briefing notes

THE TAX AND BENEFIT SYSTEM AND THE DECISION TO INVEST IN A STAKEHOLDER PENSION

Tom Clark
Carl Emmerson

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Tom Clark and Carl Emmerson*

Institute for Fiscal Studies

1. Introduction

This Briefing Note looks at the interaction of the tax and benefit system with stakeholder pensions. In particular, it asks how, in the light of recent reforms to the system of state pension provision, the welfare system differentially affects the incentive to invest in a stakeholder scheme for various groups in the population.

We start with a brief review of the nature and aim of stakeholder pensions. We go on to review how the tax treatment of stakeholder schemes compares with that of the other principal tax-privileged way to invest in financial assets, the Individual Savings Account (ISA). As we explain, individuals who expect to be saving moderate amounts for the foreseeable future may well face a difficult decision in deciding between these two vehicles. For example, they might be best served by initially placing funds in an ISA and subsequently transferring these funds into a pension as they near retirement. Next, we turn to the benefit system. We provide an overview of its structure in the wake of Labour's reforms and review how it treats different forms of financial assets. We then determine the specific groups for which the benefit system is especially likely to exert a major influence on the appropriate form in which to save for retirement and, indeed, whether to save at all.

Taken as given in all this is the current tax and benefit system, along with the current government's aspirations for how this will evolve over time. One important consideration for people will be that, in reality, governments' policies have tended to change over time. The final section briefly discusses the important issue of whether current policies, such as increasing the basic state pension in line with prices while increasing the minimum income guarantee (and eventually the pension credit) in line with earnings, may or may not prove to be politically sustainable.

* Address for correspondence: email Tom_Clark@ifs.org.uk or Carl_Emmerson@ifs.org.uk, or write to IFS, 7 Ridgmount Street, London, WC1E 7AE.
Financial support from the Financial Services Authority is gratefully acknowledged. All discussion of the relative merits of different saving strategies refers only to the broad picture and the current tax and benefit system – individuals should consider carefully their own situation.

2. Background

What are stakeholder pensions?

Stakeholder pensions have been on sale since April 2001. They are 'no frills' personal pensions that meet government-defined standards in terms of charges, flexibility and transparency. In addition, there is a degree of obligation on employers to inