lower living standards in retirement than they had enjoyed during working life.

The aim of ensuring more people meet their retirement aspirations and the overall package of reforms intended to achieve this was, and continues to be, the subject of a high degree of consensus amongst the major stakeholders in the pensions sector.

However, stakeholders wanted to know more about the incentives to save and particularly the returns on saving which individuals could expect to see under reform. They were most interested in the way that savings interact with the income-related benefit system in retirement. Income-related benefits are targeted at those who are in most need of support and give less to pensioners who have more substantial incomes.

In response, this Savings Incentives Work Programme was announced by the then Minister of State for Pensions Reform, Mike O’Brien. The terms of reference for the programme are set out in Box E1 in Appendix E. The main aims were:
• to place savings incentives in a broader context;
• to build a shared understanding of the evidence on incentives to save:
  – what those incentives are;
  – their impact on behaviour and outcomes; and
• to assess the potential costs, benefits and other impacts of changes to the tax and benefit system which could affect incentives to save for retirement against an agreed set of evaluation criteria.

The programme has drawn heavily on the advice and expertise of our stakeholders. They have helped us to set out the chief questions to consider, have proposed policy measures to analyse, and helped us to develop the analytical methods and approach. We are grateful for the time and thought of the many individuals and organisations which have contributed.

Overview of the tax and benefit system for pensions and pensioners

The analysis in this document is based on the pensions and benefit system set out in the Pensions Acts 2007 and 2008.

The Government already provides generous incentives for people to save privately for an income in retirement. Tax relief is provided on pension contributions, for those both in and out of work, with a tax-free lump sum available at the point of retirement. Where only small pension pots are built up, individuals have the opportunity to take the whole pot as a lump sum.

The reforms to the State Pension system set out in the 2007 Pensions Act provide a more generous State system, particularly for women and carers, which helps build a solid platform on which to save.

In addition, the reforms to the private pension system set out in the 2008 Act provide the opportunity for people of all income levels to save, supported by automatic enrolment. They also improve incentives for individuals through employer contributions, and introduce Personal Accounts, a new low cost pension saving vehicle.

Taken together, these reforms will significantly increase incentives to save for retirement.

Encouraging saving is an important objective, but it must be balanced against other Government objectives for pensions such as alleviating pensioner poverty and ensuring that the overall system remains affordable. There is a wide degree of consensus amongst stakeholders that the tax and benefit system must strike a careful balance between these objectives and there are inevitably trade-offs to be faced between them.
In total the Government commits significant expenditure on enabling and encouraging retirement saving. It is committed to increasing that expenditure in future. By 2050, the proportion of Gross Domestic Product (GDP) to be spent on contributory benefits (basic State Pension and Additional Pension) is projected to rise from 4.3% to 5.9%, whilst the spend on pensioner income-related benefits is projected to fall from 1.1% to 0.5% as more people are lifted off income-related benefits by the more generous State Pension and increased private pensions.

How and why do people save for retirement?

Expectations for retirement are increasing. Today’s workers enjoy a higher standard of living than previous generations, with occasional meals out, holidays abroad and other ‘daily luxuries’ accessible for the majority.

The reforms in the Pensions Act 2007 provide a fairer and more generous State Pension. But most people will aspire to more than the State Pension can provide, to continue to enjoy many of the activities they have been used to in working life. To meet these aspirations they will need to save, either in a pension or otherwise.

Economic theory tells us that rational individuals will make savings depending on their preference for income now compared to the future and how much each pound saved today will buy them in retirement. The amount that a pound saved now will generate as income in the future will depend, amongst other things, on the existence of an employer contribution and tax relief, investment returns and how long the pound has been saved for.

However, in practice, as the Pensions Commission found, millions of people are ‘under-saving for retirement’ and risk facing a substantial drop in their living standards. Many people may understand in theory they need to save for retirement, but are not acting on this belief.

This is because people’s behaviour is influenced not just by the desire to have a good income in retirement and the cost of doing so but also by a wide range of behavioural factors and other barriers.

Many individuals do not look sufficiently far ahead (myopia) or simply don’t get round to starting to save (inertia). Another factor may be the complexity of pensions: many individuals do not have a good understanding of pensions and do not take advantage of the sources of information and advice which are available.

These factors mean that today, many people are saving less than is optimal and are at risk of being disappointed by their income on retirement. The Commission, therefore, designed a package which would make it easy to save and harness inertia to encourage rather than block saving for retirement. The State Pensions reforms also emphasised the move to a more predictable, more easily understandable State entitlement.
Financial incentives to save for retirement under reform

Both the Pensions Commission and the DWP have published a large amount of research and analysis on the need to save for retirement and the factors people consider when doing so. The work programme, and this report, do not attempt to cover the full breadth of this research, but focus on a particular aspect of financial incentives – the ‘payback’ from saving, which is the extra income in retirement bought by each pound of saving. It is important to remember that this is just part of the story and many factors are important when deciding how much to save.

The value of the extra income is calculated by comparing the income an individual would receive after having saved for retirement after 2012 to the income which they would have received if they had not saved. Both these incomes may include State contributory pension entitlement, income-related benefits, a partners’ income and previous savings before reform. Payback does not show the whole amount of the pension itself. For example, if an individual receives a pension of £50 a week and has no benefit entitlement, but would have been entitled to £10 of benefit if they had no pension, their improvement in income from saving is £40, and it is this £40 that would be used in the payback calculation.

That difference in income is then compared to the value of the contributions that the individual made to their private pension during their working life, to show the total payback from saving per pound contributed.

A positive payback, that is any payback above zero, shows that an individual is better off in retirement from saving. The pensions system is designed to ensure that this is the case for all but the tiny minority most heavily reliant on the safety net of income-related benefits. A payback of £1 plus inflation means that the person got the value of their contributions back in real terms but the difference between saving and not saving was no greater than the real value of the contributions put in. A £2 plus inflation payback means that the difference in retirement between saving and not saving was double the value of the contributions put in (in real terms).

The analysis relates to savings made after 2012 under the recent pension reforms. We know that in practice the system may change – today’s new savers may be affected by the benefit system in 60 or 70 years’ time – but setting out analysis of incentives today enables us to better understand how they may be affected by any future policy change. Later sections of this report look at the impacts of varying aspects of this system.

Final outcomes from saving may be affected by a large number of factors. Our approach has been to draw on a range of analytical techniques to give as full a picture as possible, with each approach presenting different insights.

We have used two models to estimate the financial outcomes from saving – a case study approach and a population-wide model called Pensim2.
Case study results

Our case study modelling looks at a single individual or couple at a time. It can show clearly how individual characteristics interact with the pensions system to drive outcomes.

Case studies cannot show how common a particular outcome will be. However, the ‘core case studies’ used in this report have been derived from real survey data on the population eligible for automatic enrolment. Using this data, we have arrived at a set of 11 core case studies with a range of characteristics, such as different earnings levels, gender, periods of caring and self-employment, age and marital status. We have deliberately focused on those with low earnings and little saving outside any pension saving under reform\(^1\) – they are not representative of the population who will be automatically enrolled.

Table 1 shows the outcomes for these core case studies, assuming they take 25% of their pension pot as a tax-free lump sum. Results are shown in cash terms – the actual amount they will get back – and also in real terms, which takes account of the impact of inflation over these long timescales.

<table>
<thead>
<tr>
<th>Case Study Description</th>
<th>Payback (cash terms) (£)</th>
<th>Payback (real terms) (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Low earning man</td>
<td>6.20</td>
<td>3.06</td>
</tr>
<tr>
<td>2. Median earning man</td>
<td>6.16</td>
<td>3.02</td>
</tr>
<tr>
<td>3. High earning man</td>
<td>5.96</td>
<td>2.93</td>
</tr>
<tr>
<td>4. Low earning man with a period of self-employment (opts-in)</td>
<td>4.69</td>
<td>2.38</td>
</tr>
<tr>
<td>5. Low earning man with a period of self-employment (opts-out)</td>
<td>7.81</td>
<td>3.15</td>
</tr>
<tr>
<td>6. Low earning woman with career break</td>
<td>4.80</td>
<td>2.54</td>
</tr>
<tr>
<td>7. Low earning couple, woman with career break (cases 1+6)</td>
<td>6.59</td>
<td>3.28</td>
</tr>
<tr>
<td>8. Median age couple</td>
<td>4.56</td>
<td>2.55</td>
</tr>
<tr>
<td>9. Older man</td>
<td>2.39</td>
<td>1.67</td>
</tr>
<tr>
<td>10. Older woman</td>
<td>2.14</td>
<td>1.44</td>
</tr>
<tr>
<td>11. Older couple (cases 9+10)</td>
<td>2.54</td>
<td>1.74</td>
</tr>
</tbody>
</table>

Source: DWP modelling.

We have also considered seven supplementary cases which are not typical of a large proportion of the target population but focus on sets of characteristics

\(^1\) Saving under reform in this context is taken to mean workplace pension saving post-automatic enrolment in 2012. Some of the cases are assumed to have some other savings and for some of the older workers, some past pension saving. See Chapter 4 for more detail and Appendix A for full assumptions.
which have been identified as being of particular concern by stakeholders. The supplementary cases explore the impact of low earnings, long career breaks, a lack of past savings and renting on incentives to save.

<table>
<thead>
<tr>
<th>Payback from saving for the supplementary case studies</th>
<th>Payback (cash terms) (£)</th>
<th>Payback (real terms) (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>12. Low earning woman with a long career break</td>
<td>2.69</td>
<td>1.77</td>
</tr>
<tr>
<td>13. Low earning couple, woman with long career break (cases 1+12)</td>
<td>5.83</td>
<td>3.07</td>
</tr>
<tr>
<td>14. Older low earning man with no savings</td>
<td>2.01</td>
<td>1.42</td>
</tr>
<tr>
<td>15. Older low earning woman with a long career break</td>
<td>1.64</td>
<td>1.24</td>
</tr>
<tr>
<td>16. Older low earning couple (cases 14+15)</td>
<td>2.64</td>
<td>1.81</td>
</tr>
<tr>
<td>17. Older lifetime renter</td>
<td>1.00</td>
<td>0.76</td>
</tr>
<tr>
<td>18. Limited State Second Pension and private saving</td>
<td>12.14</td>
<td>3.83</td>
</tr>
</tbody>
</table>

Source: DWP modelling.

The first test is whether an individual is better off in retirement for saving. This is true for all the case studies, including those chosen to focus on characteristics which may make lower returns more likely. Two key features of the pensions system support this:

- The benefit system is designed to ensure that people are rewarded for saving for retirement: for all except those with the very lowest levels of State Pension and private saving, the increase in their pension from saving will generally be greater than any reduction in their benefit entitlement from this saving (below the so-called Savings Credit Threshold the reduction in benefit entitlement will be the same size as the increase in pension income).

- Pension rules allow individuals to take 25% of their pension pot as a lump sum and this is tax-free (and those with small pensions can take the whole pot as a lump sum). The benefits system allows up to £6,000 of saving to be held with no impact on benefit entitlement. This means that even those who are on the lowest incomes and the highest rate of benefit reduction can gain from saving.

In fact, all of the 11 core case studies get a payback of more than £1 plus inflation for each £1 they have contributed – they have gained more in retirement than the cost of their contributions – with most getting two or three times the value of their initial contributions back in real terms. All but one of the seven supplementary case studies also see a payback of at least £1 plus inflation.

One case – that of an older worker who lives in rented accommodation – resulted in a payback of £1 in cash terms, that is before accounting for inflation, but less than £1 in real terms for every £1 contributed. He is still better off in retirement.
than he would have been if he had not saved: his saving provides a tax-free lump sum of over £4,000 in today’s earnings terms at the point of retirement, and his pension is greater than the reduction in benefit entitlement.

Each of the core case studies also sees a higher payback than they would had the reforms in the Pensions Acts 2007 and 2008 not been implemented:

**Table 3 Payback with and without the Pensions Acts 2007 and 2008 reforms**

<table>
<thead>
<tr>
<th>Case Study Description</th>
<th>With reform (cash terms) (£)</th>
<th>With reform (real terms) (£)</th>
<th>Without reform (cash terms) (£)</th>
<th>Without reform (real terms) (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Low earning man</td>
<td>6.20</td>
<td>3.06</td>
<td>2.87</td>
<td>1.42</td>
</tr>
<tr>
<td>2. Median earning man</td>
<td>6.16</td>
<td>3.02</td>
<td>2.86</td>
<td>1.42</td>
</tr>
<tr>
<td>3. High earning man</td>
<td>5.96</td>
<td>2.93</td>
<td>2.83</td>
<td>1.40</td>
</tr>
<tr>
<td>4. Low earning man with a period of self-employment (opts-in)</td>
<td>4.69</td>
<td>2.38</td>
<td>4.58</td>
<td>1.79</td>
</tr>
<tr>
<td>5. Low earning man with a period of self-employment (opts-out)</td>
<td>7.81</td>
<td>3.15</td>
<td>4.37</td>
<td>1.72</td>
</tr>
<tr>
<td>6. Low earning woman with career break</td>
<td>4.80</td>
<td>2.54</td>
<td>2.55</td>
<td>1.31</td>
</tr>
<tr>
<td>7. Low earning couple, woman with career break (cases 1+6)</td>
<td>6.59</td>
<td>3.28</td>
<td>5.18</td>
<td>2.42</td>
</tr>
<tr>
<td>8. Median age couple</td>
<td>4.56</td>
<td>2.55</td>
<td>3.01</td>
<td>1.64</td>
</tr>
<tr>
<td>9. Older man</td>
<td>2.39</td>
<td>1.67</td>
<td>1.18</td>
<td>0.82</td>
</tr>
<tr>
<td>10. Older woman</td>
<td>2.14</td>
<td>1.44</td>
<td>1.38</td>
<td>0.92</td>
</tr>
<tr>
<td>11. Older couple (cases 9+10)</td>
<td>2.54</td>
<td>1.74</td>
<td>1.82</td>
<td>1.21</td>
</tr>
<tr>
<td>12. Low earning woman with a long career break</td>
<td>2.69</td>
<td>1.77</td>
<td>1.56</td>
<td>1.00</td>
</tr>
<tr>
<td>13. Low earning couple, woman with long career break (cases 1+12)</td>
<td>5.83</td>
<td>3.07</td>
<td>4.90</td>
<td>2.39</td>
</tr>
<tr>
<td>14. Older low earning man with no savings</td>
<td>2.01</td>
<td>1.42</td>
<td>1.28</td>
<td>0.90</td>
</tr>
<tr>
<td>15. Older low earning woman with a long career break</td>
<td>1.64</td>
<td>1.24</td>
<td>1.34</td>
<td>0.91</td>
</tr>
<tr>
<td>16. Older low earning couple (cases 14+15)</td>
<td>2.64</td>
<td>1.81</td>
<td>1.86</td>
<td>1.25</td>
</tr>
<tr>
<td>17. Older lifetime renter</td>
<td>1.00</td>
<td>0.76</td>
<td>1.47</td>
<td>0.96</td>
</tr>
<tr>
<td>18. Limited State Second Pension and private saving</td>
<td>12.14</td>
<td>3.83</td>
<td>6.87</td>
<td>2.15</td>
</tr>
</tbody>
</table>

Source: DWP modelling.

**Population level results**

As explained previously, case studies cannot show how common a particular outcome will be. However, another model – ‘Pensim2’ – by contrast, models the whole of future pensioner populations, taking into account the probability of different careers and behaviours. It can estimate what proportion of individuals will
have particular characteristics or see particular outcomes. However, such analysis inevitably depends on projections of the characteristics of the population and the tax and benefit system many decades into the future.

The analysis focuses on savings made into a defined contribution pension scheme with an associated employer contribution after 2012.

The results suggest that average real payback from these savings will be over £1.50 for those closer to retirement, rising to over £3 for those reaching age 22 in the ten years after 2012. The higher returns for younger people reflect both the greater number of years they have to save and benefit from investment returns, and the maturing of the State Pension reforms introduced in 2002 and those to be introduced in 2010.

Figure 1 shows the estimated average payback for modelled savers split by their date of birth. The pre-1960 group would be in their 50s or 60s in 2012 when auto-enrolment is introduced. The 1960-1970 group would be in their 40s or early 50s at the start of auto-enrolment and so on. The youngest group, born between 1990 and 2000, will be 22 or younger in 2012 and would spend all or almost all of their working lives under the reforms.

**Figure 1** Median real payback for people saving in a defined contribution pension with employer contribution after 2012

We can also model the range of variation of payback that individuals within this population can expect as a result of their individual characteristics and experiences. A focus of this work programme has been the degree of predictability of this variation around such good average outcomes. The analysis looks at the ranges of payback within each cohort taking account of the impact of households’ Pension
Credit, Housing Benefit (HB) or Council Tax Benefit (CTB) entitlements and any tax liability.

The analysis shows virtually all – 99% – of savers increasing their income or wealth in retirement through saving. This shows it is likely to be extremely rare for someone who saves to end up no better off in retirement than if they did not save.

However, nearly all do much better than that minimum. In every age group, the vast majority of individuals get more than £1 plus inflation for every £1 saved – 98% of the youngest group and 93% of older workers achieve a payback of at least £1 plus inflation per £1.

Looking at all age groups together, over 95% of savers are modelled as receiving a payback of more than £1 plus inflation for each £1 contributed under reform.

**Figure 2** Distribution of real payback from saving in a defined contribution pension with employer contribution after 2012

We have also looked at outcomes under different sets of assumptions, such as different levels of investment growth, and the impact that individuals can make themselves by making different decisions around working or saving, and looked at results using different measures of outcomes. These show that under a wide range of assumptions, the vast majority of individuals can see good outcomes from working and saving.

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2 Assuming they reach their cohort-specific life expectancy.
Characteristics of those with different levels of payback

The Pensim2 analysis has also been used to identify the characteristics of the small group who do not get at least £1 real terms payback. We have found two main sub-groups within it:

- people with a large amount of potential Pension Credit entitlement as a result of having extremely low contributory State Pension and no significant private income, or having low income and extra needs, who therefore have a large amount of potential Pension Credit; and

- those who rent in retirement and who may, therefore, have potential HB entitlement.

Not everyone with these characteristics will have a low payback. Many people with the characteristics identified above can still see positive returns and find themselves in the higher payback groups, particularly if they choose to take some or all of their pension pot as a lump sum. In addition, those in working age may not know whether they will have these characteristics when they reach retirement.

None of the analysis finds any large subgroup of working-age adults which does not, on average, get at least £1 back in real terms for every £1 put in during working life in this analysis.

A number of other characteristics we have considered are not strongly associated with lower returns. Women (including those taking career breaks to care for children or family members) and those who are on lower earnings at the introduction of automatic enrolment, see returns very similar to the average.

None of this analysis can show whether an individual should or should not save – that is a matter for the individual to decide. But it confirms that, under these reasonable assumptions, the vast majority of these savers get at least £1 plus inflation back for each £1 contributed into a pension under reform.

Analysis of policy measures suggested by stakeholders

As part of the work programme, DWP has analysed a range of policy measures that have been suggested by stakeholders to potentially improve saving incentives further.

Each measure has been evaluated using the following criteria:

- **Clarity of message**
  To what extent might the policy measures complicate or simplify understanding of messages around saving?

- **Improve expected outcomes from pension saving**
  An examination of how well targeted the measures would be on those with relatively low payback. Also, consideration of whether any groups would be adversely affected by the policy measure.
Impact on low incomes
An assessment of whether the policy measures would have particular positive or negative impacts on low income groups.

Operational impacts
A consideration of whether the policy measures would be simple to implement in delivery terms. This also considers any issues of fairness between groups which might need to be considered when designing the detailed policy.

Impact on benefit expenditure
An assessment of implications for income-related benefit expenditure.

The measures considered relate to the design of the income-related benefits system (Pension Credit, HB and CTB), the rules relating to the tax treatment of pension saving or a combination of the two.

The current benefits system has several features intended to strike a balance between targeting spending on those in most need and encouraging saving. Two of the main ones are ‘taper rates’ and ‘disregards’. Taper rates are the rules by which income-related benefits are reduced as incomes rise. The majority of pensioner benefits have taper rates below 100%, meaning the benefit is reduced more slowly than incomes rise, so that someone on benefits who has saved is likely to be better off than if they had not saved. For example, someone in receipt of Savings Credit loses 40p of Pension Credit entitlement for every extra £1 of income from other sources – a 40% taper rate. A disregard is an amount of income or capital that is ignored when calculating benefit.

Under current tax rules, an individual with a total pension pot of less than £16,500 may be able to take the whole pot as a lump sum rather than using it to provide a regular income. This is known as trivial commutation.

We have analysed policy measures which affect all three of these features: changes to taper rates in benefits, changing or introducing disregards and changing the rules on trivial commutation, and combinations of these.

Taper rate changes
Lower taper rates mean benefit entitlement is reduced more slowly as incomes rise than at present. This can improve payback for some people who were on the higher taper, and so improve their incentives. However, it also means benefit entitlement spreads higher up the income distribution so more people would be entitled to the benefit than before. These people are now interacting with the benefit system so their payback is lower than before (though it may still be well above £1 plus inflation) – their incentives have been reduced.

Conversely, higher taper rates make the benefit system less generous so fewer people have any potential benefit entitlement to lose, but those who do lose benefit entitlement lose it more quickly and so may face lower incentives. Higher taper rates also have a negative effect on pensioner poverty.
Neither option significantly improves the messages around saving. Both the options modelled slightly reduce the number of savers modelled as having payback of less than £1 plus inflation per £1 but do not eliminate the group, while the lower taper increases the proportion who see some benefit interaction and so may make the messages more complex for some.

**Income disregard**

Currently all private pension income is taken into account when benefit entitlements are calculated. This option would disregard the first slice of private pension income; income over this amount would be taken into account under the existing rules.

Introducing an income disregard would have a mixed impact on incentives to save under reform. Those with pensions below the limit would see an improved payback because their saving no longer reduces their benefit entitlement. Others, such as those who already have some pension in 2012 which would use up the disregard, could see a lower payback on their further savings.

This option would simplify messages for those with small pensions but could increase the complexity of the messages for others. It improves the incentive to save up to the disregard level but does not increase incentives to continue to save above it. Again, it increases the proportion of pensioners who would be entitled to some benefit.

For example, a £15 a week income disregard would slightly decrease the proportion of younger people with payback of less than £1 plus inflation per £1 but would slightly increase the proportion of older people in this situation as many older people have already saved enough to generate more than £15 a week of pension.

**Capital disregards**

A capital disregard already exists in the benefit system. Up to £6,000 of capital is disregarded. Capital over this amount is taken into account when calculating benefit entitlement.

Increasing the amount of capital disregarded may not directly improve the payback which can be achieved on pension saving because individuals can already choose to spend any pension lump sum they have above the capital level, but may increase payback for some individuals who do not choose to do this. In other cases it will decrease the payback on pension income by making the benefits system more generous to those with some capital savings.

Increasing the amount of capital a household can have before benefits are affected may increase the incentive to save for a lump sum which is used more gradually.

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3 Capital is broadly any money or assets. Certain types of capital may be disregarded fully, for example, a property owned and lived in by the customer, or any lump sum personal injury payments.
in retirement. It may, however, decrease incentives to save for a pension income in retirement – the main focus of reforms – by spreading benefit entitlement to those with higher amounts of savings. It also has significant benefit expenditure implications.

**Trivial commutation limit**

This measure would increase the size of the pension pot which can be trivially commuted. This can improve payback: trivially commuted capital which is sheltered by the capital disregard rules or spent so that it is not brought to account for benefit purposes will not reduce benefit entitlement, so payback could be higher than for a pension income that had a greater effect on benefit entitlement. However, taking this option reduces retirement income and introduces the risk of outliving any savings. It does not fit well with the wider goals of the pensions system, where tax relief is provided to encourage saving for a retirement income.

Again, the impact on the message is mixed. It could improve the incentive to save up to the new limit for those willing and able to take their pension as a lump sum, but also provides an incentive not to save above this level. Most of those affected can already see good returns: half have a modelled payback of £2 or greater.

Fuller details of these and other measures and combinations of measures can be found in Chapter 6 of this report.

**Summary**

Most of these suggested policy measures add complications to the overall message on saving incentives, and the impact on payback for the modelled population tends to be mixed rather than clearly improving it. A number of the policy measures do improve payback for some of those with low payback, but the impacts can be complicated. Others may see poorer payback and none of the measures makes a large difference in the average payback seen or eliminates the small group with payback of less than £1 per £1.

Most increase the proportion of pensioners eligible for income-related benefits, reversing the direction of the reforms. Furthermore, the costs to the taxpayer are generally significant and support tends to be poorly targeted.

**Information and communications**

Ensuring that appropriate information and communications are available is a vital part of the overall pension reform package.

Not all individuals will want to save in a pension at all times. Those considering whether or not to ‘opt out’ from workplace pensions will consider a number of factors, reflecting the many reasons for saving and other constraints. Each will

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4 Once the limit is exceeded, none of the pot can be trivially commuted.
have to make their own judgement as to the relative importance of each factor for them.

These factors might include:

• the need to save for retirement to have the lifestyle they want;

• the cost to them of saving, the advantage of the employer contribution and the likely payback on their saving;

• the level of security the pension scheme will provide for their savings;

• how important it is to them to have the flexibility and security of their own pension pot;

• whether they have other spending commitments that mean they need to delay saving for retirement, despite the impact on their retirement income.

To balance up the various considerations, people will need appropriate information and communications to be available.

Under current legislation, all pension providers must supply certain information to individuals when enrolling them into a pension. This will continue to be the case.

The Government is considering what further information needs to be made available. The evidence produced through this programme will inform the development of the information and communications strategy. However, we acknowledge the limitations of this programme. The analysis in this report looks at outcomes under an extrapolation of the current benefit system into the future, but the benefit system may change and we must be clear that such projections do not – and cannot – constitute a commitment to future policies.
1 The Savings Incentives Work Programme

This report presents the main results of the Savings Incentives Work Programme, set up to strengthen the evidence base in this crucial area for pensions reform, and designed to involve close working with stakeholders.

The context of this work programme is the extensive reforms following the work of the Pensions Commission. One of the key elements of these reforms was the introduction of a policy of automatic enrolment of workers into a pension.

Automatic enrolment was designed to encourage pension saving, particularly amongst low-moderate earners, in order to reduce the number of ‘undersavers’ who could expect to face significantly lower living standards in retirement than they had enjoyed during working life.

The overall package of reform was the subject of a high degree of consensus amongst the major stakeholders in pensions policy. However, in some areas stakeholders had concerns about the detail of the reform and the implications of its introduction. One of these areas was the question of the incentives to save which individuals would see under reform and in particular, the returns they could expect on their pension saving.

Much of the discussion focused on the possibility that some savers might see relatively small increases in retirement income as a result of their saving because their pension would reduce their entitlement to income-related benefits in retirement. Publications by the Department for Work and Pensions (DWP) and by other stakeholders set out the complexity of the issues – showing most people could expect good returns but some characteristics might be associated with lower returns.

Stakeholders identified a need to gather further information in this area, to gain a clearer understanding of the extent of the issue and the characteristics which might be linked with poorer returns. They also wished to see analysis of measures which might further improve incentives to save, to look at the pros and cons of such measures and consider them against wider Government objectives.
In response to these concerns the Savings Incentives Work Programme was announced by the then Minister of State for Pensions Reform, Mike O’Brien. During the Commons Pensions Bill Committee in January 2008 he set out his intentions for the programme:

‘We need to share knowledge, establish an understanding of the trade-offs, and engage with others over the coming months in shaping how we could have a shared baseline of understanding of the issues with which we have to grapple.’

The terms of reference for the work programme can be found in Appendix E, and the broad aims of the work programme were to:

- place savings incentives in a broader context;
- build a shared understanding of the evidence on incentives to save:
  - what those incentives are;
  - their impact on behaviour and outcomes; and
- assess the potential costs, benefits and other impacts of relevant measures which could affect incentives to save for retirement against an appropriate set of evaluation criteria.

This report, therefore, aims to draw together existing evidence on savings incentives and to present new evidence and analysis. It will consider the context within which any pensions policy must work – both the many factors influencing individuals’ decision-making process and the wider objectives and trade-offs which any Government must consider when designing pensions policy. It will then focus on the financial incentives to save under reform, in particular the payback which people can expect to see on their saving. Finally, it will set out the pros and cons of changes to the tax and benefit system proposed by stakeholders as striking a different balance between some of the available levers affecting returns.

A critical part of this programme has been the close engagement with interested stakeholders, including industry, consumer and employer representatives; pensioner interest groups, analytical and academic experts; and politicians including Opposition spokespeople. This has helped to shape and develop the work programme to address the key issues in this area. They have also given us the benefit of their understanding and insights, helping to ensure the analysis in this publication is sound and appropriate and to develop our understanding of the context within which we must consider the issues. They have also proposed a number of measures which we have analysed in the later part of this report.

The involvement of these interested parties has helped to achieve a remarkably broad consensus on the main issues at stake and the potential responses to it.

We are enormously appreciative of the time, energy and input we have received from all stakeholders involved in this process.
Overview of the tax and benefit system for pensions and pensioners

Chapter summary

The State has to balance a number of objectives around pensions including providing support to pensioners with the lowest incomes and most need, supporting future pensioners to provide for an adequate retirement income and ensuring that the overall system remains affordable.

Most State support for pensioners comes through the contributory system, and this is set to become more widespread as a result of the Pensions Act 2007 reforms. For those pensioners with lower income or extra needs in retirement, the most targeted and lowest cost policy for providing support is through income-related benefits. Such an approach reduces support as someone’s income rises and, therefore, can have a negative influence on incentives to save. However, income-related benefits are designed in such a way that in most cases, pensioners with some savings will be better off than if they had not saved despite the loss of some benefit entitlement.

The overall environment provides significant support for people to save into a pension.

Any Government must strike a balance between competing policy objectives. In designing policy for pensions and pensioners, the State has to balance the objectives of alleviating poverty, helping future pensioners save so that they can have an adequate income in retirement and ensuring that the cost of the pension system remains affordable.

In pursuing these objectives the Government will face inevitable and difficult trade-offs – for example, targeting spending at those in most need is essential to support the poorest but, increasing the support for those without savings,
necessarily has an impact on incentives to save. The reforms in the Pensions Act 2007 strike a sustainable balance between these objectives supported by a broad consensus around the main aspects. Figure 2.1 provides a graphical representation of this choice.

**Figure 2.1 A graphical representation of the objectives faced by Government**

This chapter will discuss the structure of the contributory State Pension in providing a foundation for saving and the impact of recent reforms, support for private saving, the role of income-related benefits in alleviating poverty and supporting pensioners with extra needs, how income-related benefits interact with saving and the policies the Government has currently got in place to support pension saving.

### 2.1 Supporting people to save sufficiently to provide an adequate income for themselves

This section describes the main elements of the tax and benefit system relevant to incentives to save for retirement.

The foundation of State support is the contributory State Pension, consisting of the basic State Pension and the State Second Pension. These play an important role in helping people build an adequate retirement pension.
A full basic State Pension provides £90.70 a week (in 2008/09) and is currently uprated by prices. In 2007/08, 85% of men and around a third of women reaching State Pension age (SPA) received a full basic State Pension.\(^5\)

The State Second Pension provides additional contributory benefit. This consists of two elements for every year of accrual – a flat rate amount for lower earners or people credited in and an additional earnings-related element for moderate to higher earners (in 2008/09 this applied to those earning £13,500 a year or more). Accruals can be built up between the age of 16 and the tax year before SPA. Those credited in include people caring for a child up to the age of six and the long-term disabled. The State Second Pension is earnings uprated in accrual and price uprated in receipt (post-SPA).

In total, 21.9 million people accrued entitlement to the State Second Pension in 2005/06. Figure 2.2 shows the number of people accruing entitlement to the State Second Pension in the 2005/06 financial year and the value of their accrual compared to what their outcomes would have been under the previous scheme, State Earnings Related Pension Scheme (SERPS). The figure shows the significant increase in support to lower earners and those credited into the State Second Pension compared to the position under SERPS. Around 70% of the working-age population are now accruing entitlement to the State Second Pension compared to just over half under the equivalent scheme in 1980.

In addition there is significant support for private saving in a pension and elsewhere.

Saving into a pension attracts tax relief at the basic rate or an individual’s marginal rate where this is higher. Up to 25% of the pensions pot may then be taken tax-free. The remainder may be subject to tax, depending on the pensioner’s position, but higher tax allowances for pensioners reduce the impact of this. Older pensioners do not start paying tax until their incomes exceed £9,000\(^6\) and less than half of pensioners pay tax\(^7\).

This relief is provided to encourage individuals to save for an income in retirement. However, in addition to the rules allowing a 25% tax-free lump sum, those with small pensions pots can take the whole amount as a lump sum through the trivial commutation rules (see Box 2a).

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\(^5\) Source: DWP Projections using the Government Actuary’s Department’s Retirement Pension Model, Great Britain only.

\(^6\) In 2008/09, tax allowances are £9,030 for those aged 65-74 and £9,180 for those aged over 75.

Box 2a: Pension lump sums

The purpose of pension saving, and the basis on which generous tax incentives are given for pension saving, is to provide an income in retirement. However, there are two routes by which some pension saving can be taken as a lump sum:

In addition to taking a pension income, there is an option to take up to 25% of the value of a pension as a tax-free lump sum. This is given not as an alternative to a pension but is taken in addition to drawing a regular income to help ease transition into retirement.
As an exception, trivial commutation rules allow individuals with small pension funds to take the full amount as a lump sum. This recognises that for small pots it may not make economic or administrative sense to turn them into what would be a very small regular pension. Twenty-five per cent of this will be tax-free, and the remainder may be subject to income tax.

The current trivial commutation limit is £16,500, increasing to £18,000 by 2010/11, and remaining at this level until 2015/16. Those whose total saving in pensions comes to less than this limit may be allowed, under the pensions tax regime, to take the whole of their pension as a lump sum. In addition HMRC have published draft regulation providing that individual occupational pension pots of less than £2,000 can be taken as a lump sum, irrespective of any other pension saving.

Taking lump sums can improve payback in some cases by minimising the interaction with income-related benefits. However, some individuals may prefer to annuitise in order to have a regular income through the whole of their retirement.

It is not mandatory for pension schemes to offer trivial commutation so whether an individual can trivially commute their pension pot depends on the rules of the particular scheme of which they are a member.

Reforms further improve the incentives to save for adequate retirement income.

The Pensions Act 2007 made significant changes to the State Pension system that increased the spread and generosity of the contributory benefit system and curtailed the income-related benefits part of State Pensions.

These reforms will lead to over 90% of both men and women receiving a full basic State Pension on reaching SPA by 2025. The key reforms are reducing the number of qualifying years to 30 and expansion of crediting activities to include those caring for more than 20 hours a week for a person with a disability.

In addition, the value of the basic State Pension will be enhanced in the future by earnings uprating. The result is that the basic State Pension is expected to approximately double in value by 2050 compared to what it would have been under pre-reform uprating policies. It also ensures that the basic State Pension remains around 75% of the Guarantee Credit level, with most people receiving the State Second Pension in addition.

Coverage of the State Second Pension will also be expanded further with credits given to people caring for a child until the age of 12 and the system of accrual will be simplified by moving to weekly credits, allowing credits and earnings to be combined to make up a qualifying year.
2.2 Alleviation of poverty and help with extra needs

The Government is committed to ensuring all pensioners have a decent and secure income in retirement.

The Government provides support to top pensioners’ incomes up to £124.05 through the Guarantee part of Pension Credit, increasing to £130 from April 2009. Furthermore, the Government has committed to earnings uprate this level, so that pensioners with the lowest income will share in the growing wealth of the nation.

In addition, households can receive extra support if they are disabled or caring for someone who is disabled and households with mortgages on their homes may also qualify for help with their mortgage interest through Pension Credit.

Currently, around 3.3 million people benefit from support through Pension Credit, each household receiving an average of £53 per week. Many of these households contain someone with a disability; around 1.2 million disabled pensioners claim Pension Credit.8

Support is also available for housing costs for those people who have inadequate incomes to pay their rents. Rents will vary by area, so this support will vary depending upon need and the local housing conditions. Around 1.5 million pensioner households get help with paying their rent through Housing Benefit (HB), receiving an average of around £60 per week. Approximately one million of these also receive support through the Guarantee element of Pension Credit.9

Finally, households with lower incomes are also entitled to support with their council tax. Once again, this will vary depending on the local level of council tax. Approximately 2.5 million pensioner households receive an average of around £15 per week to help with their council tax bills.10

The proportion of pensioners receiving support from income-related benefits is shown in Table 2.1. The proportion of pensioners eligible for income-related benefits falls over time due to the greater level of support given by contributory State Pensions in the future, increases in private pension income and greater levels of home ownership in younger cohorts.

These figures show the modelled results of a variety of individual choices and circumstances and individuals may not be able to predict in advance whether they will be in these groups. It includes older pensioners, who may not have become entitled to these benefits until later in retirement and who may have retired before the Pensions Act 2008 reforms were introduced. As discussed in Chapter 4, being

9 Local authority (LA) statistical returns August 2007.
10 LA statistical returns August 2007.
on income-related benefits in retirement does not mean that returns from saving have been poor.

Table 2.1 Projections of proportion of pensioner households entitled to income-related benefits

<table>
<thead>
<tr>
<th></th>
<th>Guarantee Credit only (%)</th>
<th>Guarantee and Savings Credit (%)</th>
<th>Savings Credit only (%)</th>
<th>Pension Credit (%)</th>
<th>Housing Benefit (HB) (%)</th>
<th>Council Tax Benefit (CTB) (%)</th>
<th>Any income-related benefit (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>10</td>
<td>20</td>
<td>15</td>
<td>45</td>
<td>20</td>
<td>50</td>
<td>60</td>
</tr>
<tr>
<td>2010</td>
<td>10</td>
<td>15</td>
<td>15</td>
<td>45</td>
<td>15</td>
<td>50</td>
<td>55</td>
</tr>
<tr>
<td>2020</td>
<td>5</td>
<td>15</td>
<td>20</td>
<td>40</td>
<td>15</td>
<td>45</td>
<td>55</td>
</tr>
<tr>
<td>2030</td>
<td>5</td>
<td>10</td>
<td>15</td>
<td>35</td>
<td>15</td>
<td>40</td>
<td>50</td>
</tr>
<tr>
<td>2040</td>
<td>5</td>
<td>10</td>
<td>15</td>
<td>30</td>
<td>15</td>
<td>35</td>
<td>45</td>
</tr>
<tr>
<td>2050</td>
<td>5</td>
<td>10</td>
<td>15</td>
<td>30</td>
<td>10</td>
<td>30</td>
<td>40</td>
</tr>
</tbody>
</table>

Source: DWP modelling.

Note: Figures rounded to nearest five percentage points. Components may not sum to totals due to rounding.

An alternative to income-related benefits would be to provide extra support through the basic State Pension. However, in practice this is unlikely to be realistic. Even the extreme example of doubling the level of the basic State Pension, which would cost in the region of £150bn by 2050\(^1\), would still leave around a quarter of pensioner households eligible for an income-related benefit.

Income-related benefits, therefore, play a vital role in supporting pensioners with low incomes and high needs. Providing less targeted support is costly and would still be insufficient to significantly eradicate the need for income-related support.

### 2.2.1 How does income-related support change as incomes rise?

As described already, the income-related benefit system aims to top up a pensioner’s income to a certain level depending on their circumstances. Inevitably, any State support will reduce the incentive to save privately by providing some protection for those who do not, but the details of the way this is done will have a bearing on the extent to which saving incentives are affected. Two of the key mechanisms in this context are known as ‘tapers’ and ‘disregards’.

A benefit taper is the rate at which the benefit is withdrawn as private income increases. Where a taper rate of less than 100% applies it ensures that those with private income will have a higher net income than if they had not saved, or if they had saved less. Income-related benefits have a range of tapers. Table 2.2 shows the range of tapers applied across the main pensioner income-related benefits and over what incomes.

\(^1\) In today’s prices, and net of savings on income-related benefit expenditure.
Table 2.2  Tapers across different income-related benefits (for a single pensioner aged 65 or more with no additional premiums)

<table>
<thead>
<tr>
<th>Income-related benefit</th>
<th>Start point of taper</th>
<th>End point of taper</th>
<th>Taper rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guarantee Credit</td>
<td>0</td>
<td>£124.05</td>
<td>100%</td>
</tr>
<tr>
<td>Savings Credit</td>
<td>£91.20</td>
<td>£173.33</td>
<td>40%</td>
</tr>
<tr>
<td>HB*</td>
<td>£143.80</td>
<td>Varies</td>
<td>65%</td>
</tr>
<tr>
<td>CTB*</td>
<td>£143.80</td>
<td>Varies</td>
<td>20%</td>
</tr>
</tbody>
</table>

Note: * For those also entitled to Pension Credit, the taper rate is applied to income net of any Pension Credit taper.

Pension Credit has two main elements: the Guarantee Credit and the Savings Credit. The Guarantee Credit is withdrawn pound for pound as income rises up to the level of the appropriate minimum guarantee. However, the Savings Credit provides further support to those with incomes above the Savings Credit Threshold (£91.20 a week). For every pound of income between the Savings Credit Threshold and the appropriate minimum guarantee, pensioners have a pound of Guarantee Credit withdrawn, but receive 60p of Savings Credit (so resulting in a net taper rate of 40%). Once a person’s income exceeds their appropriate minimum guarantee their entitlement to Savings Credit is tapered away at 40 pence in the pound.

Taper rates have the advantage that they withdraw a constant proportion of income. So for every £1 increase in pre-benefit income, they gain by the same net amount (60p in the case of the Savings Credit). However, there can be points where someone may be entitled to more than one benefit and can then face varying levels of withdrawal depending on their income.

In designing a taper there is a trade-off in terms of saving incentives. The lower the taper, the more benefit a pensioner will see for every £1 of private income. However, a lower taper has the downside of taking longer to withdraw a level of support and, therefore, spreads the interaction with income-related benefits further up the income distribution (and increases costs for a given minimum level

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12 The appropriate minimum guarantee is equal to the standard minimum guarantee (£124.05 per week for a single person) plus entitlement to additional premiums (e.g. for caring or disability).

13 Pensioners entitled to additional premiums with income between the standard minimum guarantee and the appropriate minimum guarantee, have Guarantee Credit withdrawn pound for pound and face 100% withdrawal. They continue to receive the maximum amount of Savings Credit until their income reaches the appropriate minimum guarantee at which point Savings Credit is tapered at 40 pence in the pound.
of support). So there is a trade-off here and Government needs to decide where the balance is struck.

As well as tapers, income-related benefits can have a disregard, where a sum of money is ignored in the calculation of income-related benefits. Examples of disregards include a £5 earnings disregard and a £6,000 capital disregard in Pension Credit.

The advantages of a disregard are that they can be relatively simple to understand and administer. For instance, a pensioner only needs to prove they have capital below £6,000 rather than the exact level of capital. However, any income or capital in excess of a disregard will be subject to a taper. Thus, a disregard can provide strong incentives to have income or capital up to the limit but does not improve incentives to have finance above the limit.

**Box 2b: Do people want income or capital in retirement?**

Research suggests that in retirement, most people want ‘simplicity’, ‘security’, ‘a guaranteed income level’ and ‘little or no risk’ from their income in retirement\(^{14}\), and incentives such as tax relief are intended to encourage saving for an income in retirement. However, as well as income, people may set aside savings to form a pool of capital in retirement to use for emergencies or ‘lumpy’ expenditure.

Someone taking a pension pot has a choice over whether to take some, or in a smaller number of cases all, of their pension pot as income or capital. They, therefore, have to decide on the potential trade-offs between the advantages of each.

In addition, income-related benefits treat income and capital in different ways. Significant amounts of capital can disqualify a pensioner from gaining HB and Council Tax Benefit and can reduce entitlement to Pension Credit. While a small cushion of capital is ignored for income-related benefits, larger amounts can be used by a pensioner to support themselves in the first instance rather than relying on support from taxpayers.

### 2.2.2 The balance between contributory and income-related support

Table 2.3 shows the levels of contributory State Pension for a low earner working (or credited) from age 25 and for a low-earning couple where one person works (or is credited) from age 25 but the other starts work age 16 but takes a long career break and has some part-time work as in case study 13, compared to the Guarantee Credit level.

Table 2.3 Levels of State Pension and Guarantee Credit, 2008/09 earnings terms

<table>
<thead>
<tr>
<th>Year</th>
<th>Single person example</th>
<th>Couple example</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>State Pension (£)</td>
<td>Guarantee Credit* level (£)</td>
</tr>
<tr>
<td>2020</td>
<td>140</td>
<td>124</td>
</tr>
<tr>
<td>2030</td>
<td>142</td>
<td>124</td>
</tr>
<tr>
<td>2040</td>
<td>150</td>
<td>124</td>
</tr>
<tr>
<td>2050</td>
<td>154</td>
<td>124</td>
</tr>
<tr>
<td>2060</td>
<td>154</td>
<td>124</td>
</tr>
</tbody>
</table>

Source: DWP modelling.

Note:
* Standard Minimum Guarantee.

The increase in State Pensions for both examples over time reflects the maturing of the State Second Pension so that it becomes more widespread. Over time, the State Pensions platform for someone who works or cares for much of their working life will take them clear of the Guarantee Credit level at retirement and increasingly the overall limit for Pension Credit eligibility, thereby reducing interactions with income-related benefits for any private saving.

Figure 2.3 also demonstrates the forecast reduction in reliance on income-related benefits as the State Pension reforms mature. By 2050, the proportion of Gross Domestic Product (GDP) spent on pensioner income-related benefits is projected to fall from 1.1% to 0.5%, whereas contributory benefits (basic State Pension and Additional Pension\(^{15}\)) rise from 4.3% to 5.9%. The main contributor to the rise is the growing prevalence of Additional Pension which rises from 0.8% to 1.5% over this period. The figures relate to the whole pensioner population at a given moment, so in the earlier part of the chart most spending will relate to those retiring before or soon after the introduction of the State and private reforms.

As well as reforms to the State system, incentives to save are significantly boosted by private pension reforms, building on the existing support through tax relief. These reforms provide for all employees earning above a minimum amount to be ‘automatically enrolled’ into a pension with an employer contribution. Together with tax relief, this means that for each £1 contributed by an employee out of their net income, at least £2 is paid into the pension fund.

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\(^{15}\) Additional Pension includes the State Second Pension and SERPS.
Figure 2.3  Projected State spending on pensioners

Source: DWP long-term projections, consistent with Budget 2008 projections.
Box 2c: Private pension reforms

The reforms to encourage saving in a private pension were contained in the Pensions Acts 2007 and 2008, building on the work of the Pensions Commission led by Adair Turner. The main features of the private pensions reforms were:

- Eligible workers will be automatically enrolled into qualifying work-based pension schemes.

- Contributions will be made on earnings between £5,035 and £33,540 a year in 2006/07 terms. Overall contributions into the scheme will be at equivalent to or better than 8% of this band of earnings. Employers will be required to pay at least 3%, with workers contributing 4% and around 1% in the form of tax relief.

- Workers will be able to opt out.

- A qualifying scheme may be an existing workplace pension satisfying minimum criteria, or may be the new personal accounts scheme. This is a low cost scheme set up for those employers who do not have an existing qualifying pension scheme.

2.3 Does State support reduce incentives to save?

The existence of these benefits will reduce the urgency of saving to some extent – if people genuinely believed there would be no support forthcoming from the State if they found themselves in dire need in retirement, it is likely that they would feel a greater need to provide for themselves. However, research suggests that in practice this belief is not a powerful motivator – less than half of those with no pension provision expressed confidence that there would be a State Pension when they retired16 – and one of the core roles of the State is to provide some support in times of need.

Others have suggested that individuals may choose not to save in order to deliberately maximise their benefit entitlement at retirement. For a few individuals this may be the case. However, most people aspire to more than the State minimum in retirement and will not want to see a significant drop in their income when they stop working. In addition, only a small minority will face low returns due to benefit offsets, and not all of these will be able reliably to predict that they will be in this group. Government pensions policy is grounded in the principle that for most it is appropriate for them to take personal responsibility for building up a suitable level of private saving and that it should encourage them to do so.

16 Source: Retirement Planning Monitor 2007, Marketing Sciences Ltd. Of those with no pension provision, asked ‘Do you think there will be a State Pension when you retire?’ 46% said ‘yes’, 28% said ‘no’ and 26% answered ‘don’t know’.
Employees who are not building up rights to both basic State Pension and State Second Pension through earnings (as they fall below the lower earnings threshold for National Insurance) would also fall below the threshold for automatic enrolment. The self-employed build up basic State Pension but not State Second Pension (and pay lower National Insurance contributions) and are also not automatically enrolled into a pension.

Overall, this environment provides significant support for people to save into a pension. Government provides significant expenditure on pensions which will be increasing in future. State reforms will allow for a fair and generous State system which provides a solid foundation on which to save. Private reforms will open up the opportunity for millions of people, many for the first time, to save for retirement. And current policies already in place provide incentives to save for retirement including tax incentives.

The next chapter will look at how savings works in practice within the framework described here.
3 How and why do people save for retirement?

Chapter summary

This chapter sets out the theoretical and behavioural context around the decision to save for retirement. It shows how expected returns from saving and other financial incentives to save fit into the economic framework, and describes the range of considerations that people make in practice in terms of whether and how much to save for their retirement.

Standard economic theory considers individuals’ motives to save with the assumption that they behave ‘rationally’. The two main considerations under this theory are as follows:

- The income motive concerns the desire to smooth consumption across a lifetime from periods when income is higher to periods when it is lower. Since people generally have higher incomes in working age than in retirement they have an incentive to save some of their working-age income to consume later in life.

- The price motive concerns the ‘cost’ of saving – how much someone will need to save now to buy £1 of consumption in retirement. Like any other good, people will be put off buying a higher income in retirement if it is more expensive. This, as represented by the concept of payback, and the income motive are what we refer to in this report as economic incentives to save.

Modelling from the National Institute of Economic and Social Research shows that most people, from all wealth groups, would save in a private pension if they were ‘rational’ and fully informed.

Continued
However, we know that in practice individuals’ behaviour is also affected by a large number of other factors. Prior to reform, many have not saved as standard economic theory would predict due to behavioural barriers such as myopia and inertia, as well as lack of an easily accessible vehicle. A report by PricewaterhouseCoopers, published alongside this report, notes that a lack of understanding of pensions is combined with a failure by many to access available sources of information and advice.

This report focuses on the economic incentives to save as it is in this context that the recent debate on savings incentives has taken place, and the next chapter will look in more detail at the price motive and the factors affecting it.

There are many motivations and rationales for saving, and many different means of doing so. This chapter looks at the main ways in which people save for retirement today and considers the motivations behind such saving.

3.1 Economic reasons to save for retirement

The DWP reports, Financial incentives to save for retirement and Estimating economic and social welfare impacts of pension reform, cover the economic theory underpinning retirement saving in detail, so this section offers a recap of the key factors.

Neoclassical economic theory sets out the reasons a rational person might save for retirement:

3.1.1 The income motive: To increase their retirement income

We know that for most people the State Pension alone would represent a significant drop from the living standards which they have been used to and is not likely to meet the aspirations they have for retirement. This provides a motive to move money from a time in which they are relatively richer compared to their needs, to a time when they would otherwise have fewer resources – foregoing consumption today to boost consumption in retirement. This is known as ‘income smoothing’. Fundamental to this is the concept that an extra £1 is worth more to an individual at a time when they have fewer resources relative to their needs than the same amount at a time when they are relatively well off.

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This need for income smoothing to maximise welfare was at the core of the Pension Commission’s report and recommendations. They identified a large group of ‘undersavers’, those who, if they did not increase their savings rate, would fail to meet benchmark replacement rates and so risked facing a significant cut in living standards in retirement.

Estimating economic and social welfare impacts of pension reform presented estimates of the size of the welfare gains from pension reform including the welfare benefits of improved income smoothing.

### 3.1.2 The price motive: To achieve good returns on their pension investment

The price, or substitution, motive reflects the amount of extra income in retirement achieved by each pound contributed. The lower the cost of an extra £1 of retirement income, the more likely people are to want to save more, as with other goods and services.

Research in *Financial incentives to save for retirement* demonstrated that the large majority of individuals saving under reform can expect to find that £1 saved buys them more than £1 plus inflation in retirement. Chapter 4 looks in more detail at this aspect of saving.

### 3.1.3 Additional motives

*To provide security and take personal responsibility*

Much of the discussion around incentives to save for retirement makes assumptions about the future, about both individuals’ circumstances and the future tax and benefit system. This is inevitable. But it should not be forgotten that such methods can only give us best expectations of particular outcomes. Individuals may wish to save to give the security of having a personal income and to take personal responsibility for their retirement rather than having to rely on State support – the income-related benefit system may not remain the same in the future. Others may have particular plans for retirement, for example, to save enough to afford annual holidays and meals out.

Recent research found that ‘participants felt that financial provision during retirement is an individual’s responsibility’. Many participants felt that they did not want to be reliant on the State at retirement.20

The reforms enable a flatter and clearer State support system which will make it easier for individuals to see any gap with their aspirations which they may wish to plug through private saving.

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3.1.4 The effect of these motives

The economic theory underlying these motives is clear, but the balance between the motivations will vary from individual to individual. Some will put a premium on having their own fund for flexibility and security. Others will strongly prefer to live for today and leave the future to take care of itself. These innate preferences will interact with their own plans and ambitions for the short-term and for retirement.

There are a number of other motivations for household saving in addition to a need to provide resources in retirement, and some may prefer to save for retirement outside a pension. Many people will want to save in more than one way to meet different needs. Others may prefer to opt out of pension saving for a short or longer period to focus on other savings or on paying off debt. Other savings vehicles are, however, unlikely to attract an employer contribution and may get less generous tax treatment.

Box 3a: Saving in a rational world: National Institute Tax and Benefit Model (NIBAX)

The National Institute of Economic and Social Research have developed a dynamic rational agent microsimulation model to analyse long-term behavioural responses to policy, including savings behaviour, across the lifetime of households. It is built upon the assumption of rational expectations; people understand their economic environment, the tax and benefit system, and can maximise expected lifetime welfare. Whilst people in practice may not behave as rationally as the model implies, it allows us to look simultaneously at the incentives faced by households due to the desire to smooth consumption and the tax and benefit system.

NIBAX and savings incentives

NIBAX has been used to perform introductory analyses of changes in the pensions environment and the savings incentives produced by the UK tax and benefit system. This illustrative analysis indicated that the change from the Minimum Income Guarantee to the Pension Credit significantly improved incentives to save for lower earners. Analysis of the incentives to save in a private pension under reform suggests that most individuals, including the lowest wealth groups, have incentives to build up a pension during their working lives21. Individuals in all wealth groups on average start saving in their 30s and choose to build up substantial pension savings by retirement.

3.2 Barriers to saving in practice

In practice, there are many barriers which prevent people acting in line with rational decisions under the theories above.

The Pensions Commission and the Government explicitly recognised the existence of behavioural issues, most notably myopia and inertia, and designed a package which would both make it easy to save and harness inertia to encourage rather than block saving for retirement. The State Pension reforms also took account of such psychological issues and emphasised the move to a more predictable, more easily understandable State entitlement.

Box 3b: Behavioural barriers to saving for retirement

**Inertia.** This is a key factor that has been explored by economists such as Richard Thaler. Given that retirement saving relates to something so far in the future it is a decision that is very likely to be put off until tomorrow. The way that options are presented to individuals and the effort required in taking action can have significant impacts on behaviour.

**Myopia.** In contrast to economic theory, individuals are often observed spreading their financial resources over only relatively short timeframes, particularly at younger ages. Without triggers to encourage thinking about retirement, and with pressing financial and other constraints, many people may focus on meeting working-age financial needs without considering their retirement saving.

Linked to this is ‘**hyperbolic discounting**’ where individuals do not discount the future at a constant rate, so that their preferences for future consumption are not consistently related to preferences for current consumption. This can lead to expectations for future needs not being met – people may prefer to consume more now but when they get to later life they may become unhappy with their previous decisions.

**Bounded rationality.** Pension decisions may be too complex for individuals to solve on their own, particularly as some individuals may have low financial capability. Thus, they may make decisions that may not be fully optimal. To reduce the effort (and thus cost) of making complex decisions, individuals may use ‘**rules of thumb**’ to help choose when and how to save (e.g. £x per month, regardless of income/interest rate, etc).

Continued

Habits. Individuals are habitual, which can help explain why people do not react to changed financial incentives, even if it would be rational and financially beneficial for them to alter their behaviour. For example, once in the habit of saving it is a lot easier to keep going, whilst inertia may kick in if saving is not yet habitual.

Other drivers of savings behaviour:

Loss aversion. Individuals are also often strongly averse to losing money and may often accept lower positive returns in order to avoid negative ones, even if they may be risk takers when it comes to situations where there are no loss possibilities.

Herd mentality. Individual decisions are often made by observing and copying others, particularly if this reduces the effort required to carry out a full rational analysis of all the available options. Social norms are important indicators of behaviour. If the majority of someone’s peers own a house, have an Individual Savings Account (ISA), and contribute to a pension, they may be more likely to consider taking these actions as well.

Individuals may also follow norms of ‘mental accounting’ to help conceptualise their financial obligations, for example, having different savings accounts for different purposes. This means that it is less easy to predict how current consumption will respond to gains in income as the result is dependent on which account the individual allocates the gain to. For example, a gain of £1,000 in the value of housing wealth may be allocated to a different mental account from an equivalent gain from a work bonus.

The Commission also recognised practical barriers, most notably the lack of access of some low-moderate earners to a low-cost pension scheme. Personal accounts was created to fill this gap and to help make retirement saving more cost-effective.

3.3 Attitudes to saving

The DWP has commissioned several pieces of research to better understand individuals’ attitudes to and understanding of pensions, and their likely behaviour following automatic enrolment. This includes a quantitative survey of individuals who would be eligible for automatic enrolment\(^{23}\) and a follow-up in-depth study

with a sample of respondents who took part in the survey to explore their views in more depth.\textsuperscript{24}

These studies show that most people support the principle of automatic enrolment and welcome the workplace pension reforms – 64% of respondents in the survey found automatic enrolment ‘attractive’ and 69% said they would remain in the personal accounts scheme if automatically enrolled. The studies also echo the Pensions Commission’s view that few people make pensions savings decisions on the basis of rational calculations of likely outcomes. Instead people tend to use ‘rules of thumb’ or base decisions on more broadly stated desires such as a wish for a better retirement income or affordability constraints.

There was very little evidence of individuals using concepts analogous to net present value or likely returns from saving. The employer contribution, one of the most (if not the most) important driver of returns and payback, was mentioned but was described as an important but not decisive factor in their decision about whether to remain in personal accounts.\textsuperscript{25} Uncertainty about the worth of the pension was quoted as a decisive opt-out factor by some. However, many of these respondents went on to clarify that their concerns were around whether they could contribute enough for it to be ‘worthwhile’ – they were considering the eventual impact on retirement income but did not compare it to the value of the contributions. Some of those on low incomes, who would be making relatively small contributions, struggled to associate these with the large pots which might be built up. Others were concerned about what would happen to their pension pot should they die before reaching retirement.

In this research there was no explicit mention of potential interactions with income-related benefits in retirement. Instead, individuals expressed a desire to have a higher standard of living in retirement than the State alone would provide – for example, ‘I would like to think in years to come, when I wasn’t working, I could still be able to go out and buy something for my grandchildren’ – and the desirability of saving for retirement as a general principle.\textsuperscript{26} In contrast some lower-income individuals were concerned that contributing could lead to a reduction in their existing working-age benefits because they felt they may be perceived as having ‘spare’ income (in practice the opposite is true – some working-age benefits and tax credits offset some or all pension contributions when calculating benefit entitlement – see Appendix D for details). However, a previous piece


\textsuperscript{25} ibid.

\textsuperscript{26} ibid.
of research\textsuperscript{27}, which considered people’s perceived information needs around automatic enrolment in 2012, found that some people felt they would require information on the impact of saving (into a qualifying workplace pension) on eligibility for State benefits, both at working age and in retirement.

It is likely that to some extent this reflects a lack of knowledge of the workings of the benefit system. However, it also reflected awareness that State entitlement is not likely to provide the standard of living to which they aspire and the security and flexibility of having a private income.

\textbf{Box 3c: Why individuals said they would stay in or opt out of the personal accounts scheme if automatically enrolled\textsuperscript{28}}

These figures are based on a nationally representative survey of individuals who would be eligible for automatic enrolment about their attitudes and likely reactions to the workplace pension reforms. Respondents were able to give more than one reason, and their answers were unprompted. The following findings represent responses that were given by at least 10\%\textsuperscript{29} of the relevant respondents.

Those who said they were likely to remain in the personal accounts scheme if automatically enrolled said this was because:

- they needed to start saving for retirement (49\%);
- the scheme seemed like an easy way to save (31\%); and/or
- they wanted their employer to contribute to their pension (31\%).

Those who said they would be likely to opt out – 22\% of individuals – said this was because:

- they would rather save in a different way, other than in a pension (27\%);
- they already had a personal pension (16\%);
- they were too old to start saving (16\%);
- they couldn’t afford to save (16\%); and/or
- they were concerned about the return on investments/potentially losing their money (12\%).

\textsuperscript{27} McAlpine, C., Marshall, H. and Thomas, A. (2008) *The information that people may require to support their decision to remain in, or opt out of, a workplace pension*, DWP Research Report No. 540.


\textsuperscript{29} Excluding the response of ‘other’.
This study interviewed participants in depth about their reasons for remaining in or opting out of personal accounts, following on from the quantitative survey described above.

The majority of participants viewed saving for retirement as important – even those who did not themselves wish to stay in often saw encouraging pension saving as important in general (for example, some saw it as too late for them but a positive move for the younger generation).

There were four main decision-making strategies:

• **Cost-benefit analysis.** Individuals using this approach gave careful consideration to the relative costs of participation compared to the benefits and financial gain that saving would be likely to bring. They indicated that they would take time to weigh up the information and think through the impact that the contributions would have on their financial situation, both in the short and long term.

• **Short-term financial considerations.** Participants who used this approach made their decision by considering the cost of contributions relative to their current financial circumstances and the overall perceived affordability of saving. Unlike the cost-benefit approach, participants made their decisions on the basis of perceived cost alone rather than also taking the wider or longer-term benefits of saving into account.

• **Valuing the principle of saving for retirement.** A third approach to decision-making was governed by a strong appreciation of the value of making provision for retirement. The desire for future financial security for themselves and their families was a strong driver of decision-making for those using this approach. Those using this approach were especially likely to focus on the wider benefits of saving for retirement when making their decision.

Continued

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• Linking the decision to existing political and ideological standpoints. For a few participants, their strong political and ideological views on the role of the State tended to frame their approach to deciding whether or not to remain in the personal accounts scheme. In particular, the issue of automatic enrolment and the role the State takes in encouraging saving became a strong driver of the decision-making process for some. This issue tended to polarise views among those few participants with strong political and ideological standpoints, with some feeling strongly that State intervention was a very positive aspect of the reforms and the scheme, whilst others felt that it impinged on individual rights or choice.

The factors quoted as decisive in the decision to stay in or opt out are listed below.

Reasons to stay in:
• Perceived Government backing of the personal accounts scheme.
• Desire for a decent standard of living in retirement.
• Desire for financial independence during retirement.
• Desire to start saving as soon as possible.
• Changes in personal and family circumstances.

Reasons to opt out:
• Too young or too old to save.
• Changes in personal and family circumstances.
• Perceived affordability.
• Preference for other ways of saving and investing.
• Uncertainty about what a personal account will be worth when retiring.
• Negative experience of financial interactions with Government.31

The full reports can be accessed at www.dwp.gov.uk/asd/asd5/rrs-index.asp

The next section looks at individuals’ understanding and behaviour in more detail and the potential impact on their choices under pensions reform.

31 These individuals believed that the Government would take a lead role in administering the personal accounts scheme and were concerned that small administrative errors could potentially have a serious impact on their finances should they decide to stay in the scheme.
3.3.1 Evidence on individuals’ understanding and behaviour

As part of this work programme, the Department has commissioned PricewaterhouseCoopers to carry out a literature review on the current evidence on one aspect of these issues: individuals’ perceptions and understanding of savings incentives and their actual behavioural responses to those incentives. Their report is published alongside this one.

Their key conclusions were:

- The literature is clear that there is a lack of understanding of pensions. There is also evidence that there is currently limited take-up and impact on actions of available sources of information and advice.

- In addition to these informational issues, structural and behavioural barriers prevent people from saving as economic theory would expect, including unintended consequences of the tax/benefit system and procrastination and myopia.

- Despite such barriers, employer contributions and automatic enrolment have been found to effectively incentivise joining and contributing to pension schemes.

- The actions of parents are also seen to influence saving behaviour, as well as the use of mental accounting where people have different ‘pots’ of money reserved for different things.

- Individuals make decisions between different savings vehicles but may not always have a good understanding of the benefits of each vehicle and may not make choices between vehicles on a purely rational basis.

- The literature is unclear on how to motivate people to use information about pensions and saving, and on the extent of the impact of financial education. It would be interesting to learn more about what makes people trust different sources of information, different products and different providers – particularly following the recent economic turbulence.

- A better understanding of how uncertainty functions in people’s decision making would be helpful – given that it is seen to incentivise some people to save and disincentivise others.

DWP has an ongoing research programme to build understanding of individuals’ attitudes to, and knowledge of, pensions.

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Financial incentives to save for retirement under reform

Chapter summary

The previous chapter set out the many issues that affect individuals’ savings decisions. This chapter focuses on just one of these factors – the financial outcomes and in particular the likely returns that individuals can expect from their saving.

It does not show who should or should not save – that is for an individual to decide – but does analyse the outcomes that might be expected, given reasonable assumptions about the future. It considers savings made into a defined contribution pension scheme after 2012 with an employer contribution, and looks at outcomes if these people reach their age- and gender-specific life expectancy.

This analysis shows good returns for the vast majority of those modelled.

- Virtually everybody – over 99% – is better off in retirement by saving. In other words, they have more money available to them in retirement than if they hadn’t saved.
- For the vast majority – over 95% – the improvement is greater than the cost of their contributions.
- The large majority of savers get back more than twice what they put in, even after taking inflation into account.

Sensitivity analysis shows that under reasonable variation in the modelling assumptions we still see a payback of greater than £1 per £1 for the vast majority of savers.

Payback on saving for a retirement income is likely to be greater in a pension with an employer contribution than in other savings vehicles without such a contribution. However, other vehicles may be more suitable for other forms of saving.
Chapter 3 set out some of the issues individuals consider when deciding whether to save for retirement and the main ways in which they understand these factors and take account of them in their decision-making process. It shows that the considerations are likely to vary and be given different weights depending on the individual’s own preferences, circumstances and plans for retirement.

This chapter focuses on just one of the issues – the financial outcomes and in particular, the likely ‘payback’ that individuals can expect from their saving, and the individual characteristics and State regulations that might affect these outcomes.

Payback is calculated by dividing the real value of the extra income in retirement by the real value of the contributions made into a defined contribution scheme with employer contribution post-2012. It assesses the returns to saving across all such pension saving as opposed to the marginal value of saving one additional pound.

Someone saving at the default rate of 4% with tax relief and a 3% employer contribution would have a payback of £2 per £1 before the impact of any real investment return or tax or benefit in retirement. Several of the case studies presented have payback in excess of £3 as they have many years of investment growth and limited interaction with tax or benefits in retirement.

**Box 4a: Payback**

Payback is the value in retirement of each £1 invested by an individual, taking account of matching contributions, tax relief, investment growth, the effects of the tax and benefit system, and inflation.

It helps evaluate the difference that saving makes by comparing someone’s estimated incomes both with and without saving. Incomes may include State contributory pension entitlement, income-related benefits, a partner’s income and previous savings before reform. This means that payback does not show the whole amount of the pension itself. If an individual receives a pension of £50 a week and has no benefit entitlement, but would have been entitled to £10 of benefit if they had no pension, their improvement in income from saving is £40, and it is the £40 that is used in the payback calculation.

Payback is calculated by dividing the extra money in retirement by the value of the contributions. It assesses the returns to saving across working age as opposed to the marginal value of saving one additional pound.

Payback looks only at the impact on income of each £1 of savings. It does not provide a measure of an individual’s improvement in income or overall well-being in retirement.
Nor does it take into account how strongly someone values money available now compared to money to come in the future, or the relative value of money to them at any given time – during a period when income is relatively low, each pound is likely to be worth more than when income is larger.

Payback figures are presented in real terms, to take account of the impact of inflation over a lifetime.

None of the analysis in this document can be taken to show that a particular individual should or should not save. Those who appear to have lower financial incentives may strongly wish to save, perhaps because their main priority is to have a secure and flexible income in retirement while they have fewer calls on their income today. Alternatively, those with the clearest financial gains from saving might legitimately decide to opt out of saving in a pension, for example, because their interests and plans are such that they have more need for the income today, despite the implications for their retirement incomes, or because they already have sufficient provision in place. Ultimately it is a decision for the individual.

4.1 Our analytical approach

Final outcomes from saving may be affected by a large number of factors. We cannot analyse every one of these factors for each person in the target population, nor is it possible to summarise every one of the different facets in a single easily interpretable way. Our approach has, therefore, been to draw on a range of analytical techniques to give as full a picture as possible, with each approach presenting different insights.

We have used two models to estimate the financial outcomes from saving. Our case study modelling looks at a single individual or couple at a time. It can show clearly how individual characteristics interact with the pensions system to drive outcomes. Case studies cannot show how common a particular outcome will be. However, the core case studies used in this report have been derived from real survey data on the population eligible for automatic enrolment (see Appendix A). This methodology was used to make the cases more realistic and to avoid the situation where a case with very extreme or unusual characteristics is given disproportionate weight – as much so as a far more ‘typical’ case – and that the main groups of the target population are represented. However, the cases have been chosen to focus more on those in the lowest part of the earnings distribution of those eligible for automatic enrolment and with little or no other saving – they do not show a fully balanced picture of those likely to be eligible for automatic enrolment. We have also considered supplementary cases which are not typical of a large proportion of the target population but focus on sets of characteristics which have been identified as being of particular concern by stakeholders.
The Pensim2 model, by contrast, aims to model the future population, taking into account the probability of different careers and behaviours. It can estimate what proportion of individuals will have particular characteristics or see particular outcomes. For this report we have looked at the payback from any saving by an individual in a defined contribution pension with an employer contribution after 2012.

Some inevitable limitations must be borne in mind when considering any of this analysis. The first and most obvious is that no-one can predict the future, either for an individual or society as a whole. The pension reforms aim to maximise certainty in the pension system as far as possible, setting out a vision for the pension system for the next 50 years. But other factors must be projected – tax rates, life expectancy and working habits being some of the most relevant – and future governments will retain the ability to make further reforms. Such future changes are particularly important here where modelling must look many decades into the future. Under current life expectancy assumptions, we expect that many of the individuals automatically enrolled into a pension in 2012 will live well into their 90s and beyond, so final outcomes will be influenced by the shape of the world as far forward as the 2080s and 2090s.

**Box 4b: Lessons from the Savings Incentives Work Programme: factors influencing outcomes in retirement**

As part of the Savings Incentives Work Programme, Professor John Hills presented a list of some of the individual characteristics which might affect an individual’s resources in retirement and so the likely outcomes from saving:

- Gender
- Age
- Employment status and earnings
- Existing savings
- Existing pension rights
- Housing tenure
- Likely future employment pattern
- State of health
- Future investment returns
- Future housing plans
- Likelihood of marriage surviving
- Risk aversion
- Assets and relations with elderly relatives
- Great Aunt Ethel’s state of health…and all of those things for any partner.

Continued
In addition, any analysis must take account of the characteristics of the system within which they are (or are not) saving, including:

- Pension rules
- Contributions from employers
- Tax relief on contributions
- Interaction with benefits in working life
- Potential interactions with tax and benefit rules in retirement.

These models look solely at financial outcomes, and in particular at the likely payback from saving. Other research, both within and outside Government, has looked at wider impacts and issues and how these various issues are likely to impact on individuals’ actual behaviour.

These figures look far into the future so account must be taken of inflation. Most of the figures in this report, including payback figures, are shown in real terms to take account of inflation. This means the figures clearly show the impact on saving of an individual’s ability to spend and consume – a real payback of £2 means they can buy twice as much in retirement as they have given up during working life by saving. Where stated, payback figures are also shown in cash terms – the actual amount they will get back.

We have also taken account of the likely growth of earnings. People may consider not only the amount their income may buy but how it compares to the income of their peers and the income they have been used to themselves in working life. In 2050, an income that looks high today, even after taking account of inflation, might leave someone unable to afford the goods and activities they have become used to and which their friends can afford.

The State pensions and benefits system recognises this, with State Second Pension accruals already linked to earnings and the basic State Pension and standard minimum guarantee in Pension Credit linked to earnings in the long-term under reform.

Levels of income are, therefore, also shown in today’s earnings terms to reflect how they will compare to incomes in the population at that time.

Appendix A gives further details of the modelling used, while Appendix B sets out the evidence on the working-age population today which has underpinned the analysis and interpretation here.
Box 4c: Lessons from the Savings Incentives Work Programme: choosing appropriate case studies

Previous analysis of incentives to save and the impact of reforms as a whole has made use of case studies, in particular as part of the Gender Impact Assessment where case studies devised with the help of the Equality and Human Rights Commission were used to show the impact of reforms on particular groups.

Initial discussions with stakeholders as part of the Savings Incentives Work Programme emphasised the need to understand likely outcomes from saving for particular groups and to understand more about the typicality of such cases. Case studies were suggested as a clear way to present such information, while grounding their definition in real world data ensures that we are not focusing on ‘extreme’ examples.

All earnings data is based on the group eligible for automatic enrolment, who have lower earnings on average than the population as a whole. However, stakeholders suggested that the cases illustrated should be disproportionately those on lower earnings even for this group. The cases should not, therefore, be taken to be a balanced picture of those likely to be eligible for automatic enrolment. However, the Pensim2 modelling is based on a representative sample of the whole population.

Figure 4.1 provides an overview of the approach adopted and the main characteristics considered: first the target population is split by age, then it is subdivided into groups by the most important characteristics and at least one case taken from each group. For each of these cases other important characteristics are modelled using information from survey data for that group. These form the 11 core case studies. Seven supplementary case studies are developed by taking particular characteristics of interest (e.g. renters) and using survey data to inform the choice of other characteristics for these cases. Further detail of our approach and the full definitions of the case studies used are in Appendix A.
The seven supplementary cases are:

- a single woman with a very long career break and where most of her saving takes place later in life;
- the same woman coupled with a low earning man;
- a single older low earning man with no other savings;
- a single older women with a very long career break, low earnings and no other savings;
- the above two cases as a couple;
- an older worker who has lived in rented accommodation throughout his life and is eligible for Housing Benefit (HB) in retirement;
- an individual who has spent considerable time outside employment without caring or disability credits and so has a limited State Second Pension record coupled with an unusually short period of private pension saving.
4.2 Expected payback for individuals

Table 4.1 shows the outcomes from saving under reform\textsuperscript{33} for the core case studies. They assume each individual saves, where applicable, at the default rate under the proposed reforms and the employer contribution is the minimum required under reform. They assume the individual takes the tax-free lump sum at State Pension age (SPA), which is by far more usual than annuitising the whole pot. Total income is shown, including State Pension and benefits and any pre-2012 pension income as well as further saving under reform. Payback figures relate only to pension saving made after 2012.

Table 4.1 Weekly income and payback from saving for the core case studies

<table>
<thead>
<tr>
<th></th>
<th>Results in today’s prices</th>
<th>Results in today’s earnings equivalent</th>
<th>Payback</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Income (£)</td>
<td>Lump sum (£)</td>
<td>Income (£)</td>
</tr>
<tr>
<td>1. Low earning man</td>
<td>477</td>
<td>29,325</td>
<td>185</td>
</tr>
<tr>
<td>2. Median earning man</td>
<td>508</td>
<td>45,712</td>
<td>197</td>
</tr>
<tr>
<td>3. High earning man</td>
<td>548</td>
<td>69,765</td>
<td>213</td>
</tr>
<tr>
<td>4. Low earning man with a period of self-employment (opts-in)</td>
<td>441</td>
<td>26,876</td>
<td>172</td>
</tr>
<tr>
<td>5. Low earning man with a period of self-employment (opts-out)</td>
<td>433</td>
<td>22,795</td>
<td>168</td>
</tr>
<tr>
<td>6. Low earning woman with career break</td>
<td>441</td>
<td>10,170</td>
<td>171</td>
</tr>
<tr>
<td>7. Low earning couple, woman with career break (cases 1+6)</td>
<td>869</td>
<td>39,493</td>
<td>338</td>
</tr>
<tr>
<td>8. Median age couple</td>
<td>648</td>
<td>30,258</td>
<td>332</td>
</tr>
<tr>
<td>9. Older man</td>
<td>253</td>
<td>3,639</td>
<td>189</td>
</tr>
<tr>
<td>10. Older woman</td>
<td>220</td>
<td>1,781</td>
<td>161</td>
</tr>
<tr>
<td>11. Older couple (cases 9+10)</td>
<td>424</td>
<td>5,420</td>
<td>311</td>
</tr>
</tbody>
</table>

Source: DWP modelling.

Notes: Net weekly income is shown for year 2 in retirement as it is assumed that any capital is spent in the first year of retirement, including the lump sum. Net income includes some income from previous pension saving for some older workers, as well as any State entitlements. Lump sum figures are from post-2012 saving only. For individual assumptions see Appendix A.

All of these case studies find that saving improves their income in retirement as we would expect, and all get a payback of at least £1 plus inflation for each £1 contributed.

\textsuperscript{33} Saving under reform in this context is taken to mean workplace pension saving post-automatic enrolment in 2012. Some of the cases are assumed to have some other savings and for some of the older workers some past pension saving. See Appendix A for full assumptions.
Table 4.2 shows outcomes when some of the decisions around lump sums and capital draw down are varied. The first columns show the base scenario as outlined above. The middle columns show the scenario that will give the highest income stream in retirement: that where the individual annuitises all of their pension pot (including the lump sum) and spends this and other capital steadily throughout retirement. The final columns show the impact of taking the whole pension pot as a lump sum where this is permitted under trivial commutation rules and spending all of their capital quickly.

### Table 4.2  Outcomes from saving for the core case studies with varied decumulation decisions

<table>
<thead>
<tr>
<th></th>
<th>Lump sum and capital spent (base case)</th>
<th>Whole pot annuitised, capital drawn down gradually</th>
<th>Whole pot trivially commuted and capital spent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net income (£)</td>
<td>Payback (£)</td>
<td>Net income (£)</td>
</tr>
<tr>
<td>Low earning man</td>
<td>185</td>
<td>3.06</td>
<td>192</td>
</tr>
<tr>
<td>Median earning man</td>
<td>197</td>
<td>3.02</td>
<td>247</td>
</tr>
<tr>
<td>High earning man</td>
<td>213</td>
<td>2.93</td>
<td>339</td>
</tr>
<tr>
<td>Low earning man with a period of self-employment (opts in)</td>
<td>172</td>
<td>2.38</td>
<td>178</td>
</tr>
<tr>
<td>Low earning man with a period of self-employment (opts out)</td>
<td>168</td>
<td>3.15</td>
<td>174</td>
</tr>
<tr>
<td>Low earning woman with career break</td>
<td>171</td>
<td>2.54</td>
<td>174</td>
</tr>
<tr>
<td>Low earning couple, woman with career break (cases 1+6)</td>
<td>338</td>
<td>3.28</td>
<td>356</td>
</tr>
<tr>
<td>Median age couple</td>
<td>332</td>
<td>2.55</td>
<td>381</td>
</tr>
<tr>
<td>Older man</td>
<td>189</td>
<td>1.67</td>
<td>213</td>
</tr>
<tr>
<td>Older woman</td>
<td>161</td>
<td>1.44</td>
<td>159</td>
</tr>
<tr>
<td>Older couple</td>
<td>311</td>
<td>1.74</td>
<td>360</td>
</tr>
</tbody>
</table>

Source: DWP modelling.

Notes: Most case studies have pension pots that would be above the trivial commutation limit and so this option is not available to them.

In the case where the whole pension pot is drawn down gradually, capital from non-pension savings (where applicable) is assumed to be spent at the rate of 10% of the remaining sum per year and included in the income figures. Net income also includes some income from previous pension saving for some older workers.

The payback will vary between these options because of differences in both the total paid out in real terms and potentially different interactions with the tax and benefit system.
The Pensim2 analysis is more complex. The analysis presented here shows the outcomes from saving in any defined contribution pension with an employer contribution after 2012 under reform. It takes account of any reduction in entitlement to benefits in retirement from saving but does not include any increases in benefit entitlement during working life. This will tend to produce an underestimate of the average payback from saving – true outcomes may be higher on average.

The model does not take into account any impact on behaviour from information provided or other communications around reform.

Results from this model echo those from the case studies above. Figure 4.2 shows the average payback by age and gender. All groups can expect to get back significantly more, on average, in real terms than they put in. Younger groups, who have more time to benefit from investment returns as well as seeing the full benefit of the State Pension reforms, can expect to get back £2 or more plus inflation for each £1 contributed.

**Figure 4.2** Median real payback for people saving in a defined contribution pension with employer contribution after 2012

![Bar chart showing median real payback by birth cohort and gender](chart.png)

This suggests that, under reasonable assumptions, most individuals can expect good returns from saving.
4.3 Range of returns

The results opposite show expected outcomes by broad characteristics and for the core case studies based on survey data. We know that not everyone will see these average outcomes and a focus of this work programme has been the degree of predictability of the variation around such good average results.

Figure 4.3 shows the ranges of payback for each cohort given full knowledge of their future characteristics, and making fixed assumptions about factors such as their date of death. It does not represent a range of variation predictable in advance. We see that in every age group, the vast majority of individuals get more than £1 plus inflation for every £1 saved, ranging from 93% for the oldest group to 98% for those with a full adult lifetime under reform.

In total, over 95% of savers get more than £1 plus inflation for every £1 saved.

Figure 4.3 Distribution of real payback from saving in a defined contribution pension with employer contribution after 2012

Source: DWP modelling using Pensim2 model.

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Those who die unexpectedly shortly after annuitising their pension will inevitably get lower returns than those who live much longer, but this is not predictable in advance (where a shorter retirement is predicted, impaired life annuities can increase returns). The analysis here eliminates this source of variation by assuming everyone lives exactly to the average age for their gender and birth cohort. See Appendix A for more details.
Our supplementary case studies were designed to improve our insight into the range of returns seen by showing the results for a wider range of characteristics, particularly those which have been suggested as potentially leading to lower returns. These characteristics may not be common in the population – for example, most older people have some pension or non-pension savings.

### Table 4.3 Weekly income and payback from saving for the supplementary case studies

<table>
<thead>
<tr>
<th>Case Description</th>
<th>Results in today's prices</th>
<th>Results in today's earnings equivalent</th>
<th>Payback</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Income (£)</td>
<td>Plus lump sum (£)</td>
<td>Payback</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Income (£)</td>
<td>Lump sum (£)</td>
</tr>
<tr>
<td>12. Low earning woman with a long career break</td>
<td>436</td>
<td>5,646</td>
<td>169</td>
</tr>
<tr>
<td>13. Low earning couple, woman with long career break (cases 1+12)</td>
<td>862</td>
<td>34,970</td>
<td>335</td>
</tr>
<tr>
<td>14. Older low earning man with no savings</td>
<td>214</td>
<td>1,503</td>
<td>160</td>
</tr>
<tr>
<td>15. Older low earning woman with a long career break</td>
<td>204</td>
<td>1,715</td>
<td>149</td>
</tr>
<tr>
<td>16. Older low earning couple (cases 14+15)</td>
<td>348</td>
<td>3,219</td>
<td>255</td>
</tr>
<tr>
<td>17. Older lifetime renter</td>
<td>346</td>
<td>6,047</td>
<td>229</td>
</tr>
</tbody>
</table>

Source: DWP modelling.

Notes: Net weekly income is shown for year 2 in retirement as it is assumed that any capital is spent in the first year of retirement, including the lump sum. Net income includes some income from previous pension saving for some older workers, as well as any State entitlements. Lump sum figures are from post-2012 saving only. For individual assumptions, see Appendix A.

For all cases, income on retirement is increased from post-reform saving. The lowest payback is shown for the older renter, who, in the base case, gets back the full amount of his contributions in nominal terms but does not get back an increase to compensate for inflation – his nominal payback is £1 but his real payback is below £1. He is still better off in retirement than he would have been if he had not saved: his saving provides a tax-free lump sum of over £4,000 in today's earnings terms at the point of retirement, and his pension is greater than the reduction in benefit entitlement.

The older, low earner examples would see relatively little impact on income because their low earnings mean they make only very small contributions. However, they would be able to trivially commute their savings and gain a cushion of savings.
4.4 Sensitivity analysis

Any projections of future private pension income are inevitably based on assumptions about how the economy and society will develop in future. These represent the best estimate of the future. This section looks at the degree to which outcomes vary in response to any variation in the assumptions made. This is predominantly done through scenario analysis, which involves changing several assumptions such as the assumed rate of return on investments and employment histories to create two ‘scenarios’. This method is appropriate for giving a guide to the overall sensitivity of results and the likely precision of the central estimates.

Scenario 1 shows the impact of higher investment returns and employment among other changes while scenario 2 shows the impact of changes in the opposite direction, so decreases in investment returns, etc. Appendix A sets out in detail our central assumptions and the variations used to create the scenarios.

This shows that changes in assumptions have only a small impact on the modelled paybacks. This echoes previous analysis35 and reflects two key aspects of reform in particular: the State Pension reforms, which ensure that most people can expect to accrue a State Pension well above the Pension Credit minimum, and the value of the matching contributions. Even large changes in assumptions do not significantly affect the impact of these two factors and so the overall payback levels are similar.

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Box 4d: Lessons from the Savings Incentives Work Programme: the importance of sensitivity analysis

As part of the savings incentives work programme we have consulted with a range of academic experts to help us develop our analytical programme.

These experts agreed that no single analytical approach can give the full picture and so a variety of analytical methods should be used. They also emphasised the inevitable uncertainties in projecting into the future. They accepted that the main assumptions we have made seemed reasonable but that some scenario analysis is important to demonstrate the impact of reasonable variation in these assumptions.

They also emphasised the disconnect between economic theory and real world behaviour and the need to consider behavioural issues, drawing on both quantitative and qualitative work.

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We also know that individuals’ own decisions can impact on their payback. For example, choosing to work an extra five years would increase payback for all the case studies shown – retiring later gives more time for investment growth on
average and results in a higher private pension, and may be sufficient to take an individual above the benefit entitlement level of income for some or all of their retirement (see Appendix C).

When interpreting modelled outcomes, it is important to remember that individuals may react to factors such as their predicted income as they get closer to retirement, they do not simply follow paths as our modelled individual must do. The next chapter looks at the degree to which we can identify characteristics associated with different levels of payback and Chapter 7 looks at how we can help individuals take account of this and other relevant factors when deciding whether to remain in a pension.

4.5 Comparison of incentives with and without pensions reform

The case studies can also be used to compare the impact of reform on incentives to save. Table 4.4 shows the paybacks for our core case studies if the reforms in the Pensions Acts 2007 and 2008 had not been implemented. It assumes the individual does save without automatic enrolment, but they do not receive an employer contribution, and that the Guarantee Credit is uprated by earnings. All of the core cases see a higher payback under reform. Without reform, two of our core case studies, the older man and older woman, and three of our supplementary cases would have got payback of less than £1 plus inflation per £1 contributed. Only one case study sees a higher payback in the pre-reform scenario – that of the older renter. This is because he now has a much lower State Pension and so receives Guarantee Credit in retirement, passporting him onto full HB. The reforms do enable him to build up a larger private pension and a higher lump sum.
### Table 4.4 Payback with and without reform

<table>
<thead>
<tr>
<th></th>
<th>With reform (cash terms) (£)</th>
<th>With reform (real terms) (£)</th>
<th>Without reform (cash terms) (£)</th>
<th>Without reform (real terms) (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Low earning man</td>
<td>6.20</td>
<td>3.06</td>
<td>2.87</td>
<td>1.42</td>
</tr>
<tr>
<td>2. Median earning man</td>
<td>6.16</td>
<td>3.02</td>
<td>2.86</td>
<td>1.42</td>
</tr>
<tr>
<td>3. High earning man</td>
<td>5.96</td>
<td>2.93</td>
<td>2.83</td>
<td>1.40</td>
</tr>
<tr>
<td>4. Low earning man with a period of self-employment (opts-in)</td>
<td>4.69</td>
<td>2.38</td>
<td>4.58</td>
<td>1.79</td>
</tr>
<tr>
<td>5. Low earning man with a period of self-employment (opts-out)</td>
<td>7.81</td>
<td>3.15</td>
<td>4.37</td>
<td>1.72</td>
</tr>
<tr>
<td>6. Low earning woman with career break</td>
<td>4.80</td>
<td>2.54</td>
<td>2.55</td>
<td>1.31</td>
</tr>
<tr>
<td>7. Low earning couple, woman with career break (cases 1+6)</td>
<td>6.59</td>
<td>3.28</td>
<td>5.18</td>
<td>2.42</td>
</tr>
<tr>
<td>8. Median age couple</td>
<td>4.56</td>
<td>2.55</td>
<td>3.01</td>
<td>1.64</td>
</tr>
<tr>
<td>9. Older man</td>
<td>2.39</td>
<td>1.67</td>
<td>1.18</td>
<td>0.82</td>
</tr>
<tr>
<td>10. Older woman</td>
<td>2.14</td>
<td>1.44</td>
<td>1.38</td>
<td>0.92</td>
</tr>
<tr>
<td>11. Older couple (cases 9+10)</td>
<td>2.54</td>
<td>1.74</td>
<td>1.82</td>
<td>1.21</td>
</tr>
<tr>
<td>12. Low earning woman with a long career break</td>
<td>2.69</td>
<td>1.77</td>
<td>1.56</td>
<td>1.00</td>
</tr>
<tr>
<td>13. Low earning couple, woman with long career break (cases 1+12)</td>
<td>5.83</td>
<td>3.07</td>
<td>4.90</td>
<td>2.39</td>
</tr>
<tr>
<td>14. Older low earning man with no savings</td>
<td>2.01</td>
<td>1.42</td>
<td>1.28</td>
<td>0.90</td>
</tr>
<tr>
<td>15. Older low earning woman with a long career break</td>
<td>1.64</td>
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<td>1.34</td>
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</tr>
<tr>
<td>16. Older low earning couple (cases 14+15)</td>
<td>2.64</td>
<td>1.81</td>
<td>1.86</td>
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</tr>
<tr>
<td>17. Older lifetime renter</td>
<td>1.00</td>
<td>0.76</td>
<td>1.47</td>
<td>0.96</td>
</tr>
<tr>
<td>18. Limited State Second Pension and private saving</td>
<td>12.14</td>
<td>3.83</td>
<td>6.87</td>
<td>2.15</td>
</tr>
</tbody>
</table>

Source: DWP modelling.

#### 4.6 Alternative outcome measures

The analysis in this report focuses on outcomes from saving measured by the income achieved in retirement and the payback on an individual’s contributions. Other measures could be used to highlight particular aspects of financial outcomes and this section illustrates outcomes measured by the internal rate of return (IRR) on saving and the replacement rate achieved. Other measures, such as outcomes taking into account the welfare gains from income smoothing, are presented in other DWP publications.\(^{36}\)

The IRR is defined as the increase in value of the contribution per year, averaged over the life of the investment (see Appendix A for more detail).

**It is important to note that the IRRs presented here are not the same as investment returns.** Investment returns show only the gross increase through returns on investment in a particular year. IRRs include this impact but also take into account the value of the matching contribution (meaning a higher rate of return in that year) and any tax liability or loss of benefit in later years (which will reduce the rate of return for that year). Fuller details are given in Appendix A.

Because the IRR is an annual figure, while payback shows the total return, there is no simple relationship between the two. However, for a given case study, a change resulting in an increase in payback will generally result in a similar increase in the IRR and vice versa\(^{37}\). A payback of £1 plus inflation per £1 is always equivalent to an IRR equal to the rate of inflation – 2.87\% in our modelling.

A replacement rate shows an individual’s income in the first year of retirement as a proportion of their income in their final year of work. A change that increased a person’s retirement income by 10\% (but did not affect income in working life) would also increase their replacement rate by 10\%. Again, details can be found in Appendix A.

As we would expect, the results using these measures give very much the same picture as our main results focusing on payback.

All the case studies are better off in retirement for saving. All the core cases and all but one of the supplementary case studies have an IRR significantly above inflation, reflecting the benefits of the employer contribution and tax relief as well as investment growth. The older renter has an IRR of zero – this means that the income he receives in retirement is exactly equal to the cash value of his contributions (equivalent to a payback of £1 per £1 in nominal terms).

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\(^{37}\) The exception is measures which affect the timing of contributions or income received – such timing changes will not affect the payback measure but will affect the IRR.
Table 4.5  Comparison of outcome measures

<table>
<thead>
<tr>
<th>Core case studies</th>
<th>Real payback (£)</th>
<th>Internal rate of return – IRR (%)</th>
<th>Replacement rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Low earning man</td>
<td>3.06</td>
<td>7.07</td>
<td>61</td>
</tr>
<tr>
<td>2. Median earning man</td>
<td>3.02</td>
<td>7.01</td>
<td>48</td>
</tr>
<tr>
<td>3. High earning man</td>
<td>2.93</td>
<td>6.92</td>
<td>38</td>
</tr>
<tr>
<td>4. Low earning man with a period of self-employment (opts-in)</td>
<td>2.38</td>
<td>6.28</td>
<td>55</td>
</tr>
<tr>
<td>5. Low earning man with a period of self-employment (opts-out)</td>
<td>3.15</td>
<td>6.53</td>
<td>54</td>
</tr>
<tr>
<td>6. Low earning woman with career break</td>
<td>2.54</td>
<td>6.93</td>
<td>88</td>
</tr>
<tr>
<td>7. Low earning couple, woman with career break (cases 1+6)</td>
<td>3.28</td>
<td>7.42</td>
<td>67</td>
</tr>
<tr>
<td>8. Median age couple</td>
<td>2.55</td>
<td>7.62</td>
<td>47</td>
</tr>
<tr>
<td>9. Older man</td>
<td>1.67</td>
<td>7.74</td>
<td>47</td>
</tr>
<tr>
<td>10. Older woman</td>
<td>1.44</td>
<td>6.02</td>
<td>69</td>
</tr>
<tr>
<td>11. Older couple (cases 9+10)</td>
<td>1.74</td>
<td>8.00</td>
<td>49</td>
</tr>
<tr>
<td>12. Low earning woman with a long career break</td>
<td>1.77</td>
<td>7.23</td>
<td>60</td>
</tr>
<tr>
<td>13. Low earning couple, woman with long career break (cases 1+12)</td>
<td>3.07</td>
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<td>1.42</td>
<td>6.25</td>
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<td>15. Older low earning woman with a long career break</td>
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<td>16. Older low earning couple (cases 14+15)</td>
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<tr>
<td>17. Older lifetime renter</td>
<td>0.76</td>
<td>0.00</td>
<td>63</td>
</tr>
<tr>
<td>18. Limited State Second Pension and private saving</td>
<td>3.83</td>
<td>6.34</td>
<td>53</td>
</tr>
</tbody>
</table>

Source: DWP modelling.

4.7  Outcomes from saving in alternative vehicles

Individuals will have the choice to save in a pension or in alternative vehicles. When saving for retirement, pensions have the advantage of tax relief and, where applicable, an employer contribution.
Income and saving from all sources may be taken into account when calculating benefit entitlement.

Box 4e sets out possible alternative vehicles for saving and how pensions and other savings vehicles can be used together to meet different needs.

Box 4e: Outcomes from saving in alternative vehicles

It is often quoted, particularly in periods of financial turbulence, that you would be better off putting savings ‘under a mattress’.

However, putting money under a mattress will not give any return on the investment, and inflation means that the real value of that money will fall over time. A vehicle with an interest rate at least as great as inflation is needed to keep the value of any savings steady.

As an example, if the lower earning man case study placed an equivalent amount of cash under the mattress instead of into a pension, his real payback would be only 62 pence per pound invested, whilst that from being automatically enrolled into a pension under reform would be around five times higher at £3.0638.

Other vehicles

Different savings vehicles are designed for different purposes and many people will want to save in different ways to meet both shorter-term and longer-term needs. Government has provided financial incentives to save and encouraged financial capability and inclusion through a number of vehicles:

- Tax-advantaged Individual Saving Accounts (ISAs), introduced in 1999, have been successful in developing and extending the saving habit and ensuring a fairer distribution of tax relief.
- The Child Trust Fund (CTF) was introduced in 2005 and will ensure that, in future, all children will have a financial asset at age 18.
- In order to provide additional support for working-age people on lower incomes, the Saving Gateway will be introduced nationally, with the first accounts available to savers in 2010. The scheme offers the incentive of a Government contribution for each pound saved, helping to kick-start a saving habit.

Continued

Assuming the maximum is spent in the first year of retirement, ie the whole of the cash saving under the mattress and the 25% lump sum of pension saving. Payback on pension saving includes the effect of any interaction with the tax and benefit system of the remaining 75%.
These savings vehicles help to build savings and assets for all, throughout the life cycle, but are different types of product to pensions. For example, ISAs can complement pensions.\textsuperscript{39} There are a number of distinct advantages to pensions which make them one of the best ways to save for retirement. Tax relief is given on both pension contributions and capital growth, with tax relief increasing the value of contributions by a quarter for someone on the basic rate of income tax, and by two-thirds for a higher rate tax payer. Pension saving also provides a tax-free lump sum, representing income that has never been taxed, and with pension saving taxed on withdrawal rather than at the time of saving, many people may benefit if they retire onto a lower rate of income tax than that which they faced when saving.

Pension saving also has the advantage of attracting an employer contribution, which under automatic enrolment will, alongside tax relief, double the value of the individual contribution. Furthermore, there is no temptation to erode pension saving in the way there is for other types of asset, and annuitising a pension will give a regular fixed amount however long you live, which may be harder to achieve with other savings products.

Savings from all sources are taken into account when determining benefit entitlement. It is not appropriate to compare returns in pensions after taking into account benefit entitlement with gross returns in other savings products as saving in these products may also affect benefit entitlement. The correct comparison would be with other savings after any tax or benefit interaction.

\textsuperscript{39} HM Revenue & Customs (HMRC) ISA Omnibus Survey 2005.
5 Characteristics of those with different levels of payback

Chapter summary

None of the analysis finds any large subgroup of the working-age population which will not benefit from saving. However, it does identify two sets of characteristics in retirement which are associated with lower returns than average: those with extremely limited entitlement to the State Pension and no significant private income or with low income and extra needs, and those who rent in retirement with a low-moderate income. Many people in these groups can still see payback of £1 or more plus inflation, particularly if they choose to take some of their pension pot as a lump sum, but an individual who expects to be in one of these groups at retirement may wish to consider their decision more carefully.

However, virtually all savers, including the vast majority of those in the groups above, will be better off in retirement through saving as any reduction in entitlement to benefit will be smaller than the value of the pension.

This section looks in more detail at links between characteristics and outcomes. The characteristics used will not all be known at the point of automatic enrolment but have been chosen as being to some degree predictable by an individual, particularly by those closer to retirement. This is a crucial point: decisions at the point of saving cannot be based on characteristics that only emerge later.

Three broad groupings emerge from this analysis: i) those who have very low State Pension entitlement and few other resources or who have limited resources and extra needs; ii) those who are renting in retirement; and iii) the majority group who do not have these characteristics and into which the vast majority of those automatically enrolled will fall.
Two notes of caution should be borne in mind when considering the groupings presented here:

The first is that it does not, by itself, show whether any particular group or person should opt in or opt out. Individuals will make their own decisions based on a wide range of factors of which expected returns is just one, and different people may make different judgements about the same pieces of information.

The second is that it is based on broad groupings and pieces of analysis based on particular assumptions. Where a characteristic or set of characteristics is shown to be linked to higher or lower payback this does not mean that all people in the group will see these outcomes. What it does show is that on current assumptions, most people in this group are projected to achieve broadly these outcomes and they may wish to factor such correlations into their decision-making. It would be false to suggest that having any particular characteristic means poor returns or a poor deal from saving.

5.1 Those with very limited State Pension entitlement or other savings, or limited entitlement/savings and extra needs

Those with high Pension Credit entitlement may face a high taper rate and so have lower payback.

The Savings Credit in Pension Credit rewards those who have saved for themselves above a minimum level (within a certain range) – effectively reducing the taper rate. An individual will not be eligible to receive this reward if their total State and private resources amount to a sum less than the lower threshold of the Savings Credit (see Chapter 2 for details on thresholds and tapers).

Individuals may fall into this group because they have made relatively few contributions to the National Insurance system during their working life, perhaps due to living abroad (and not accruing pension there) or doing activities which are not eligible for credits, and have not made significant private savings prior to reform. This relates to a small group of people and one which will be falling over time.

Some individuals who have low income (but above this very low threshold) but are eligible for the premia in Pension Credit for disability or caring needs, and who have already received the maximum Savings Credit, will also face higher taper rates.

Around 70% of those modelled as having payback of less than £1 per £1 have some Guarantee Credit entitlement and so may have faced high taper rates on some of their private pension.

These people are likely to be benefiting from significant amounts of income-related benefits and might otherwise be in severe poverty.
We can look in more detail at this group:

- The vast majority of this group will have higher income and/or capital in retirement than if they had not saved. Less than 10% of those with payback of less than £1 plus inflation per £1 - less than 0.5% of the savers analysed – have Guarantee Credit but no Savings Credit entitlement in retirement. Furthermore, they could benefit from getting 25% of their pot back through the tax-free lump sum – equivalent to half the value of their own contributions for those saving at the default level in personal accounts.

- Anyone who is employed and not building State Pension entitlement is by definition earning below the Lower Earnings Limit (LEL) and so should fall below the threshold for automatic enrolment. Just 25 years of State Pension accruals through employment or credits after 2002 is sufficient to take a single individual above the Savings Credit Threshold, even before any private saving is included.

- This means that, under reform, someone with entitlement to the Guarantee Credit but not Savings Credit will not have a full history of automatic enrolment and will not have a large amount of alternative private saving. Pensim2 analysis projects that a third of this group will have a pension below the trivial commutation limit. People in this group who trivially commute and take their pot with little or no benefit interaction see good returns.

- Those who have extra entitlement to Pension Credit to reflect disability or caring duties are entitled to the same savings reward as other groups. Those who have reached this maximum while retaining some Guarantee Credit entitlement will not get further savings reward on higher private incomes.

People in this group are those who are gaining from the safety net of the minimum income. We do not expect individuals – particularly younger individuals – to be planning or expecting to receive such benefits.

### 5.2 Those renting in retirement

Those who rent in retirement may see lower payback (even if they are not in the group above) due to their interaction with Housing Benefit (HB).\(^{40}\) Around two-thirds of those with payback of less than £1 per £1 have some HB entitlement, or would have had some if they had not saved.

However, modelling shows many renters can see payback of £1 per £1 or more. The average payback for those renting in retirement is over £1 per £1 contributed plus inflation for all age groups and over £2 per £1 for younger groups. This incorporates the impact of the 25% lump sum allowance but does not include any gains in benefit entitlement during working life so may underestimate the true returns.

\(^{40}\) HB is available to renters to support their housing costs. For each £1 of private income, HB entitlement may be reduced by 65p. For owner-occupiers with an outstanding mortgage a separate benefit may be available.
Detailed analysis shows that only around half of renters modelled will see some reduction in HB due to their pension saving. Around 25% are modelled as trivially commuting some or all of their pension\(^{41}\) (which then does not interact with benefits), while around a third of the remainder – 25% of renters – are not eligible for HB even if they do not save under reform\(^{42}\). Not all of those who do see HB withdrawal will have less than £1 per £1 payback – for example, they may only fall onto HB during later years, their potential HB entitlement may be small in relation to their pension, or the 25% lump sum and taper rate may leave them with payback of more than £1 plus inflation per £1 contributed. Those with some Guarantee Credit entitlement are entitled to full HB and their income will be tapered at the Pension Credit rate only. Those on the HB taper (but not in the group discussed above with high Pension Credit tapers) should still be better off in retirement from saving.

The large impact of trivial commutation partly reflects the fact that those who rent in retirement are more likely to have broken work records and lower earnings and so are more likely than the average pension saver to have only small pots at retirement (see Appendix B). Around a third of renters aged between 50 and 68

\(^{41}\) As with other Pensim2 analysis, this assumes that the trivial commutation limit rises in line with earnings from 2010. This figure includes a small number who commute very small pots of less than £2,000 but have other pension saving which they do not trivially commute.

\(^{42}\) Today around two-thirds of pensioner renters receive HB and a third do not. A very small number have HB which does not interact with saving, for example because their HB eligibility ends before they draw on their pension income.
State Pension age (SPA) are in employment compared to over half of owner-occupiers\[43\].

**Box 5a: Impact of HB on payback**

HB is withdrawn as income increases at a rate of 65%, which means that for every extra £1 of pension income, HB is reduced by 65p. However, most individuals choose to take the tax-free lump sum and will receive the matching contribution, so many will see a real payback of over £1 per £1 invested. The following gives a very simplified example:

- Net contribution of £1.
- Matching contribution gives a pension pot of £2.
- Investment growth gives a further £1 on top of inflation (for example, in practice the amount will depend on the level of growth and the number of years for which the contribution is invested).
- 25% can be taken as a tax-free lump sum. If it is below the capital disregard (or spent) it will not affect benefit entitlement. The net value of this lump sum is £3\( \times \)25\%\( \times \)75p.
- £2.25 remains to use for an annuity. An annuity with a total real value of £2.25 of retirement will lead to a reduction in HB over retirement of up to £2.25\( \times \)65\%\( \times \)1.46.

The increase in net income over retirement from the annuitised pension is, therefore, £2.25 - £1.46 = 79p.

This gives total payback of 75p + 79p = £1.54.

This gives a single simplified example. In practice, payback could be increased by further investment growth and possibly by increases in working-age benefit entitlement and/or tax credits. It could also be increased should the individual choose to trivially commute the pension. Conversely, it could be reduced if they have less investment growth, if they choose not to take the lump sum, if they do not get full value from their annuity, if there was a long-term interaction between the capital taken and HB entitlement or if there was also a reduction in entitlement to other benefits or a tax liability.

The figures above do not take account of any higher benefit or tax credit entitlement in working life resulting from the pension contributions. This may be particularly important for this group for two reasons: analysis suggests renters have lower incomes on average during working age and so are more likely to be eligible for income-related support, and if they have rented for their whole life they will have had more opportunity to gain extra working-age HB. This means that the payback shown above may underestimate the true value of a net £1 saved.

\[43\] English Longitudinal Study of Ageing Wave 1.
Key points about this group cover three main issues: the fact that the size of this group is likely to decline, the impact of saving on income and their motive for income smoothing:

- Around 10% of savers modelled\(^{44}\) are projected to have some HB entitlement at some point in retirement, compared to around 20% of the whole pensioner population today. This reflects increasing levels of home ownership – 15% of today’s 50-54 year olds are renting compared to 33% of over 80 year olds.\(^{45}\)
- Not all renters will be eligible for HB even if they opt out of automatic enrolment. Eligibility depends on both income and capital. Many of the remainder can see a good payback on saving. The majority of those renting get at least £1 plus inflation for each £1 contributed and many get significantly more.
- People in this group are likely to see a drop in living standards if they do not save – by definition they do not have significant alternative savings\(^{46}\) and they may face higher housing costs in retirement than those who are owner-occupiers. They, therefore, have a motive to save to smooth income. Those who have been renting on low incomes during working life will have a weaker income smoothing motive but will have been eligible for HB during this time, and potentially also for tax credits, meaning their payback is likely to be higher.

Analysis of those renting and close to retirement suggests that renters are less likely to be automatically enrolled, and if automatically enrolled they are less likely to save above the trivial commutation limit: they are more likely to be unemployed or to have left work due to disability and those in work tend to be on lower incomes and have lower wealth (see Appendix B). Amongst those aged between 50 and SPA, earning over £5,000 and offered a pension by their employer, 61% of those renting took up the scheme compared to 79% of owner-occupiers\(^ {47}\).

5.3 The majority group

The majority of the population do not fall into either of the above groups. They can expect, with some confidence, to get at least £1 plus inflation back for each £1 subject to their age of death and other assumptions. Many will get back considerably more.

There is no single characteristic or small group of characteristics that easily distinguishes between those likely to get a little more than £1 and those likely to get £2 or £3 per £1 contributed. Age is a factor but it is a weak predictor – over a third of the oldest group get over £2 per £1. Other likely factors include working and savings patterns which affect average investment returns (those saving earlier

\(^{44}\) That is the population modelled in Chapter 4 – those contributing to a defined contribution pension with employer contribution after 2012.
\(^{45}\) English Longitudinal Study of Ageing Wave 1.
\(^{46}\) Those with savings above the capital limit are not entitled to HB unless they also have entitlement to the Guarantee Credit.
\(^{47}\) English Longitudinal Study of Ageing Wave 1.
in life can expect more investment growth), those affecting decumulation (the decision whether or not to take a tax-free lump sum or trivially commute) and characteristics affecting potential benefit entitlement. Men and women see similar returns.

Low earnings has been suggested as a characteristic possibly linked with poor returns. The modelling suggests this link is weak: the following chart shows payback for those with earnings equivalent to the bottom 25% of the group eligible for automatic enrolment. Reforms mean that State Pension entitlement, and, therefore, payback and other outcomes in retirement, become much less dependent on earnings levels during working life.\(^{48}\) In addition, the ability to trivially commute a small pension pot particularly improves payback for lower earners whose savings are more likely to be within the trivial commutation limit.

**Figure 5.2 Median real payback for those on lower earnings**

![Bar chart showing median real payback for different birth cohorts.](chart)

Source: DWP modelling using Pensim2 model.

Many within this majority group will see some interaction with the benefit system at some time in their retirement. However, we do not expect it to be common for this interaction to exceed the benefits of the matching contribution, investment growth, and advantages of the tax-free lump sum.

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\(^{48}\) The current complex calculation of additional pension will be replaced by a new flat rate amount of £1.60 (in 2008/09 earnings terms) a week for each qualifying year and by around 2030, the earnings-related element for those earning above £13,500 (in 2008/09 earnings terms) will be withdrawn.
There is no guarantee that everyone in the majority group will in fact see good outcomes – for example, those dying shortly after retirement will not see good returns. Those who already have good pension provision and/or are currently on a low income will not have a good income smoothing motive.

Individuals in this group may still wish to consider whether their expected returns, likely extent of income smoothing and competing draws on their income are such that they prefer to remain opted-in.

5.4 Summary

The groups in this chapter relate to characteristics in retirement so we cannot say how many people will identify themselves as being in one of these groups. Information provided to individuals will need to take into account the inherent uncertainties in considering the future, including the risk that the benefit system will change in the future. Implications for information and communications is discussed in Chapter 7.

However, the analysis here confirms that, subject to the modelling assumptions, the vast majority of individuals can expect good returns from saving.
Chapter summary

This chapter looks at the impact of making hypothetical changes to the pensions and benefits system proposed by stakeholders to try to further improve incentives to save for retirement, particularly for those cases currently modelled as having relatively lower payback.

These changes were:

- changing taper rates – the rate at which benefit entitlement falls as incomes increase;
- introducing an income disregard;
- increasing the capital disregard;
- introducing a flexible disregard;
- combining an income disregard with a steeper taper rate;
- increasing the trivial commutation limit; and
- increasing both the trivial commutation limit and the capital disregard.

The evidence suggests that the impact of these measures tends to be mixed, reflecting the complexity of the trade-offs that must be made in designing any pension and benefits policy. Most of the policies add complications to the overall message on saving incentives. A number of the policy measures do improve payback for some of those with low payback, although the impacts can be complicated and mixed and some may see poorer payback – none of the measures makes a large difference in the average payback seen or eliminates the group with payback of less than £1 per £1. Furthermore, costs are generally significant and support tends to be poorly targeted.
This chapter presents an assessment of a range of policy measures that have been suggested by stakeholders to potentially improve saving incentives further, and in particular to improve modelled payback particularly for those cases that have relatively lower payback under the current system.

The following measures were considered:

- **Taper rates**: changing the rate at which benefits are withdrawn as income increases.
- **Income disregard**: disregarding a slice of pension income in benefit calculations.
- Combining an income disregard with a steeper taper rate.
- **Capital disregard**: increasing the amount of capital which can be held without it affecting benefit entitlement.
- **Flexible disregard** which can be applied to either income or capital.
- **Trivial commutation**: increasing the trivial commutation limit.
- Increasing both the trivial commutation limit and the capital disregard.

They have been assessed against a set of criteria including clarity of message, impact on outcomes from pension saving (measured using payback), impact on those with low incomes, operational impact and benefit expenditure implications.

The impact of these measures tends to be mixed, reflecting the complexity of the trade-offs that must be made in designing any pension and benefits policy. Most of the policies add complications to the overall message on saving incentives. A number of the policy measures do improve payback for some of those with low payback, although the impacts can be complicated and some may see poorer payback – none of the measures makes a large difference in the average payback seen or eliminates the group with payback of less than £1 per £1.

Most increase the proportion of pensioners eligible for income-related benefits, reversing the direction of the reforms. Furthermore, the costs to the taxpayer are generally significant and support tends to be poorly targeted.

The analysis covers the three major income-related benefits received by pensioners – Pension Credit, Housing Benefit (HB) and Council Tax Benefit (CTB).

### 6.1 Criteria

Each policy measure considered has been evaluated using the following criteria:

- **Clarity of message**
  The extent to which the policy measures might complicate or simplify understanding of messages around saving.
• Impact on expected outcomes from pension saving
  An examination of how well targeted the measures would be on those with relatively low payback. Also, consideration of whether any groups would be adversely affected by the policy measure.

• Impact on low incomes
  An assessment of whether the policy measures would have particular positive or negative impacts on low income groups.

• Operational impacts
  A consideration of whether the policy measures would be simple to implement in delivery terms. This also considers any issues of fairness between groups which might need to be taken into account when designing the detailed policy.

• Impact on benefit expenditure
  An assessment of implications for income-related benefit expenditure.

The analysis considers the impact on incomes and on benefit expenditure. However, it does not take into account the potential for wider impacts on other areas of Government. In particular it does not include any estimate of the likely impact on tax receipts or on the cost of tax relief.

To assess the impacts of the policy measures on expected outcomes from pension saving we have used two approaches, as with the analysis in previous chapters of incentives under the current system. Case studies are used to demonstrate how the various policy measures affect the payback of benefit units with particular life histories. These are not representative of the pensioner population as a whole, but designed to focus disproportionately on those with lower earnings and few savings, or those with particular characteristics. Secondly, we have included analysis of the impact on the average payback of different cohorts and the distribution of payback across the pensioner population.

The modelling looks at the impact on payback for saving under reform, that is saving in defined contribution schemes after 2012 with an employer contribution, as described in Chapter 4. However, the policy measures interact with all private pension income or pension pots, not just that part of a pension which has been derived from pension saving under reform. The level of pre-2012 saving can be important in determining the impact of the policy measures on payback. These issues are described in more detail in the following sections.

The impact on pensioners with low income has been assessed by analysing what proportion of those pensioners who gain or lose in terms of total weekly income fall into the top, middle or lowest third of the pensioner income distribution.

The impacts under the key criteria for each measure have been drawn out in the following assessment and summary tables are presented at the end of the chapter.
6.2 Changing taper rates on savings

Increasing taper rates in the benefit system would reduce the impact on net income of saving for those pensioners on the taper rate, reducing their payback. However, other savers could see a higher payback because they have less potential benefit entitlement. Conversely, lower tapers would increase the number of pensioners who might interact with the benefit system if they did not save, decreasing incentives for some, but others would face lower taper rates and greater incentives.

Two policy measures are considered under this section – abolishing the Savings Credit and reducing the Savings Credit taper rate to 30%.

6.3 Abolish Savings Credit

6.3.1 Description

Savings Credit is the second element of Pension Credit, available to people aged 65 or over. It was designed to ensure that those low and moderate earners who have modest savings for retirement benefit from their savings. Without Savings Credit, individuals lose £1 of benefit for each £1 of income until they have reached the Guarantee Credit level. The Savings Credit effectively reduces this to 40p for each £1.

There is also an element of HB and CTB related to Savings Credit – for those of Savings Credit age but not eligible for Guarantee Credit, the maximum value of the Savings Credit is added to their applicable amount in HB and CTB calculations. Any Savings Credit in payment is counted as income and taken into account in the calculations.

Under this proposal, Savings Credit would be abolished for all those aged over State Pension age (SPA) from 2012. The additional rule in HB and CTB would also be removed.

6.3.2 Clarity of message

Savings Credit was designed to reward those who had made provision above a very basic level for their own retirement, and it is not surprising that abolishing would have a mixed impact on messages about incentives to save, increasing the number of people losing £1 of benefit for each £1 of income. However, by making the benefits system less generous it would reduce the number of people who might expect their saving to interact with benefit entitlement in retirement.

6.3.3 Impact on expected outcomes from pension saving

Individuals who move from being entitled to both Guarantee Credit and Savings Credit (around 15% of the pensioner population) to being on Guarantee Credit only see reduced payback as they now face a £1 per £1 taper – someone who is in this position for the whole of their retirement may benefit from a lump sum
but would not increase their retirement income through saving. Conversely, those who would now have no Pension Credit entitlement whether they save or not will find their payback improved, as they no longer lose any Pension Credit entitlement by saving. However, many of those on Savings Credit already see a payback significantly greater than £1 per £1.

Those moving from Guarantee Credit and Savings Credit to being on Guarantee Credit only will see a greater impact – they will lose a reward of 60p per £1 of pension income while those moving from Savings Credit only to no Pension Credit will only see a difference of 40p per £1 of income, from a net gain of 60p per £1 to a net gain of £1 (before any other benefit entitlement is taken into consideration).

The case studies reflect this. In general it is those with relatively lower payback – who may have a greater degree of dependency on benefits – who see a reduction in their payback. For example, the supplementary case study of the older single woman with no other savings who has taken a very long (partly uncredited) career break now has real payback of less than £1 per £1. Those with the highest paybacks under the current system tend to see a slight increase.

The older renter sees a small increase in payback but remains below £1 plus inflation per £1.

All those who would have been entitled to some Savings Credit in retirement see a drop in their income.

The Pensim2 analysis reflects these mixed results. There is little impact on the average payback. Focusing on the proportion modelled as having returns of less than £1, we see a slight improvement for all groups.

**Figure 6.1 Median real payback with and without Savings Credit**

Source: DWP modelling using Pensim2 model.
The proportional fall in the group with payback below £1 is slightly greater for those in younger cohorts. As the State Second Pension matures, individuals with a good career of working or caring will be taken well above the Guarantee Credit level on retirement through their State Pension only. Removing the Savings Credit means they would have little or no interaction with Pension Credit whether they save or not, and so this measure improves their payback (but lowers their income). We would expect it to be rare for a younger person to have a pension too large to trivially commute but to have insufficient State Pension to take them above the Guarantee Credit level at retirement.

6.3.4 Low incomes

As a consequence of abolishing the Savings Credit there will be a significant number of pensioner households who have less net income than previously, around 3.5 million in 2050. This would particularly affect those already with relatively low incomes. In 2050, around 55% of the pensioners who would see lower income under this policy are in the lower third of the pensioner income distribution and a further 40% are in the middle third.

6.3.5 Operational impacts

Reducing the number of pensioners receiving benefits would result in operational savings, and abolishing Savings Credit would be a simplification of the benefit system.
The results discussed are based on a scenario where the Savings Credit is abolished with immediate effect from 2012. This would lead to a significant number of losers. One way of avoiding this would be to put in place transitional arrangements at the cost of reduced savings and increased complexity.

6.3.6 Benefit expenditure

Removing an element of the income-related benefit system results in lower expenditure on that system than currently projected; the value of these savings falls over time as the importance of Savings Credit fades. By 2050 annual savings are estimated at around £1.5 billion in real terms, equal to approximately 0.04% of Gross Domestic Product (GDP).

6.4 30% taper rate

6.4.1 Description

Currently, the Savings Credit accrues at the rate of 60p for every £1 of qualifying income above the threshold, up to the maximum value. Entitlement is reduced by 40p for every £1 of income above a household’s Guarantee Credit level.

Under this measure Savings Credit would be accrued at the rate of 70p for every £1 of qualifying income, and Savings Credit entitlement would be reduced by 30p for every £1 of income above the appropriate minimum guarantee, and is therefore, more generous than current rules.

6.4.2 Clarity of message

This measure increases the number of pensioners eligible for benefits and so increases the number of savers who might interact with the benefit system (though it also slightly increases incentives to save for those who would interact with Savings Credit in the current system). The overall message would be similar to that under the current system as the overall structure is not changed and the taper rate is changed by only ten percentage points.

6.4.3 Impact on expected outcomes from pension saving

This measure, like the abolition of Savings Credit, has a mixed impact on paybacks. Payback will be increased where income currently interacts with the 40% taper, however, it will reduce payback for some individuals who had previously been above the Pension Credit limit but now see more interaction between their savings and the benefit system.

Some but not all of the case studies with relatively low payback would see some improvement in payback under a more generous Savings Credit taper rate. For example, payback for the older woman would rise from £1.44 in the base case to £1.59 under the policy measure. The older lifetime renter would see a very slight gain in payback, but it would remain less than £1.
Many of the case studies with relatively high payback who have very little interaction with the current benefit system would see some deterioration.

We would not expect to see large changes in payback for any one case since the reduction in the taper rate can increase net income by only 10p per £1 of pre-benefit income, and those newly drawn onto the taper lose only 30p of benefit entitlement per £1 of income. Many people on the Savings Credit under the current system have good payback as only 40p of entitlement is lost per £1 of income.

Pensim2 analysis suggests the overall impacts are small, reflecting the combination of relatively small impacts in any individual case and the mixed impacts within each cohort.

Figure 6.3  **Median real payback with 40% and 30% Savings Credit tapers**

Source: DWP modelling using Pensim2 model.
6.4.4 Low income

Around four million pensioner households would gain through a higher net income by 2050. Just over half of these – around 55%, are in the bottom third of the pensioner income distribution, with a further 40% in the middle third. None lose in terms of income.

6.4.5 Operational impacts

This measure would not increase administrative complexity but it would result in more pensioners becoming eligible for income-related benefits and so increase the administrative burden.

6.4.6 Benefit expenditure

Reducing the taper rate increases the generosity of Savings Credit and, therefore, comes at a cost; the additional annual cost is broadly at the same level over time, around half a billion pounds in real terms by 2050 (approximately 0.01% of GDP in 2050).

6.5 Private pension income disregard

6.5.1 Description

There are various disregards currently available in income-related benefits. For example, the first £6,000 of any capital resource is disregarded. Additionally, limited amounts of earnings, income from certain war pensions, and payments from tenants or boarders, for example, are all wholly or partially disregarded in income-related benefit calculations.
However, net private pension income (i.e. after taxation) is taken into account in income-related benefit calculations at the appropriate taper rate.

Under this measure the first £15 of weekly net private pension income would not be counted for Pension Credit, HB and CTB purposes and therefore, have no effect on the amount of benefit a household could be entitled to. To maintain its value over time the level of the disregard would be linked to average earnings. This ensures that as earnings levels in the wider economy grow over time, the relative value of the disregard would not erode.

The value of a £15 disregard would depend on the benefits received. For example, for someone on the Savings Credit now, £15 of private pension could reduce their benefit entitlement by £6, meaning they are £9 per week better off overall from having saved. Under this measure their benefit would not be affected so they would be £15 better off, a gain of £6 in net income.

Two other values of disregard have been modelled to test the sensitivity of this measure: £10 and £20.

### 6.5.2 Clarity of message

A private pension income disregard could simplify the message for some individuals, specifically for those who do not expect to have private pension income of more than the value of the disregard (e.g. £15 a week). For this group the message would be that their private pension income would be wholly hidden from income-related benefit calculations. However, for those who have or who may have private pension income of more than the disregard the message could be more complex – they have improved incentives to save up to the disregard, but the incentive to continue saving above this level would be affected by the same factors that affect saving under the current system, so an additional step would be required in the decision-making process.

Additionally, there would be an increase in the proportion of pensioners potentially interacting with the income-related benefit system when previously they did not.

### 6.5.3 Impact on expected outcomes from pension saving

Income disregards mean that the first slice of private income has no impact at all on benefit entitlement, but further income above the disregard results in a reduction of benefit at the appropriate taper rate until benefit entitlement is exhausted. The impact on payback on pension saving under reform for a particular person will, therefore, depend on whether the disregard has already been ‘used up’ by other pension saving such as pre-2012 saving.

The case studies illustrate these mixed impacts (see Table 6.2 for details). For almost all of the case studies, estimated payback would improve – this reflects the focus on those with small pensions and little pre-2012 saving. The older lifetime renter who has an initial payback of less than £1 would see this jump to over £2. All of his pension income is covered by the disregard so he does not lose any
benefit entitlement by saving. However, this measure is not well targeted; those with relatively high payback and income could gain from this measure as well as those on lower incomes.

The case of the older man shows how someone who has already made pension savings which use up most or all of the disregard could find that payback on their post-2012 saving actually falls. He has existing pension savings in 2012 which under the current system would take him out of Pension Credit entitlement. He is entitled to CTB, so his benefit entitlement is reduced by 20p for every extra £1 of pension income. If a £15 private pension income disregard is introduced, £15 of his income from pre-2012 savings would be disregarded and so he would now be entitled to Pension Credit if he made no savings after 2012. He, therefore, faces a higher taper on his post-2012 pension savings and consequently, payback on post-2012 pension savings falls. His total income would, however, increase, particularly in later years when he gets more Pension Credit.

This is the only case study to show such an interaction, reflecting the deliberate focus on those with low earnings and little or no pre-existing savings. In reality the majority of older individuals in the target population do have existing pension savings.

A similar effect will be seen amongst younger people who have other savings which use up the disregard, such as a defined benefit pension.

Pensim2 analysis, which models the whole population, shows clearly the mixed impact of this measure.

There is little impact on average returns in any group. This is partly because of the mixed effects discussed above. It is also a reflection of the fact that only a minority will be eligible for income-related benefits in retirement even with the introduction of the disregard, and for most of those on income-related benefits the impact of the disregard will be only a few pounds per week – small in relation to their overall pension.
The overall impact on the proportion with payback of less than £1 is also small. Older cohorts actually see an increase, reflecting their higher likelihood of having existing pension savings in 2012.

**Figure 6.6 Proportion with real payback of less than £1 plus inflation without and with a £15 income disregard**

Source: DWP modelling using Pensim2 model.
Note: Results for the youngest two cohorts are combined due to small sample size.
6.5.4 Low income

By 2050 around 3.5 million pensioner households could gain from a £15 private pension income disregard in terms of net income. Around 55% of these are in the bottom third of the pensioner income distribution, with a further 40% in the middle third.

6.5.5 Operational impacts

Introducing a private pension income disregard would create an additional benefit rule and therefore, could increase the administrative burden. Additionally, specifying income only from a private pension would increase the verification process.

The income disregard modelled above applies to private pension income only; income from a State Pension has been fully taken into account. In practice this would create a fairness issue around individuals who made the decision to contract out of the State Earnings Related Pension Scheme or the State Second Pension. Those who contracted out would gain from the income disregard, whereas those who remained contracted in would have the equivalent pension income counted in full.

Any changes to avoid this issue would increase complexity and so increase administration costs.

The option to contract out of defined contribution pension schemes will be removed from April 2012 so over time the significance of this issue will decrease.

6.5.6 Benefit expenditure

This measure would have a substantial cost in terms of additional income-related benefit expenditure. The additional annual cost of a £15 disregard would be around £2 billion in real terms by 2050 (approximately 0.05% of GDP). For a £10 private pension income disregard, the additional cost would be around £1.5 billion in real terms by 2050 (approximately 0.03% of GDP), and for a £20 disregard around £2.5 billion (approximately 0.06% of GDP).

6.6 Combined income disregard and Savings Credit taper rate

6.6.1 Description

This measure builds on the income disregard set out above.

Under this measure, the first £15 of weekly private pension income would not be counted for benefit purposes. Additionally, Savings Credit would be accrued at the rate of 50p for every £1 of qualifying income, and Savings Credit entitlement would be reduced by 50p for every £1 of income above the appropriate minimum guarantee – less generous than current rules.
So this measure combines a private pension income disregard with less generous Savings Credit taper rates.

### 6.6.2 Clarity of message

The two proposed changes move in different directions in terms of generosity of the benefit system which could create a complex message, particularly in the short-term.

As discussed previously a private pension income disregard could simplify the message for some individuals, specifically those with private pension income equal to or less than the value of the disregard. For others the message could be more complex as a result of the disregard because an additional step would be required.

### 6.6.3 Impact on expected outcomes from pension saving

The impact on payback depends on whether the income disregard shelters enough of an individual’s saving under reform to counteract the less generous Savings Credit, or whether the less generous savings credit rules result in an individual no longer having potential benefit interaction, for example if their State Pension now takes them above any Pension Credit entitlement.

Analysis shows outcomes very similar to the £15 income disregard, reflecting the relatively modest increase in the Savings Credit taper, with other benefits remaining unchanged.

Almost all the case studies would gain so this measure is not particularly well targeted at those with relatively low payback.

However, in contrast to the income disregard measure, there are two case studies which would lose in terms of income, which suggests that they lose more from the increase in the taper rate than they gain from the income disregard. These cases are two of the poorest in income terms.

One of the case studies – the older man – would see payback fall.

The impacts shown by the Pensim2 analysis are similar to those seen for the £15 income disregard. Figure 6.7 shows the impact on those modelled as having payback of less than £1 per £1.
6.6.4 Low income

There could be a significant number of gainers and losers in terms of net income under this measure. Over time the number of losers falls; to around half a million in 2050; again this is due to the reforms to Savings Credit. Around 60% of these are in the bottom third of the pensioner income distribution with the remainder in the middle third. The number of gainers is broadly constant over time at around 3.5 million; around 55% of these are in the bottom third of the pensioner income distribution.

6.6.5 Operational impacts

Operational issues would be similar to those of a disregard with no taper change.

6.6.6 Benefit expenditure

Despite the less generous tapering in Savings Credit, this measure would still result in considerable additional expenditure on income-related benefits. Additional annual expenditure is estimated to build over time to around £1.5 billion in real terms by 2050 (approximately 0.04% of GDP in 2050). The costs of this measure are slightly lower than a straight private pension income disregard because changes to the Savings Credit taper rate create some savings.
6.7 Capital disregard

6.7.1 Description

Capital in this context refers to private savings, investments, land and property and any pension pot taken as a lump sum or trivially commuted. The treatment of capital in the benefit system, therefore, directly affects payback on the lump sum part of any pension. However, changes to the capital rules can also affect payback on pension income by affecting benefit entitlement as a whole.\(^{49}\)

Currently, the first £6,000 of a household’s capital is excluded from income-related benefit calculations, that is, the first £6,000 of capital is disregarded for benefit purposes.

Capital over £6,000 is treated as providing a weekly ‘notional’ income which is taken into account in income-related benefit calculations – every £500, or part of £500, above £6,000 results in a notional income of £1 per week.

For example, if a single pensioner had capital resources of £8,300 the first £6,000 would be fully disregarded, leaving £2,300 which gives a notional income of £5 per week.

In HB and CTB there is also a capital limit of £16,000 – those with capital above this limit are not eligible for HB or CTB, unless they are passported via entitlement to the Guarantee Credit.

Neither of these levels are subject to a specific uprating policy (there is no legislative requirement to review or uprate these amounts on an annual basis and the general rule is that these are left unchanged).

Under this measure the amount of capital which is disregarded would be increased from £6,000 to £20,000 in 2012. Additionally, the capital limit in HB and CTB would be increased to match the capital disregard (i.e. from £16,000 to £20,000).

To maintain their values over time the level of both the capital disregard and the capital limit would be linked to average earnings.

6.7.2 Clarity of message

This measure would not change the structure of the benefits system, so the main elements of the savings message would remain the same. However, it would significantly increase the proportion of pensioners potentially interacting with the income-related benefit system, by around 15 percentage points, to 55%, in 2050.

\(^{49}\) An example would be an individual who has a large capital sum which means they are not entitled to any benefit under the current system whether they have pension income or not. If the capital rules changed so that they had benefit entitlement despite the capital sum, any pension income would interact with the benefit system and their payback could be reduced.
Conversely, it could simplify the messages around saving for those individuals who plan to take a small pension as a lump sum and have little capital in total, but this would not apply to those who plan to take a pension income.

6.7.3 Impact on expected outcomes from pension saving

An increase in the capital disregard could increase payback for some by disregarding more of pension lump sums or trivially commuted pots derived from the pension saving under reform and therefore, reducing the interaction with income-related benefits. This measure will not affect the maximum payback an individual can achieve as they may now be able to spend capital above the disregard and avoid any reduction in benefit entitlement. Raising the limit would reduce the incentive to spend any capital above the current £6,000 limit, so encouraging saving for the purpose of smoothing consumption over their retirement or to maintain a cushion of saving. However, in practice individuals do not always spend capital above the limit.

On the other hand, capital derived from other sources would also be treated more generously, increasing the number of people potentially eligible for benefits, so a wider group of pensioners would see an interaction between private pension income and income-related benefits potentially reducing payback. Under this measure, in 2050 around 55% of the pensioner population are estimated to be eligible compared to around 40% if current rules continued.

Most of the case studies with relatively low payback have pension pots and capital below the current disregard of £6,000; payback for these cases would not be improved under this measure. For example, the older lifetime renter’s 25% lump sum would be just over £4,000 in today’s earnings terms, well below the current capital disregard.

A number of the examples do have capital above the current disregard, so raising the capital disregard could improve their payback, depending on the source of their capital (i.e. whether it has been derived from pre- or post-2012 pension savings) and their spending patterns. These cases already see relatively high payback under the current rules. For example, the low earning man with a period of self-employment (who continues saving while self-employed) has capital resources of £10,658 (all derived from post-2012 savings); well above the level of the current disregard.

Although these case studies are only illustrative, they do indicate that this measure may not be well targeted at those with low payback.

Pensim2 analysis of this measure would reflect the increased benefit eligibility and consequent reduction in payback on pension income, but does not apportion capital between post-2012 pension saving and other saving, so does not provide a full picture. If we were to assume that individuals spent any capital from their pension above each disregard in order to maximise payback, the impact of this option would be to lower average payback and to increase the number with relatively low payback.
6.7.4 **Low income**

Under this proposed measure around 3.5 million pensioner households would gain in terms of net income. Around half of these are in the bottom third of the pensioner income distribution, however, 10% are in the top third.

6.7.5 **Operational Impacts**

This would significantly increase the number of pensioners entitled to benefits so would increase administrative costs. However, the higher limit would mean that benefit units with capital of less than £20,000 would only have to produce a limited amount of evidence regarding their capital resources.

6.7.6 **Benefit expenditure**

Raising the capital disregard to £20,000 would incur significant additional costs, particularly in future years. Additional annual expenditure on income-related benefits rises over time to almost £4 billion in real terms by 2050 (approximately 0.1% of GDP).

6.8 **Flexible disregard**

6.8.1 **Description**

The current rules are set out above – capital above £6,000 is treated as providing an income for benefit purposes, and all private pension income is fully taken into account for benefit purposes.

Under this measure all capital would be treated as providing income for benefit purposes (i.e. including the first £6,000) as described above – every £500 or part of £500, above £6,000 gives a notional income of £1 per week.

However, the first £15 of ‘qualifying income’ would be ignored in benefit calculations, where ‘qualifying income’ is defined as the sum of income from capital and private pension income. To maintain its value over time the level of this ‘flexible’ disregard would be linked to average earnings.

6.8.2 **Clarity of message**

The pension saving messages would be less clear than for a separate income disregard as the message that small pension incomes are disregarded would now only apply to those with no capital. Again, this would increase the numbers who might interact with the benefit system.

This would be a significant change in benefit rules and so there could be considerable additional complexity during the transitional period.

6.8.3 **Impact on expected outcomes from pension saving**

The effects on payback are again mixed. If a benefit unit has no capital resources, impacts are similar to a £15 income disregard – see above.
If a benefit unit has no private pension income the policy measure equates to a slightly more generous capital disregard so the impact on payback would only apply to those who choose not to spend their capital as described in Section 6.7. Note that this measure would only allow up to £1,500 of additional capital to be disregarded, so the impact is much more likely to be focused on private pension income.

For those with pension income of more than £15 a week, there would be an incentive to spend all of their capital to maximise the amount of pension income that is disregarded. However, in practice we would expect many pensioners to prefer to keep some capital. The analysis of the impact of a £15 disregard set out already could, therefore, be used as a guide to the potential impact of this policy option, but one which is likely to overstate the impact.

6.8.4 Low income
An estimated four million pensioner households could gain higher net income under this measure; around 60% of these are in the bottom third of the pensioner income distribution.

6.8.5 Operational impacts
This would introduce a new rule into the system. In addition, treating capital as income would require all capital to be verified no matter how small, potentially increasing the administrative burden significantly.

As in the example of an income disregard there would be an issue with regard to those contracting out of the State Earnings Related Pension Scheme or the State Second Pension which could lead to further complexity.

6.8.6 Benefit expenditure
Estimates of additional expenditure on income-related benefits are of a similar magnitude to a £15 private pension income disregard: an additional annual cost of around £2 billion in real terms by 2050 (approximately 0.05% of GDP).

6.9 Trivial commutation

6.9.1 Description
Trivial commutation rules allow individuals to take a small pension pot as a lump sum; 25% of this lump sum is tax-free (see Box 2a). The current trivial commutation limit is £16,500 which will be increased to £18,000 by 2010/11.

This measure assumes the trivial commutation limit is increased by 50% in 2012, and is earnings uprated over the long term. As with all the assumptions in this paper, this allows long-term modelling to help inform broader conclusions but may not reflect actual policy either in the long or short term.
6.9.2 Clarity of message

This measure affects only those who choose to take their whole pension as a lump sum, and who think they might have a pension pot between the current and proposed limits. This means it would not affect messages to those who are saving to provide an income in retirement, nor those expecting to have pots below the current limit or above the proposed limit. It would extend the group who may be able to save knowing that they have the option of trivially commuting if they wish.

6.9.3 Impact on expected outcomes from pension saving

Trivial commutation allows those with small pots to take the full amount as a lump sum rather than converting some or all of it into an income stream. This could have two effects on income-related benefit entitlement.

Firstly, weekly income would be lower so entitlement to income-related benefits could increase. Secondly, the trivially commuted pot would be counted as capital for benefit purposes. The first £6,000 of this would be disregarded (as explained in Chapter 2) but the remainder would be counted as providing an income in line with the rules set out above. If the trivially commuted pot is less than the capital disregard of £6,000, the full pot would be disregarded in income-related benefit calculations.

Increasing the trivial commutation limit would allow individuals between the old and new limit to trivially commute and take their full pension pot as a lump sum, but would not impact on any other individuals. As with the capital disregard options, the impact of this depends on individuals’ choices to spend or save the capital.

Three of the core case studies are able to trivially commutate their pension under the base assumptions – they would not be affected by this measure.

Under the increased trivial commutation limit, the case study with limited State Second Pension and private saving, the woman from the median age couple case and the older renter case study would also be able to trivially commute their pension pots. Two of these examples already benefit from relatively high payback, which indicates that this measure is not well targeted at those with low payback. Payback for the older lifetime renter increases from less than £1 to over £2 after trivially commuting he spends all capital above the capital disregard level reasonably quickly. It is worth noting that this case study is very close to the current limit, so many renters on lower income than this case – i.e. lower than average for renters in the group eligible for automatic enrolment – would expect to be able to trivially commute under the existing system.

However, as a result of trivially commuting, incomes in retirement are lower.

If they trivially commuted but did not spend the sum, and their total capital (including other savings) exceeded the capital disregard, their payback could be lower.
Pensim2 analysis confirms that while those modelled as receiving lower payback are slightly more likely to be able to benefit than average overall the measure is not well targeted – only 8% of the people who benefit from the increased limit currently receive payback less than £1 for £1, whilst nearly three-quarters (71%) receive payback of greater than £2.

Raising the trivial commutation limit would reduce the proportion modelled as having returns of less than £1 plus inflation per £1 by 0.5 percentage points.

This measure moves away from the income smoothing rationale; those that are newly able to trivially commute would no longer convert their pension pot into a retirement income stream. It also provides a perverse incentive to save only a limited amount in order to trivially commute and to quickly spend much of the lump sum in order to maximise benefit entitlement in retirement. Both of these would tend to result in lower incomes in retirement.

6.9.4 Low incomes

Only a limited number of people are affected by the measure – only those with pension pots between the old and new limit. Around 30% of those potentially affected are in the top third of the pensioner income distribution, with a further 30% in the middle third. As discussed already, those choosing to take advantage of this measure could end up with lower incomes.

6.9.5 Operational impacts

Trivial commutation rules already exist in the current tax and benefit system. However, this measure could potentially increase the number of pensioners facing interactions between their capital and income-related benefits.

6.9.6 Benefit expenditure

This measure would only impact on individuals reaching a decision point regarding whether to trivially commute their pension pot, so costs build slowly over time. By 2050 annual costs would have built to around £0.5 billion in real terms (approximately 0.01% of GDP).

It should also be noted that the costs presented here focus on income-related benefit impacts only – they do not account for any tax implications.

6.10 Trivial commutation limit and capital disregard

6.10.1 Description

This measure combines two of the measures previously discussed – changes to the trivial commutation rules and changes to the capital disregard.

Similarly to the previous measure, the first component would increase the trivial commutation limit by 50% in 2012.
The second component would increase the amount of capital which is disregarded in income-related benefit calculations from £6,000 to £30,000 in 2012. Additionally, the capital limit in HB and CTB would be increased to match the capital disregard (i.e. from £16,000 to £30,000). To maintain their value over time the levels would be linked to average earnings.

Raising the capital disregard as well as the trivial commutation limit would reduce the potential for increased interaction with income-related benefits; any lump sum from trivial commutation would be hidden from income-related benefit calculations because of the higher capital disregard, assuming the individual had no other capital.

6.10.2 Clarity of message
Again, the changes to the capital disregard would substantially increase the proportion of pensioners potentially interacting with the income-related benefit system.

Conversely, this measure would extend the group who may be able to save knowing that they have the option of trivially commuting if they wish, and, if they had no other savings, would prevent any interaction between the trivially commuted lump sum and the benefit system.

6.10.3 Impact on expected outcomes from pension saving
As discussed already raising the trivial commutation limit could improve payback for some groups, although it does not appear well targeted at those with relatively low payback. Increasing the capital disregard alongside the trivial commutation limit reduces the likelihood that the trivial commutation lump sum, when added to other capital, would reduce entitlement to benefits.

However, raising the capital disregard would be a substantial increase in the generosity of income-related benefits as discussed above. As a consequence the number of pensioners interacting with the benefits system would rise. This could increase the number of individuals with potential benefit entitlement if they do not save after 2012 and so could reduce payback for those who choose not to trivially commute.

6.10.4 Low income
A significant number of pensioner households could gain net income under this measure; around 3.5 million by 2050. Around 45% of these are in the bottom third of the pensioner income distribution. Conversely around half a million would see a lower net income in 2050 – approximately 40% of these are in the top third of the pensioner income distribution.
6.10.5  Operational impacts

The benefit rules affected by this proposed measure are already in place in the current tax and benefit system.

The measure would significantly increase the number of pensioners entitled to benefits so would increase administrative costs. However, the higher capital disregard would mean that benefit units with capital of less than £30,000 would only have to produce a limited amount of evidence regarding their capital resources.

6.10.6  Benefit expenditure

This measure would incur significant additional annual costs of around £5 billion by 2050 in real terms (approximately 0.12% of GDP). Correspondingly, there are significant impacts on the proportion of pensioner households eligible to income-related benefits – an increase of around 20 percentage points, to 60% in 2050.

These are large numbers perhaps because the increase in the capital disregard and trivial commutation limit is fairly substantial; an interesting consideration is how sensitive these figures are to the levels chosen.

Earlier analysis of a £20,000 capital disregard and raising the trivial commutation limit as separate measures indicates that the vast majority of the additional expenditure is due to the higher capital disregard; the change to the trivial commutation limit only accounts for a small part. So even if a slightly different combination was considered, perhaps keeping the trivial commutation limit at £30,000, but increasing the capital limit by a smaller amount, say to £20,000, the costs would still be significant. Additionally, the impacts on those with relatively low payback would be limited.

6.11  Summary tables of policy measures analysis

The following tables give the main results of the analysis underpinning this chapter.
Table 6.1 Impacts of the policy measures in 2050

<table>
<thead>
<tr>
<th>Policy Measure</th>
<th>Proportion of pensioner households eligible for IRBs¹</th>
<th>Gainers – total weekly income (millions)²</th>
<th>Losers – total weekly income (millions)²</th>
<th>Proportion of gainers by income tercile³</th>
<th>Proportion of losers by income tercile³</th>
<th>Additional annual IRB expenditure/saving (£ million)⁴</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abolish Savings Credit</td>
<td>35%</td>
<td>-</td>
<td>3.5</td>
<td>-</td>
<td>55% 40% 5%</td>
<td>-1,500</td>
</tr>
<tr>
<td>Savings Credit taper rate (30%)</td>
<td>40%</td>
<td>4.0</td>
<td>-</td>
<td>55% 40% 5%</td>
<td>-</td>
<td>500</td>
</tr>
<tr>
<td>Income disregard (£10)</td>
<td>40%</td>
<td>3.5</td>
<td>-</td>
<td>55% 40% 5%</td>
<td>-</td>
<td>1,500</td>
</tr>
<tr>
<td>Income disregard (£15)</td>
<td>40%</td>
<td>3.5</td>
<td>-</td>
<td>55% 40% 5%</td>
<td>-</td>
<td>2,000</td>
</tr>
<tr>
<td>Income disregard (£20)</td>
<td>40%</td>
<td>4.0</td>
<td>-</td>
<td>55% 40% 5%</td>
<td>-</td>
<td>2,500</td>
</tr>
<tr>
<td>Income disregard (£15) and Savings Credit taper rate (50%)</td>
<td>40%</td>
<td>3.5</td>
<td>0.5</td>
<td>55% 40% 5%</td>
<td>60% 40% 5%</td>
<td>1,500</td>
</tr>
<tr>
<td>Capital disregard (£20,000)</td>
<td>55%</td>
<td>3.5</td>
<td>-</td>
<td>50% 40% 10%</td>
<td>-</td>
<td>4,000</td>
</tr>
<tr>
<td>Combined income and capital disregard</td>
<td>40%</td>
<td>4.0</td>
<td>-</td>
<td>60% 35% 5%</td>
<td>-</td>
<td>2,000</td>
</tr>
<tr>
<td>Trivial commutation (£30,000)</td>
<td>40%</td>
<td>-</td>
<td>1.0</td>
<td>-</td>
<td>-</td>
<td>500</td>
</tr>
<tr>
<td>Capital disregard and trivial commutation (£30,000)</td>
<td>60%</td>
<td>3.5</td>
<td>0.5</td>
<td>45% 40% 10%</td>
<td>35% 30% 40%</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Source: DWP modelling using Pensim2 model.

Notes:

¹ Rounded to the nearest five percentage points.
² Rounded to the nearest 500 thousand.
³ Rounded to the nearest five percentage points.
⁴ 2008/09 prices, rounded to the nearest £500 million.
Table 6.2 Impacts of the policy measures on the case study examples

<table>
<thead>
<tr>
<th>Case Description</th>
<th>Base case</th>
<th>Abolished Savings Credit</th>
<th>30% Savings Credit taper</th>
<th>£15 income disregard</th>
<th>50% Savings Credit taper with £15 income disregard</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Income (£)</td>
<td>Capital (£)</td>
<td>Payback (£)</td>
<td>Income (£)</td>
<td>Capital (£)</td>
</tr>
<tr>
<td>1. Low earning man</td>
<td>185</td>
<td>11,629</td>
<td>3.06</td>
<td>184</td>
<td>11,629</td>
</tr>
<tr>
<td>2. Median earning man</td>
<td>197</td>
<td>18,128</td>
<td>3.02</td>
<td>196</td>
<td>18,128</td>
</tr>
<tr>
<td>3. High earning man</td>
<td>213</td>
<td>27,667</td>
<td>2.93</td>
<td>212</td>
<td>27,667</td>
</tr>
<tr>
<td>4. Low earning man with a period of self-employment (opts-in)</td>
<td>172</td>
<td>10,658</td>
<td>2.38</td>
<td>170</td>
<td>10,658</td>
</tr>
<tr>
<td>5. Low earning man with a period of self-employment (opts-out)</td>
<td>168</td>
<td>9,040</td>
<td>3.15</td>
<td>167</td>
<td>9,040</td>
</tr>
<tr>
<td>6. Low earning woman with career break</td>
<td>171</td>
<td>4,033</td>
<td>2.54</td>
<td>170</td>
<td>4,033</td>
</tr>
<tr>
<td>7. Low earning couple, woman with career break (cases 1+6)</td>
<td>338</td>
<td>15,662</td>
<td>3.28</td>
<td>338</td>
<td>15,662</td>
</tr>
<tr>
<td>8. Median age couple</td>
<td>332</td>
<td>16,032</td>
<td>2.55</td>
<td>332</td>
<td>16,032</td>
</tr>
<tr>
<td>9. Older man</td>
<td>189</td>
<td>2,774</td>
<td>1.67</td>
<td>186</td>
<td>2,774</td>
</tr>
<tr>
<td>10. Older woman</td>
<td>161</td>
<td>1,331</td>
<td>1.44</td>
<td>148</td>
<td>1,331</td>
</tr>
<tr>
<td>11. Older couple (cases 9+10)</td>
<td>311</td>
<td>4,105</td>
<td>1.74</td>
<td>311</td>
<td>4,105</td>
</tr>
</tbody>
</table>

Continued
Table 6.2  Continued

<table>
<thead>
<tr>
<th>Case Description</th>
<th>Income (£)</th>
<th>Capital (£)</th>
<th>Payback</th>
<th>Income (£)</th>
<th>Capital (£)</th>
<th>Payback</th>
<th>Income (£)</th>
<th>Capital (£)</th>
<th>Payback</th>
<th>Income (£)</th>
<th>Capital (£)</th>
<th>Payback</th>
</tr>
</thead>
<tbody>
<tr>
<td>12. Low earning woman with a long career break</td>
<td>169</td>
<td>2,239</td>
<td>1.77</td>
<td>168</td>
<td>2,239</td>
<td>2.01</td>
<td>170</td>
<td>2,239</td>
<td>1.60</td>
<td>170</td>
<td>2,239</td>
<td>2.36</td>
</tr>
<tr>
<td>13. Low earning couple, woman with long career break (cases 1+12)</td>
<td>335</td>
<td>13,868</td>
<td>3.07</td>
<td>335</td>
<td>13,868</td>
<td>3.16</td>
<td>335</td>
<td>13,868</td>
<td>3.06</td>
<td>335</td>
<td>13,868</td>
<td>3.22</td>
</tr>
<tr>
<td>14. Older low earning man with no other savings</td>
<td>160</td>
<td>1,146</td>
<td>1.42</td>
<td>146</td>
<td>1,146</td>
<td>1.12</td>
<td>164</td>
<td>1,146</td>
<td>1.57</td>
<td>162</td>
<td>1,146</td>
<td>2.15</td>
</tr>
<tr>
<td>15. Older low earning woman with a long career break</td>
<td>149</td>
<td>1,282</td>
<td>1.24</td>
<td>140</td>
<td>1,282</td>
<td>0.55</td>
<td>151</td>
<td>1,282</td>
<td>1.35</td>
<td>150</td>
<td>1,282</td>
<td>2.17</td>
</tr>
<tr>
<td>16. Older low earning couple (cases 14+15)</td>
<td>255</td>
<td>2,428</td>
<td>1.82</td>
<td>250</td>
<td>2,428</td>
<td>1.73</td>
<td>255</td>
<td>2,428</td>
<td>1.83</td>
<td>256</td>
<td>2,428</td>
<td>2.10</td>
</tr>
<tr>
<td>17. Older lifetime renter</td>
<td>229</td>
<td>4,093</td>
<td>0.76</td>
<td>217</td>
<td>4,093</td>
<td>0.86</td>
<td>232</td>
<td>4,093</td>
<td>0.78</td>
<td>239</td>
<td>4,093</td>
<td>2.34</td>
</tr>
<tr>
<td>18. Limited State Second Pension and private saving</td>
<td>152</td>
<td>5,879</td>
<td>3.83</td>
<td>147</td>
<td>5,879</td>
<td>2.35</td>
<td>154</td>
<td>5,879</td>
<td>4.18</td>
<td>159</td>
<td>5,879</td>
<td>6.46</td>
</tr>
</tbody>
</table>

Source: DWP modelling.
### Table 6.3  Impact on the proportion with payback of less than £1 plus inflation

<table>
<thead>
<tr>
<th>Reduction in proportion with less than £1 modelled payback (defined contribution savers under reform) (percentage points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abolish Savings Credit</td>
</tr>
<tr>
<td>Savings Credit taper rate (30%)</td>
</tr>
<tr>
<td>Income disregard (£10)</td>
</tr>
<tr>
<td>Income disregard (£15)</td>
</tr>
<tr>
<td>Income disregard (£20)</td>
</tr>
<tr>
<td>Capital disregard (£20,000)</td>
</tr>
<tr>
<td>Flexible disregard</td>
</tr>
<tr>
<td>Income disregard (£15) and Savings Credit taper rate (50%)</td>
</tr>
<tr>
<td>Trivial commutation</td>
</tr>
<tr>
<td>Capital disregard and trivial commutation limit at £30,000</td>
</tr>
</tbody>
</table>

Source: DWP modelling using Pensim2 model.
7 Information and communications

Chapter summary

Ensuring appropriate information and communications are available is a vital part of the reform package.

We know that not all individuals will want to save in a pension at all times. Those considering whether or not to opt out will consider a large number of factors, reflecting the many reasons for saving discussed previously and other constraints. Each will have to make their own judgement as to the relative importance of each factor for them.

They will need appropriate information and communications to be available to support their decision.

Under current legislation, all pension providers must supply basic information to individuals when enrolling them into a pension. This will continue.

The Government is considering what further information needs to be available. The evidence produced through this programme will inform the development of the information and communications strategy. However, in doing this we must acknowledge the limitations of this programme. The analysis in this report looks at outcomes under the current benefit system, but we do not know what the benefit system will look like in the future and we must be clear that such projections do not constitute a commitment to future policies. Our information and communications strategy must ensure that individuals understand that benefit entitlement may change by the time they retire, and that they should bear this in mind when considering whether and how much to save in their pension.

Continued
Information and communications must also take account of individuals’ different needs and different levels of desired engagement with the decision, as well as the uncertainties inherent in considering the future.

We must also consider the impact of indirect messages such as the media and informal sources, as well as information provided directly to individuals.

Ensuring appropriate information and communications are available is a vital part of the reform package. The Government’s position was set out in Personal accounts: a new way to save\(^50\): ‘All stakeholders agree that providing access to good quality information will be critical’ – a statement which is true for the whole of the reform programme.

We know that not all individuals will want to save in a pension at all times. Those considering whether or not to opt out may consider a large number of factors, reflecting the many reasons for saving discussed already and other constraints. Each will have to make their own judgement as to the relative importance of each factor for them.

These factors might include:

- the need to save for retirement to have the lifestyle they want;
- the cost to them, the advantage of the employer contribution and the likely payback on their saving;
- the level of security the scheme will provide for their savings;
- how important it is to them to have their own pension pot; and
- whether they have other spending commitments that mean they delay saving for retirement, despite the impact on their retirement income.

People will, therefore, need appropriate information and communications to be available to support their decision.

Under current legislation, individuals being enrolled into a pension must be provided with basic information. This information is needed to support individuals’ decisions and will continue to be required of schemes into which people will be automatically enrolled as a result of the reforms. In addition, further information about pensions is already available to individuals, either directly from Government (e.g. DirectGov) or via more independent sources such as The Pensions Advisory Service.

The Government is considering what other information should be made available to support decisions about retirement planning, including information about the issue of interaction with benefits in retirement. The evidence produced through this programme will inform the development of the information and communications strategy.

However, in doing so we must acknowledge the limitations of this programme. The analysis in this report is based on projections of the tax and benefit system, and on the characteristics of the population, many years into the future. This helps us to analyse the incentives to save under the current system, but in practice we do not know what the future system will look like.

Any information on the impact of benefit interactions must be clear that benefits, unlike State Pension entitlement, do not represent an accrued entitlement, but may be changed by future governments. Focusing on payback figures does not take account of the additional security and flexibility of having one’s own income from a pension, compared to a decision to rely on benefits.

This evidence also makes clear that potential benefit entitlement does not necessarily mean that the expected payback on saving will be low.

The information strategy must also recognise the fact that not all individuals will engage to the same degree in the decision-making process. Research demonstrates that understanding of pensions is low, and that people will wish for different levels of support. It also shows that expected returns are only one of the factors individuals might take into account when deciding whether or not to save, with affordability and the security of the pension pot being seen as the most important issues.51

The reforms aimed to make it possible to provide clearer messages to more individuals about saving for retirement by:

• Reforming the State Pension to provide a solid platform for saving for the vast majority of people, and to make it easier for people to establish the level of State Pension they can expect.

• Reducing the spread of income-related benefits, so that fewer people will expect their savings to interact with benefit entitlement.

• Giving wider access to an employer contribution.

• Providing access to a low cost pension scheme through personal accounts for those without access to a qualifying scheme.

• Introducing automatic enrolment to remove behavioural barriers to saving.

The aim of information provision in this area must, therefore, be to provide individuals with the information necessary to enable them to make appropriate decisions about opting out – it cannot say that any individual should or should not opt out.

51 McAlpine, C., Marshall, H and Thomas, A., (2008), The information people may require to support their decision to remain in, or opt out of, a workplace pension. DWP Research Report No. 540.
7.1 The impact of uncertainty on communications

We know that many individuals’ decisions will be influenced, to a large extent, by indirect messages through the media and other routes as well as information provided directly to them. Messages from Government must be carefully designed so that they balance the uncertainties involved with the message that for the vast majority of individuals, the right approach will be to save for retirement.

The reforms to the State Pension and benefit system will help enable this message by providing greater certainty about the State provision that individuals can expect, so making clear the gap (if any) between an individual’s State entitlement and their existing provision, and their desired income in retirement.

The communications and information supporting the reform programme will also provide opportunities for us to challenge some of the myths which risk discouraging the majority of individuals who would benefit from saving. Box 7a outlines some of these myths.

Box 7a: challenging myths around saving

Those on benefits in retirement will not gain from saving

The vast majority of those on benefits in retirement are on taper rates that are below 100%, so while their savings may reduce their benefit entitlement, they will still have more income in retirement than someone with the same history who did not save.

They may also be able to benefit from taking some or all of their pension as a lump sum.

Those with broken work records will lose out

Recent reforms to State Pensions mean that those who are unable to work due to caring responsibilities – including those caring for young children – or due to sickness or disability will be able to build up State Pension entitlement for those years. They are likely to retire with a good State Pension, and to have good incentives to save further.

I should just put the money in an Individual Savings Account (ISA)/in a bank

As discussed in Box 4e, different savings vehicles are designed for different purposes. Many people will want to save both into a pension for the longer term and into an ISA or bank account for shorter-term needs.

However, in saving for retirement, pension saving has the advantages of receiving an employer match and tax relief, plus a tax-free lump sum on withdrawal.

All forms of savings will be taken into account when benefit entitlement is calculated, not just pension income.
Appendix A
Notes on modelling and analysis and further sensitivity analysis

The Government uses a variety of models to analyse different aspects of the tax and benefit system, with each model having different strengths and weaknesses. Most of the analysis in this report comes from one of two models: the Pensim2 model and the iPen model.

Pensim2 is the Department’s dynamic micro-simulation model of future pensioner incomes: it takes a sample of approximately 57,000 people of the Great Britain population based on survey information, then moves the data for each person and household forward in time. Important life events and processes are modelled, including birth, marriage, pension contributions and income, work patterns, changes of partners and death.

The model uses probability-based processes with random number generation to create a life history for each member of the dataset, for each year to 2100.

This means we can make estimates about the outcomes for the population in future years such as the average payback, and look at total costs and benefits to the whole population under particular assumptions. However, at present not every detail of the tax and benefit system can be fully modelled. In particular, no account is taken of any increase in benefit entitlement during working life due to making pension contributions, thus missing out one of the potential gains from saving. Any benefit impact in retirement (on Pension Credit, Housing Benefit (HB) and Council Tax Benefit (CTB)) is considered in the modelling.

iPen, in contrast, models a single individual or couple at a time. These ‘case studies’ are hypothetical individuals, with their present characteristics chosen and the whole of their future lives set out in the modelling. They cannot be said to
represent a particular person working today, as for any real individual their future history will be uncertain and so, even if their existing characteristics are identical to the example, their future is unlikely to be so. In particular, a real individual may have the opportunity to make choices to maximise their overall benefit.

This model does not provide estimates of the likelihood of an outcome (although we have estimated from other sources the prevalence of characteristics used to define the cases – see below). However, it shows clearly how a set of characteristics can lead to particular outcomes in retirement. iPen is able to take account of benefit offsets in working life due to pension contributions but this is not used in any of our main case studies as it would require further assumptions to be made about household circumstances.

**Defining the case studies**

In developing the case studies we have moved beyond simple assumptions and drawn on analysis of the target population to make them as realistic as possible and to show a range of possible outcomes. However, we have placed a greater emphasis on low earnings and some other characteristics than would be seen on average in those automatically enrolled. This was done to take into account the greater interest of stakeholders in those cases.

Different issues must be considered for those who are automatically enrolled into a pension scheme from an early age and those who are older at the point of automatic enrolment. Stakeholders have expressed a particular interest in workers who are older when the legislation on automatic enrolment takes effect in 2012 as they will benefit from fewer years of contributions than those who are younger when the reforms take effect. This group represents around a quarter of the group we expect to be automatically enrolled in 2012. We have, therefore, begun by segmenting the population by age. For each age group we have then drawn on survey data to inform our choice of other characteristics to form a set of 11 core case studies.

While none of these can be considered ‘representative’ in the traditional sense we can look at the frequency of particular characteristics that have been used for the case studies. Figure A.1 shows some of the most important. The area of the circles reflects the approximate number of people falling into each category. These categories are not always exclusive, for example, some people will be over 50 and have had a self-employment spell and will be currently in employment with their earnings reflected in the earnings levels calculations.
Figure A.1 Characteristics used to define case studies

Source: DWP modelling.
Further characteristics are defined by taking average or common values of that characteristic for people within that group or a wider population. For example, the older case studies are assumed to have previous pension saving equal to the median for that age group and gender, while the younger examples are assumed to have no previous pension as this is the most common situation. Unless otherwise stated, they are assumed to have a State Pension based on working from the age of 25. Appendix B describes key features of the population which would be eligible for automatic enrolment under reform which were used to inform this work.

This methodology avoids the situation where a case with very extreme or unusual characteristics is given disproportionate weight – as much as a more ‘typical’ case – and that the main groups of the population are represented. However, we have also considered seven supplementary cases which are not typical of a large proportion of the target population but focus on sets of characteristics which have been identified as being of particular concern to stakeholders.

The inclusion of these examples allows us to fully examine the impact of particular policies on these groups of greater concern. However, when interpreting results it should be remembered that these cases may show more extreme characteristics which will be found only rarely in the eligible group.

The case studies used are:

**Core case studies**

1. **Low earning man**
   25 in 2012.
   Full work history from 25-State Pension age (SPA).
   Earnings of £16,137 based on ASHE 07 data for 25th percentile male ‘auto-enrolment’ group uprated to 2008/09 earnings terms.

2. **Median earning man**
   25 in 2012.
   Full work history from 25-SPA.
   Earnings of £22,140 based on ASHE 07 data for median male ‘auto-enrolment’ group uprated to 2008/09 earnings terms.
   Other savings at SPA in 2008/09 earnings terms of £23,060 based on ELSA 2002 data for median male employee in a pension.

3. **High earning man**
   25 in 2012.
   Full work history from 25-SPA.
   Earnings of £30,951 based on ASHE 07 data for 75th percentile male ‘auto-enrolment’ group uprated to 2008/09 earnings terms.
   Other savings at SPA in 2008/09 earnings terms of £60,879 based on ELSA 2002 data for 75th percentile male employee in a pension.
4. **Low earning man with a period of self-employment (opts in)**
25 in 2012.
Full work history from 25-SPA with the last 12 years in self-employment (evidence suggests most self-employment is in later years where average duration of self-employment = 12 years for men). Throughout self-employment the individual contributes to a workplace pension but the employer does not.
Earnings of £16,137 based on ASHE 07 data for 25th percentile male ‘auto-enrolment’ group uprated to 2008/09 earnings terms.
In the extended working lives analysis (see Appendix C) the five additional years working part-time are spent in employment.

5. **Low earning man with a period of self-employment (opts out)**
25 in 2012.
Full work history from 25-SPA with the last 12 years in self-employment (evidence suggests most self-employment is in later years where average duration of self-employment = 12 years for men).
Earnings of £16,137 based on ASHE 07 data for 25th percentile male ‘auto-enrolment’ group uprated by 2008/09 earnings terms. The individual does not continue workplace pension saving during the period of self-employment.
In the extended working lives analysis (see Appendix C) the five additional years working part-time are spent in employment.

6. **Low earning woman with career break**
25 in 2012.
Starts work aged 25. Between 27-33 takes a childcare break (receiving full credits). Evidence suggests the average age of having a first child is 27 and the average length of time taken out of work for childcare is seven years.
Earnings of £10,149 based on ASHE 07 data for 25th percentile female ‘auto-enrolment’ group uprated to 2008/09 earnings terms.

7. **Couple: cases 1 and 6**

8. **Couple = Median age man + Median age woman**
Man aged 39 and woman aged 38 in 2012 (median ages of eligible group for auto-enrolment).
Full work history from 25-SPA.
Man has earnings of £22,140 based on ASHE 07 data for median male ‘auto-enrolment’ group uprated to 2008/09 earnings terms.
Woman has earnings of £14,678 based on ASHE 07 data for median female ‘auto-enrolment’ group uprated to 2008/09 earnings terms.
Man has other savings at SPA of £23,155 in 2008/09 earnings terms based on ELSA 02 data for employees in a pension.
9. Older median man

55 in 2012.
Full work history from 25-SPA.
Earnings of £21,178 based on ELSA 2002 data for median older male ‘auto-enrolment’ group uprated to 2008/09 earnings terms.
Other savings of £12,822 at SPA in 2008/09 earnings terms based on ELSA 2002 data for median male employees eligible for auto-enrolment.

10. Older median woman

54 in 2012.
Full work history from 25-SPA.
Earnings of £12,176 based on ELSA 2002 data for median older female ‘auto-enrolment’ group uprated to 2008/09 earnings terms.
Other savings of £10,770 at SPA in 2008/09 earnings terms based on ELSA 2002 data for the median female employees eligible for auto-enrolment.

11. Older couple: cases 9 and 10

Supplementary case studies

12. Low earning woman with a long career break

25 in 2012.
Age 16-25, she works part-time, earning around 60% of median earnings for female employees eligible for auto-enrolment. Age 26-50, she takes a career break – raising three children (she is entitled to full basic State Pension and State Second Pension credit but since her youngest child reaches age 12 after 18 years, she has seven years without credits). Age 51-SPA, she returns to work until SPA earning around 60% of median earnings for female employees eligible for auto-enrolment, rising steadily to median earnings for this group.
Median earnings for this group are £14,678 based on ASHE 07 data for median female auto-enrolment group uprated to 2008/09 earnings terms.

13. Couple: cases 1 and 12

14. Older low earning man with no savings

55 in 2012.
Full work history from 25-SPA.
Earnings of £11,918 based on earning 2008 National Minimum Wage level working a 40 hour week.
No other savings.
15. Older low earning woman with a long career break

54 in 2012.
Age 16-25, she works, earning around 60% of median earnings for female employees eligible for auto-enrolment. Age 26-50, she takes a career break – raising three children (she is entitled to full basic State Pension credits until her youngest child reaches age 16, after 22 years, she has three years without credits). Age 51-SPA, she returns to work until SPA, earning around 60% of median earnings for female employees eligible for auto-enrolment, rising to median earnings for the group.
Median earnings for this group are £14,678 based on ELSA 2002 data for median female employees auto-enrolment.
No other savings.

16. Couple: cases 14 and 15

17. Older lifetime renter
Male.
50 in 2012.
Full work history from 25-SPA.
Income £18,836 based on ELSA 2002 data for median male renting employees eligible for auto-enrolment uprated to 2008/09 earnings terms.

18. Limited State Second Pension and very short-term saving
Male.
22 in 2012.
Works from age 22-41 and receives basic State Pension credits from age 42-SPA.
Earnings of £15,000 per year.
Full basic State Pension, 20 years, State Second Pension and 20 years of pension saving.

Assumptions and definitions

Both models rely on forecasting the world many decades ahead. To do this we must make assumptions about the future. These are based on best expectations and existing data, but as we cannot be certain about future developments, we also produce results for Pensim2 under different ‘scenarios’ to assess how dependent the results are on the detail of the assumptions.

Table A.1 sets out the main assumptions and the variations used to produce the scenario analysis.

We have also looked separately at the impact of choosing, or not, to trivially commute where possible, and whether or not to take the 25% tax-free lump sum. Further sensitivity analysis of the impact of different assumptions on hypothetical examples was set out in Financial incentives to save for retirement\textsuperscript{52}, based on a model similar to iPen.

### Table A.1  The main assumptions used under the base and scenario variants

<table>
<thead>
<tr>
<th>Variable</th>
<th>iPen</th>
<th>Pensim2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings growth</td>
<td>In line with HM Treasury economic assumptions: Real earnings growth 2%.</td>
<td></td>
</tr>
<tr>
<td>Price inflation</td>
<td>2.87%. This is the Retail Price Index (RPI) equivalent of the Bank of England's 2% Consumer Price Index (CPI) target.</td>
<td></td>
</tr>
<tr>
<td>Tax system</td>
<td>Up-rated in line with earnings. This is not current practice, but up-rating it in line with prices would lead to an implausibly high tax take in the long term, and so earnings uprating has been used instead. As with other assumptions, this should not be taken to imply Government policy.</td>
<td></td>
</tr>
<tr>
<td>State pensions and benefits system</td>
<td>As proposed in Pensions Acts 2007 and 2008. Earnings uprating of basic State Pension from 2012. Pensions Credit, HB and CTB are all included where appropriate. SPA is held constant at 68 from 2046 onwards.</td>
<td></td>
</tr>
<tr>
<td>State entitlement</td>
<td>Based on work history with starting credits for ages 16-18 – then no other credits received except as specified.</td>
<td>Based on modelled career history.</td>
</tr>
<tr>
<td>Work history*</td>
<td>Neither working nor credited until age 25, then as specified based on survey evidence.</td>
<td>Probabilistically modelled, based on LLMDB2 dataset which is derived from National Insurance records and British Household Panel Survey (BHPS) panel survey data. The probability equations for being in work include children, partnership and marital status variables. The trend in employment rates is consistent with the HM Treasury cohort employment model with base case assumptions. Approximate overall employment rate of 75%. Scenario analysis: Approximate overall employment rate increased or reduced by five percentage points.</td>
</tr>
<tr>
<td>Life expectancy</td>
<td>Government Actuary's Department’s cohort life expectancy forecasts of cohort and gender-specific life expectancy at age 60 for women and 65 for men. Deaths of individuals before annuitising are not modelled in this analysis; their pension funds can be inherited.</td>
<td></td>
</tr>
<tr>
<td>Disability</td>
<td>Not modelled directly though State and private pension entitlement for an individual taking time out of work due to disability would match examples receiving caring credits.</td>
<td>Probabilistically modelled for age 60 and over only.</td>
</tr>
</tbody>
</table>
Table A.1 Continued

<table>
<thead>
<tr>
<th>Variable</th>
<th>iPen</th>
<th>Pensim2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual contribution rate</td>
<td>Personal accounts default rate, with contributions phased in. Savings when not automatically enrolled as specified.</td>
<td>Personal Accounts: default rate. Occupational defined contribution schemes: minimum 5% gross from 2012. Savings into personal pensions or into personal accounts when not automatically enrolled are modelled dependent on employment status and earnings – higher earners are much more likely to save in a personal pension. Non-automatic enrolment saving, like defined benefit saving, is not included in the payback analysis but is modelled.</td>
</tr>
<tr>
<td>Employer contribution rate</td>
<td>Personal accounts default rate, with contributions phased in.</td>
<td>Personal accounts: default rate. Occupational defined contribution schemes: minimum 3% from 2012. Anyone in a pension scheme with contributions of at least 3% remains in that scheme with the same level of contributions, until they move job. Anyone in a pension scheme with lower contributions has the contributions increased to the minimum. Anyone else is offered a personal account with contributions at the minimum level. Individuals can still be offered a good scheme throughout the simulation and are not limited to the personal accounts minimum.</td>
</tr>
</tbody>
</table>
| Opt out rate*                | n/a                                                                  | Probabilistically modelled, constant throughout the simulation. Membership rates of occupational and personal pension schemes other than personal accounts are consistent with Family Resources Study (FRS) data. Membership rates for personal accounts are derived using Individuals’ attitudes and likely reactions to the workplace pension reforms 2007: Report of a quantitative survey'. Scenario analysis: Opt-out rate for personal accounts reduces to 18% and increases to 46%. Stock membership rates of occupational schemes fall by 20% or increase by 25%, whilst personal pensions increase by 15% and decrease by 25%.
<table>
<thead>
<tr>
<th>Variable</th>
<th>iPen</th>
<th>Pensim2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scheme change</td>
<td>As specified.</td>
<td>90% of public sector employees remain in schemes if they change jobs.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>25% of private sector employees remain in the same scheme if they change jobs.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>0% of people remain in the same scheme if they change sectors.</td>
</tr>
<tr>
<td>Investment growth*</td>
<td>Lifestyled, with 80% held in equities and 20% bonds early in life moving to 100% in bonds over final ten years. Returns are assumed to be approximately 5.1% real for equities and 1.6% for bonds.</td>
<td>3.5% real growth.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Scenario analysis: increased or decreased by 0.5 percentage points.</td>
</tr>
<tr>
<td>Administration charges</td>
<td>Annual management charge of 0.5%, in line with assumptions based on international experience from the Pensions Commission research (Second Report, Pages 396-398).</td>
<td>Personal accounts: 0.5%.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Workplace defined contributions: Split equally between 0.5% and 1%.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Personal pension: Split between 1%, 1.25%, 1.5% in ratio 1:1:2.</td>
</tr>
<tr>
<td>Tax-free lump sum and trivial commutation**</td>
<td>In the base case the 25% lump sum only is taken and spent, though the impact of other options is shown in Chapter 4. It assumes the limit remains at 1% of the announced Lifetime Allowance for pension schemes to 2015/16 and is uprated by earnings thereafter.</td>
<td>In the base case all trivially commute where possible, of those who cannot trivially commute 50% take the maximum lump sum of 25%, 25% take 12.5% and 25% take no lump sum. The base modelling assumes the limit is earnings uprated from 2010/11 onwards, however, analysis is also shown in Appendix C for the extreme situation where all income is annuitised. This is not a likely situation but is included to show the degree of sensitivity of the results to individual's decisions to take, or not, a lump sum.</td>
</tr>
<tr>
<td>Annuity type</td>
<td>Single life, inflation-linked.</td>
<td>Probabilistically modelled.</td>
</tr>
<tr>
<td>Housing tenure</td>
<td>As specified.</td>
<td>Probabilistically modelled at retirement dependent on age, income, employment status, pension membership/income, widowhood and couple/single. Based on assumption that there will be a slowing of the growth of housing ownership in 2008 working through to a flat housing tenure distribution.</td>
</tr>
</tbody>
</table>
Table A.1 Continued

<table>
<thead>
<tr>
<th>Variable</th>
<th>iPen</th>
<th>Pensim2</th>
</tr>
</thead>
<tbody>
<tr>
<td>HB and CTB*</td>
<td>Increased in line with earnings. Simplified average level of housing benefit assigned in retirement to eligible individuals.</td>
<td>Rents/council tax increased in line with earnings. No modelling of tenure or HB in working life. Level of HB assigned in retirement based on a range of variables. Scenario analysis: increase in line with earnings plus or minus 0.5%.</td>
</tr>
<tr>
<td>Split between defined benefit and defined contribution pensions*</td>
<td>n/a</td>
<td>Probabilistically modelled with reduction in proportion of defined benefit schemes to 30% of new members of occupational schemes (other than group personal pensions). Scenario analysis: proportion of new entrants in defined benefit schemes remains at current level (ie 53%) or falls to 10%.</td>
</tr>
<tr>
<td>Contracting out*</td>
<td>No contracting out.</td>
<td>Private sector defined benefit: consistent with the assumed defined benefit/defined contribution shift and the DWP assumptions on employees in contracted out defined benefit schemes. Scenario analysis: either no change or faster decline in private sector defined benefit (defined contribution contracting out abolished in 2012 for all scenarios).</td>
</tr>
<tr>
<td>Other savings</td>
<td>Non-pension savings (and existing pension savings for older individuals) modelled based on the ELSA.</td>
<td>Modelled based on survey data.</td>
</tr>
</tbody>
</table>


Note: Items varied in the scenario analysis are marked *, the ** mark attached to the assumptions on lump sums indicates separate sensitivity analysis.
The main outputs used in the models are defined below:

**Payback**
Defined as the total increase in net income in retirement due to saving divided by the total net contributions made by the individual. Working-age tax credit and benefit offsets are not taken into consideration. All figures are net of tax and benefit offsets in retirement. Further explanation is given in Box 4a.

**Income**
Income is shown in 2008/09 earnings terms, and refers to the second year of retirement. This ensures that any lump sum spent in the first year is not included as income. Unless otherwise specified, it is assumed that 25% of the pension pot is taken as a lump sum and income figures show only the impact of the portion of the pot which is annuitised.

**Distribution of payback**
Chapter 4 shows the distribution of payback seen under the assumptions above in Pensim2. The analysis does not show the impact of ‘systematic’ uncertainties such as the future benefits system – these are assumed to be fixed in line with the assumptions set out above. It also assumes that each adult reaches retirement and lives to their birth cohort and gender specific average age.

In practice those who expected to have a shorter life expectancy would be able to access impaired life annuities (not modelled in Pensim2) to boost their returns. If we were to include other sources of variation we would see a greater variation in paybacks but similar patterns and average returns for each group.

**Analysis of proposed measures**
Pensim2 analysis has been used to consider the impacts of the policy measures on pensioners with lower incomes, and income-related benefit entitlement and expenditure.

The impact on pensioner households with low income has been assessed by analysing what proportion of those pensioner households who gain or lose in terms of total net weekly income as a result of a policy measure, fall into the top, middle or lowest third of the pensioner income distribution.

To model the income-related benefit entitlement and expenditure implications, Pensim2 has been run separately for each of the policy measures and compared to the baseline, which includes both State and private pension reforms. Additional expenditure or saving is presented on an annual basis in 2008/09 price terms.

It should be remembered that these models show long-run outcomes which ignore cyclical and other variation in economic performance and macroeconomic trends and assume a particular set of tax and benefit parameters which may not be those seen in practice.
Both models focus purely on levels of income, adjusted for inflation and earnings growth as appropriate. They take no account of the increased value which individuals may attached to each £1 later in life when they are likely to be on a lower income, that is the decreasing marginal utility of each £1 with increasing income.

**Alternative outcome measures**

**Internal rate of return compared to payback**

The internal rate of return (IRR) expresses total return on an investment (after any tax and benefit impact) as the rate of return that would give the amount received if the investment earned these returns each year (and there was no tax and benefit deduction). It is calculated by setting the cost of the investment made minus the net payouts discounted by r (the IRR) equal to zero and solving for r.

In the context of automatic enrolment the IRR effectively equates contributions to a pension to the annuity income from saving. In the example below it is assumed that an individual contributes £100 to a pension in the year prior to SPA and thereafter receives an income for four years. The internal rate of return in this instance is 17.09%.

\[
100 - \frac{30}{(1+r)^1} - \frac{35}{(1+r)^2} - \frac{40}{(1+r)^3} - \frac{45}{(1+r)^4} = 0 \quad r = 17.09\%
\]

To summarise, rather than expressing the value of savings in terms of a ratio of the value of contributions to the value of retirement gains as with payback, the internal rate of return is the rate of annual increase that would equate the value of contributions and the value of retirement gains.

**Replacement rates**

Replacement rates are one of several measures of retirement outcomes and are often used to conceptualise pensions adequacy. They are a means of comparing an individual’s income prior to retirement to their income at retirement in percentage terms. Typically, gross replacement rates are used as net replacement rates incorporate the more complicated effects of the tax and benefit system, an important consideration for incentives to save.

There are a number of ways that replacement rates can be calculated and there is no consensus on the proper methodology. The DWP typically calculates replacement rates using income immediately before and after retirement but there are alternative methods.

Whilst comparing an individual’s income before retirement with income at SPA is an easy rule of thumb, this measure of replacement rates is imperfect. Final earnings are volatile. Individuals often reduce their hours of work immediately prior to retirement or leave the labour force altogether. For the purposes of the analysis in this report this is not a major issue as the replacement rates shown
relate to our cases studies which in most cases assume earnings grow in line with average earnings until retirement. However, no account is taken of any gaps in work history.

Reduced earnings before SPA (compared to lifetime average) could have an upward bias on the replacement rate. Similarly, earnings immediately prior to SPA, even if from full-time employment, do not always represent a worker’s lifetime earnings. For example, an individual who has taken breaks from the labour market returning to work in the years prior to retirement would have a downward bias on the replacement rate.

In addition, given people theoretically smooth consumption over the lifetime it is possible that earnings immediately prior to SPA may not be representative of consumption at that time even if it is pre-retirement consumption rather than earnings that retirement income seeks to replace.

Although replacement rates can be useful as a broad indicator of adequacy they can mask a number of factors and must be interpreted with care. No sum of money is correct for every retired individual. Furthermore, individuals ought to balance income in retirement with consumption patterns established during working years. They are further complicated by the fact that the needs of individuals vary after retirement. Limited understanding of why and how needs change is an additional reason to interpret replacement rates with care.
Appendix B
Analysis of the target population

This appendix looks in more detail at the population which is likely to be eligible for automatic enrolment under reform.

We know that today’s population of pensioners will not provide a good guide to the future. It is, therefore, vital to distinguish between data looking at pensioners at a particular point in time and data that looks only at those likely to be eligible for automatic enrolment after 2012. In 2007, the average age of those over State Pension age (SPA) was 7353. These people would have been born in 1934 and would have spent their working lives in a very different environment to those working from 2012 onwards.

Not everybody of working age will be eligible for automatic enrolment, and not all those who are automatically enrolled will remain in a pension. Some already save in a pension. The Pensim2 analysis in the report looks at all those who are modelled as saving in a defined contribution pension with an employer contribution, including those who would be modelled as saving even without reform but excluding those who are modelled as opting out. However, this appendix, based on survey data rather than modelling, looks specifically at those who are not currently saving but who would be automatically enrolled if the reforms were introduced immediately.

This analysis looks particularly at the population aged 50-SPA. This is because the characteristics of this group, such as financial wealth and household formation are more relevant when attempting to predict characteristics at retirement than for younger groups – those near the beginning of their career can expect their characteristics to change significantly before retirement.

53 Median age of those of SPA or over. Source: Population Estimates Unit, Office for National Statistics.
We find that over three-quarters of male and over half of female employees aged 50-SPA likely to be eligible for automatic enrolment have some pension wealth from prior saving. Around three-quarters of this group have some other financial wealth.\textsuperscript{54}

We also looked at the household composition of this group and found that over 80\% of employees eligible for automatic enrolment are part of a couple.\textsuperscript{55}

All of these factors are relevant when analysing the financial incentives to save in a pension and the interaction of pension saving with income-related benefits. These characteristics have been used to inform the assumptions in the case studies described in Appendix A.

**Earnings trajectories**

For the majority of the case studies we have assumed earnings rise in line with average earnings in the population over working life. We know that this is unlikely to be a true reflection of reality for most people but making this assumption allows us to look at different characteristics without the added complexity of earnings differentials over time and without examining an unmanageable number of cases.

We have looked at earnings amongst the group who would be eligible for automatic enrolment if it were introduced today. We have included a range of earnings profiles from this group but have focused the case studies on those with lower earnings as stakeholders were particularly interested in this group. This includes someone earning at the 25th percentile of earnings for the eligible group (which is lower than the 25th percentile for the overall working-age population).

We have not included an extremely low earner because, although there are likely to be number of people with very low earnings at a certain point of time in their working life, it is unlikely that they will stay on low earnings for all of their working life. Figure B.1\textsuperscript{56} shows that for the group of men on very low earnings, of between around £4,700 and £16,100 at age 25 (based on earnings from the lower earnings limit to the 25th percentile of male earnings for the group eligible for automatic enrolment), average earnings increase over time, levelling out during the mid-30s and throughout the 40s and then start to decline throughout the 50s. Twenty per cent of this group have earnings of more than £32,000 at the peak age.

\textsuperscript{54} English Longitudinal Study of Ageing (ELSA).

\textsuperscript{55} ibid.

\textsuperscript{56} Source: Lifetime Labour Market Database. Recorded earnings figures for 1985/86 and 1986/87 were artificially boosted for lower earners to protect their benefit entitlement records due to changes in National Insurance rules and rates. This analysis uses derived estimates of earnings prior to boosting. The de-boosting process produces a slight underestimate of the amount of earnings for these years and should be treated accordingly.
Figure B.1  Male earnings trajectories across the income distribution

For women the distribution is very different, although we can see very clearly that earnings are not static over time.

Source: Lifetime Labour Market Database.
In addition, many low earners will be second earners in a household or have other income sources that they may be able to draw upon. Table B.1 shows the position in the overall income distribution of working-age adults for various earnings bands. The figures shown are equivalised and so take into account the size of the household.

57 Earnings bands are based on the Lower Earnings Limit (LEL) and on earnings for the 25th, 50th and 75th percentiles for group likely to be eligible for automatic enrolment.

58 The income measures used to derive the estimates shown employ the same methodology as the Department for Work and Pensions (DWP) publication Households Below Average Income series, which uses disposable household income, adjusted (or ‘equivalised’) for household size and composition, as an income measure as a proxy for standard of living. Based on Organisation for Economic Cooperation and Development (OECD) equivalisation factors. For further details see www.dwp.gov.uk/asd/hbai/hbai2007/contents.asp
the household and are also presented on an after-housing costs basis. We have looked at men and women separately as we know that they have very different earnings profiles. However, a very similar pattern emerges for men and women when looking at household income distribution.

As might be expected, the lowest earners are concentrated in the lowest quintile and the highest earners are concentrated in the top quintile. However, the table shows that for a large number of individuals this is not the case. For example, just under a quarter of very low earning men and women (those between the LEL and the 25th percentile earnings for the group likely to be automatically enrolled), are in the top 40% overall in the household income distribution.

### Table B.1 Position in income distribution of working-age adults

<table>
<thead>
<tr>
<th>Net earnings (excluding income from self-employed)</th>
<th>Bottom quintile (%)</th>
<th>Second quintile (%)</th>
<th>Third quintile (%)</th>
<th>Fourth quintile (%)</th>
<th>Top quintile (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Men</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Less than LEL</td>
<td>41</td>
<td>22</td>
<td>14</td>
<td>11</td>
<td>13</td>
</tr>
<tr>
<td>2. LEL – £16,100</td>
<td>19</td>
<td>29</td>
<td>28</td>
<td>17</td>
<td>6</td>
</tr>
<tr>
<td>3. £16,100 – £22,140</td>
<td>5</td>
<td>20</td>
<td>29</td>
<td>34</td>
<td>11</td>
</tr>
<tr>
<td>4. £22,140 – £31,000</td>
<td>2</td>
<td>12</td>
<td>21</td>
<td>32</td>
<td>35</td>
</tr>
<tr>
<td>5. Over £31,000</td>
<td>1</td>
<td>2</td>
<td>10</td>
<td>22</td>
<td>66</td>
</tr>
<tr>
<td><strong>Women</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Less than LEL</td>
<td>42</td>
<td>25</td>
<td>14</td>
<td>9</td>
<td>10</td>
</tr>
<tr>
<td>2. LEL – £10,100</td>
<td>17</td>
<td>32</td>
<td>27</td>
<td>17</td>
<td>7</td>
</tr>
<tr>
<td>3. £10,100 – £14,700</td>
<td>8</td>
<td>23</td>
<td>31</td>
<td>26</td>
<td>12</td>
</tr>
<tr>
<td>4. £14,700 – £20,700</td>
<td>4</td>
<td>11</td>
<td>24</td>
<td>39</td>
<td>23</td>
</tr>
<tr>
<td>5. Over £20,700</td>
<td>1</td>
<td>3</td>
<td>9</td>
<td>24</td>
<td>63</td>
</tr>
</tbody>
</table>

Source: Based on Households Below Average Income data which is sourced from the Family Resources Survey 2006/07.

Notes: Working-age adults from the age of 22 to below SPA (60 for women and 65 for men). Earnings bands are expressed in annual 2008/09 terms. Quintiles are of equivalised income after housing costs.

### Evidence on tenure and Housing Benefit entitlement

Many stakeholders have expressed a particular interest in those who are likely to be eligible for Housing Benefit (HB) in retirement. This is because HB can represent a significant amount of support from the State and so has the potential for a greater withdrawal of benefit due to increasing private income.
HB is paid to those who rent their home and who are on a low income with limited savings. It is not possible to know today which renters will go on to be eligible for HB in retirement – many younger people rent before going on to buy a house, while older renters may receive an inheritance, for example. In addition, around a third of pensioners who rent today do not receive HB59.

Using ELSA we can see people approaching retirement today are more likely to own their own home than current pensioners: 15% of today's 50-54 year olds are renting compared to 33% of over 80 year olds.60 This suggests that the proportion of pensioners renting is likely to fall. Some of those who are currently renting may go on to be owner-occupiers, for example, through inheritance.

Those in employment are less likely to rent than individuals who are unemployed or have left work due to disability, suggesting renters will be less likely to be either in a workplace pension or eligible for automatic enrolment. Individuals who rent and are in employment are likely to be in lower paid work than owner-occupiers and generally have less financial wealth.

We can also look at the history of those who are pensioners receiving HB today to see whether they would be likely to have been automatically enrolled. We have focused on basic State Pension records as this age group will have had little or no interaction with State Second Pension. This data should be treated with caution as renting is more common amongst today’s pensioners than among later cohorts approaching pension age.

This data echoes the survey findings above that link renting with lower income and less engagement with the labour market, suggesting that this pattern has remained over time. They also suggest that men eligible for HB, like the population as a whole, nevertheless, have full, or nearly full, basic State Pension entitlement due partly to the crediting system in place during their working life.61

Figure B.3 shows the basic State Pension entitlement of male pensioners with and without HB. It shows that those with HB are slightly more likely to have lower State Pension entitlement to those without but the difference is small, and for both groups around 95% have entitlement to at least 60% of a full basic State Pension and so would be entitled to a full, or near full, basic State Pension under reform.

59 Family Resources Survey 2006/07.
60 ELSA Wave 1.
61 The Pensions Act 2007 extended the credits available in State Pensions.
Female pensioners today have much lower entitlements to State Pension, reflecting both the rules in force during the early years of the National Insurance system and their lower engagement with the labour market compared to later cohorts of women. Again, those with HB have similar entitlement to benefit to those without. These figures show entitlement based on the woman's own record only;
they do not include any pension earned on the basis of a spouse’s record so underestimate the actual pension entitlement.

**Figure B.4 State Pension entitlement of female pensioners**

*Source: Lifetime Labour Market Database/Single Housing Benefit Extract.*
However, we see much greater differences when considering the source of their entitlement for years since 1975. For men, Class 1 accruals which are derived from employment is the main source of accruals for both groups. However, those receiving HB have twice as much of their basic State Pension entitlement through credits than those who do not, suggesting that, on average, they have spent more years outside the labour market. Credits were available during this period for a number of situations including unemployment and incapacity, and autorecredits were given to men aged 60-64 not otherwise accruing basic State Pension. Women have fewer total years reflecting their lower basic State Pension entitlement, but again, those receiving HB have more credits. Women in both groups have similar amounts of Home Responsibilities Protection62.

Figure B.5  Average years of accrual from 1975 by source

Source: Lifetime Labour Market Database/Single Housing Benefit Extract. Notes: Class 1 accruals are based on employment, Class 2 on self-employment. Figures are based on accruals to basic State Pension in 1975/76 and thereafter as detailed data is not available for earlier years. It includes only those pensioners aged under 80 in 2007 so excludes the oldest pensioners who would have had very few years of potential accruals within the dataset.

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62 Home Responsibilities Protection was given to those with caring responsibilities from 1978 and reduced the number of years required to accrue a full basic State Pension rather than giving a positive credit.
This suggests that in the past, those who went on to claim HB in retirement had spent slightly less time in the labour market than the population as a whole. If this were replicated among today's workers it would suggest those likely to be on HB in retirement were less likely to be automatically enrolled in a pension at any given point, and so might be more likely to reach retirement either with no pension or with a pension small enough to be trivially commuted than the population as a whole, or equivalently, those with pension income would be less likely to have an interaction with HB than those without a pension income. However, these averages hide much variation and there will be some people with both pension income and HB and some with neither.
Appendix C
The impact of different choices on outcomes

We also know that individual choices can affect returns, in particular the choice to take some or all of the pension as a lump sum or not. Without the ability to take any of the pension as a lump sum, incomes would be spread out more evenly across retirement but returns for some would be poorer, either because they do not live long enough to get a good return from their annuity or because they see some benefit withdrawal due to the extra annuity income. The main Pensim2 analysis assumes that everyone who is able to, trivially commutes their pension pot63 and that of the remainder, half take a 25% tax-free lump sum and a further quarter take 12.5% of their pot as a lump sum (see Appendix A for more detail on assumptions used).

To establish the sensitivity of results to this assumption we consider the extreme case where no-one takes any 25% lump sum or trivially commutes at all but annuitises their whole pension. We now see lower returns across all cohorts but average returns for each cohort remain above £1 per £1. Figure C.1 shows the results.

63 It is assumed that the trivial commutation limit increases in line with earnings and that those who take a lump sum spend that part which is not sheltered by the capital disregard.
The impact of different decisions on the core case studies are shown in Chapter 4.

Impact of varying working and savings decisions

As well as decisions made at the decumulation stage, such as whether or not to take a lump sum, there are a number of decisions made during working life that will affect pension outcomes. In the main case studies analysis we have made the assumption that when in work the individual saves at the default contribution level and does not save when not working, and that they retire at State Pension age (SPA). This section looks at the effect of changing some of these default assumptions.

Changing the contribution level

The following example shows the effect of varying the assumption around saving during a career break for a couple. In the earlier low earning couple case where the woman takes a seven-year break from the labour market, we assumed that the woman stopped contributing to her pension during that break and that the man continued to contribute into his own pension.

If we vary this assumption so that the woman continues her contributions throughout the career break64 (assuming that she is able to draw on income from a source other than earnings) then income on retirement increases for the couple by a further £1 per week and their lump sum increases by around £560.

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64 She continues her individual contributions at the same rate but does not receive employer contributions.
If we assume that both the man and the woman stop contributions during the woman’s career break, for example due to heavier calls on their income for child-rearing this would reduce their income on retirement by £5 per week compared with the base scenario and by £6 per week compared with the scenario where they both continue saving. The lump sum in this scenario is over £2,500 lower than in the base scenario.

Table C.1  Varying assumptions on contributing during a career break

<table>
<thead>
<tr>
<th>1. Base case – woman stops contributions and man continues through the woman’s career break</th>
<th>2. Both the woman and man continue contributions throughout the woman’s career break</th>
<th>3. Both the woman and man cease contributions through the woman’s career break</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income (£)</td>
<td>Lump sum (£)</td>
<td>Payback (£)</td>
</tr>
<tr>
<td>338</td>
<td>15,662</td>
<td>3.28</td>
</tr>
</tbody>
</table>

Source: DWP modelling.

In the following scenarios we analyse the effect of varying assumptions for the median man example. Scenario 2 in Table C.2 shows that delaying saving for the first ten years of working life reduces income in retirement by £7 per week and reduces the lump sum by almost £5,000 when compared with the base case. This also reduces the payback quite considerably as he does not benefit from as many years of employer contributions and compound interest on his savings.

Conversely, if this individual were to double his contributions during this period, this would increase his income on retirement by £5 per week when compared with the base scenario and by £12 per week when compared with the opt-out scenario. The final scenario assumes that the individual contributes the maximum amount permitted into personal accounts. This increases his income on retirement by around £11 per week when compared with the base scenario.
### Table C.2  Varying assumptions on contributing for the median man

<table>
<thead>
<tr>
<th></th>
<th>Income (£)</th>
<th>Lump sum (£)</th>
<th>Payback (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Base case - median man</strong></td>
<td>197</td>
<td>18,128</td>
<td>3.02</td>
</tr>
<tr>
<td></td>
<td>190</td>
<td>13,154</td>
<td>2.61</td>
</tr>
<tr>
<td><strong>2. Median man opts-out for first ten years</strong></td>
<td>202</td>
<td>21,208</td>
<td>3.05</td>
</tr>
<tr>
<td></td>
<td>208</td>
<td>24,788</td>
<td>1.83</td>
</tr>
</tbody>
</table>

Source: DWP modelling.
Working past State Pension age

Extending working life beyond SPA increases years spent in employment and saving for retirement and reduces the number of years in retirement to be funded. Individuals prepared to work beyond SPA could, therefore, raise their retirement income.

The transition from work to retirement often involves a move towards part-time employment. In April-June 2008, over a fifth of men aged 65-69 and over a third of women aged 60-64 were in employment, the majority of whom were working part-time. Evidence from the Labour Force Survey (LFS) also shows that the average age of withdrawal from the labour force for men and women has increased since data was first available in 1984. This example, therefore, assumes that the individual works part-time for five years after SPA. It has also been assumed that the individuals take their State Pension at SPA and they take their private pension when they stop working.

Each individual can increase their retirement income through working longer, with the size of the increase depending on the amount of extra private pension rights they have built up (and which will give a higher income since they have been claimed later). The average payback over all savings increases for all the cases shown – retiring later gives more time for investment growth on average and, since total pension income is higher, may reduce the amount of benefit lost per £1 of pension income for those cases with benefit interactions in the base case.

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### Table C.3  Impact of working five years part-time from SPA with drawdown on State Pension from SPA

<table>
<thead>
<tr>
<th></th>
<th>Income with extended working life (£)</th>
<th>Income – no extension of working life (£)</th>
<th>Improvement in income from extended working life (£)</th>
<th>Payback (£)</th>
<th>Improvement in payback from extended working life (£)</th>
<th>Lump sum (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Low earning man</td>
<td>187</td>
<td>179</td>
<td>7</td>
<td>3.52</td>
<td>0.46</td>
<td>12,861</td>
</tr>
<tr>
<td>2. Median earning man</td>
<td>202</td>
<td>190</td>
<td>12</td>
<td>3.40</td>
<td>0.38</td>
<td>20,196</td>
</tr>
<tr>
<td>3. High earning man</td>
<td>224</td>
<td>205</td>
<td>20</td>
<td>3.31</td>
<td>0.38</td>
<td>30,963</td>
</tr>
<tr>
<td>4. Low earning man with a period of self-employment (opts-in)</td>
<td>174</td>
<td>166</td>
<td>8</td>
<td>2.89</td>
<td>0.51</td>
<td>11,834</td>
</tr>
<tr>
<td>5. Low earning man with a period of self-employment (opts-out)</td>
<td>170</td>
<td>163</td>
<td>7</td>
<td>3.74</td>
<td>0.60</td>
<td>10,122</td>
</tr>
<tr>
<td>6. Low earning woman with career break</td>
<td>168</td>
<td>166</td>
<td>3</td>
<td>2.95</td>
<td>0.41</td>
<td>4,360</td>
</tr>
<tr>
<td>7. Low earning couple, woman with career break (cases 1+6)</td>
<td>336</td>
<td>324</td>
<td>12</td>
<td>3.78</td>
<td>0.50</td>
<td>17,221</td>
</tr>
<tr>
<td>8. Median age couple</td>
<td>334</td>
<td>319</td>
<td>16</td>
<td>2.94</td>
<td>0.39</td>
<td>17,883</td>
</tr>
<tr>
<td>9. Older man</td>
<td>185</td>
<td>183</td>
<td>2</td>
<td>1.86</td>
<td>0.20</td>
<td>3,411</td>
</tr>
<tr>
<td>10. Older woman</td>
<td>158</td>
<td>157</td>
<td>1</td>
<td>1.66</td>
<td>0.22</td>
<td>1,466</td>
</tr>
<tr>
<td>11. Older couple (cases 9+10)</td>
<td>305</td>
<td>301</td>
<td>4</td>
<td>1.98</td>
<td>0.23</td>
<td>4,878</td>
</tr>
<tr>
<td>12. Low earning woman with a long career break</td>
<td>166</td>
<td>164</td>
<td>2</td>
<td>1.95</td>
<td>0.20</td>
<td>2,566</td>
</tr>
</tbody>
</table>
### Table C.3 Continued

<table>
<thead>
<tr>
<th>Case Description</th>
<th>Income with extended working life (£)</th>
<th>Income – no extension of working life (£)</th>
<th>Improvement in income from extended working life (£)</th>
<th>Payback (£)</th>
<th>Improvement in payback from extended working life (£)</th>
<th>Lump sum (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>13. Low earning couple, woman with long career break (cases 1+12)</td>
<td>333</td>
<td>321</td>
<td>11</td>
<td>3.48</td>
<td>0.42</td>
<td>15,427</td>
</tr>
<tr>
<td>14. Older low earning man with no savings</td>
<td>157</td>
<td>157</td>
<td>0</td>
<td>1.64</td>
<td>0.22</td>
<td>1,254</td>
</tr>
<tr>
<td>15. Older low earning woman with a long career break</td>
<td>147</td>
<td>146</td>
<td>1</td>
<td>1.30</td>
<td>0.06</td>
<td>1,531</td>
</tr>
<tr>
<td>16. Older low earning couple (cases 14+15)</td>
<td>252</td>
<td>245</td>
<td>7</td>
<td>2.03</td>
<td>0.21</td>
<td>2,785</td>
</tr>
<tr>
<td>17. Older lifetime renter</td>
<td>228</td>
<td>227</td>
<td>0</td>
<td>0.86</td>
<td>0.10</td>
<td>4,753</td>
</tr>
</tbody>
</table>

Source: DWP modelling.

Notes: Figures may not sum due to rounding. Case 18 has not been modelled as in the base scenario this individual is not in work from age 42 to SPA. Incomes are quoted for the year after stopping work.
Appendix D
The impact of benefit entitlement in working life

The main analysis in this report has assumed that individuals do not receive benefits during working age. In fact many receive Housing Benefit (HB), Council Tax Benefit (CTB) and tax credits.

Around two and a half million working-age families and around one and a half million pensioner households are in receipt of HB. Over 90% of HB recipients also receive CTB. In total there are over two and a half million working-age families are in receipt of CTB.

For recipients of working-age benefits, contributing to a pension may increase benefit entitlement during working life. Some or all pension contributions can be deducted from income, effectively lowering income taken into account. Lower income could increase benefit entitlement. Receipt of working-age benefit may, therefore, be an added incentive to save.

The following analysis will illustrate the net effect of contributing £1 to a pension.

Tax credits

Individuals and couples with an income below £6,420 (2008/09) per year can receive the maximum amount of tax credit for which they are eligible. Those with an income above this threshold will see their tax credits tapered away at a rate of up to 39p (2008/09) for every extra pound of gross income.


Within Child Tax Credit (CTC), the family element is retained until income exceeds £50,000 per annum (£958.90 per week), at which point it starts to be tapered away at a rate of £1 for every extra £15 of income. For those in receipt of CTC only, they will be eligible for the full amount of CTC until annual gross income reaches £15,575 (2008/09 rates). If a family receives Income Support (IS) or income-based Jobseeker’s Allowance (JSA), it will automatically receive the full amount of the CTC for which it qualifies.

For those individuals on the first tapered part of the tax credit system, pension contributions will actually increase entitlement to tax credits. Investing an extra £1 in a pension scheme increases the amount of tax credit received by 39p. For those on the second taper, this extra investment will increase tax credit received by 7p.

Impact on HB and CTB

HB and CTB disregard 50% of pension contributions. As contributions increase, the amount of HB/CTB individuals are eligible for should rise. If savings increase by £1 then income brought to account falls by 50p. With this lower income HB rises by 33p (65% of 50p) and CTB rises by 10p (20% of 50p). Net income due to HB/CTB rises by 43p.

Impact on both tax credits and HB/CTB

Increasing pension contribution has the following effect:

- The £1 pension contribution reduces income brought to account by £1.
- Tax credit entitlement increases income by 39p, offsetting some of the income lost. Thus far the overall loss of income from contributing an extra £1 is 61p.
- HB and CTB entitlement is calculated after disregarding 50% of the gross pension contribution and accounts for any extra income from tax credits.
- For HB and CTB entitlement calculation purposes, income has fallen by 50p (50% of £1) but taking account of tax credits increases it by the 39p calculated above, meaning the income taken into account falls by 11p.
- HB entitlement increases by 7p (65% of 11p).
- CTB entitlement increases by 2p (20% of 11p).
- The total loss of income to contribute an extra £1 = -£1 + £0.39 + £0.07 + £ 0.02 = £0.52.

Individuals in receipt of tax credits, HB and CTB, effectively pay only 52p for an ‘individual’ contribution of £1, which, with the employer match and tax relief will mean £2 is contributed to their pension. The receipt of working-age benefits, thus, enhances payback from pension saving.
Appendix E
The Savings Incentives Work Programme

The Savings Incentive Work Programme was set up in January 2008 in response to stakeholder interest in incentives to save for retirement under reform. The objective of the programme was to extend and present evidence on incentives to save, looking at the impact of existing reforms and the potential impact of measures to further improve incentives. This is intended to build understanding of this complex and important area, and to enable debate to continue on the basis of a sound, common evidence base.

The full Terms of Reference for the programme are given in Box E1.

A central part of the programme’s methodology has been to work closely with stakeholders to take advantage of their input and expertise. The methods of engagement were chosen to match stakeholders’ preferences and programme needs and included:

• formal seminars to draw together participants to exchange insights;
• analytical meetings bringing together academic experts to advise on the detailed design of the analytical programme;
• informal meetings with experts in particular areas; and
• regular email communications to update stakeholders and give opportunity for feedback on progress.

This input has helped us to shape the whole of our programme. In particular, stakeholders have assisted us in:

• identifying the key challenges faced and inevitable trade-offs;
• advising on our analytical strategy and in particular assisting us in drawing together an appropriate selection of case studies to convey the range of circumstances faced by the target audience;
• drawing out the criteria which must be considered in evaluating any proposed measure affecting incentives to save; and

• proposing and agreeing a priority list of measures for detailed analysis.

Key conclusions which we have taken account of in our work include:

• Any Government faces competing objectives, and the existing package represents a good balance which has engendered a great deal of support. It is vital that this consensus is maintained. Analysis of potential measures to further improve incentives should, therefore, take account of the degree to which they fit within the existing package. However, it is right to consider whether there are any changes within this package which could improve incentives without adverse affects on other Government objectives.

• Few individuals are likely to be able, or willing, to engage in the detailed discussions of incentives which have been a focus of debate amongst commentators. Any analysis must, therefore, pay heed to the implications of incentives on how we can best communicate the benefits of saving given the inevitable complexities and uncertainties faced when planning for retirement. Information needs to be well-balanced – due to the inherent uncertainty of life events.

• A range of tools is needed to consider the issue of savings incentives – there was recognition that there is no one ‘supermodel’ that is capable of providing us with answers to all the questions that have been posed.

• It is important to consider the inevitable limitations of models and uncertainty about the future, and the appropriate context for analysis. Where appropriate sensitivities should be discussed and sensitivity and scenario analysis presented to aid the interpretation of results.

• We know that individuals in the real world do not always behave as classical rational individuals with full knowledge. There was agreement that we must consider real-life behaviour and that a literature review could help to provide some of the context needed on perceptions, understanding and behaviour. It was also suggested that it would be helpful to consider what insights qualitative research can provide.

• Stakeholders requested analysis of the expected outcomes from saving for those with different characteristics, and for an evaluation of policy measures that have been suggested, against agreed criteria.

• There was emphasis on the importance of considering savings incentives at the point of automatic enrolment, not just final outcomes which depend on how entire life histories pan out in practice.

• Case studies were seen as a clear way of conveying information about incentives for some of the range of characteristics we see in the real world. However, it is vital to remember that such case studies depend on assumptions about a future life history which will be subject to a great deal of uncertainty at the point of automatic enrolment.
The DWP savings incentives team would like to take this opportunity to thank the many individuals who have willingly given their time and expertise to support us in developing this programme.

Box E1: Terms of Reference for the Government’s Pension Savings Incentives Work Programme

The work programme will consider the following issues to further develop understanding of the Government’s pension reforms. It will:

a. Establish a shared understanding of the evidence on financial incentives to save for retirement following reform, the likely range of outcomes in retirement, and how these might affect future behaviour, focusing on the potential interaction between pension saving and income-related benefits. As well as exploring the current data, research and analysis, this will identify any gaps in the existing evidence base. It will also consider the role that generic information and guidance might play in relation to this particular issue.

b. Assess the potential costs, benefits and other impacts of relevant measures which could affect incentives to save for retirement against an appropriate set of evaluation criteria. These criteria will need to reflect the balance of objectives in the overall reform package, based on the work of the Pensions Commission – including alleviating poverty, encouraging personal responsibility in saving for retirement, and the affordability and sustainability of the pensions and benefit system – as well as wider Government objectives for the tax and benefit system.

The work will involve active engagement with key external stakeholders, with Government leading on producing or commissioning work as necessary. The Government will aim to complete this work programme by the end of 2008 and publish a report.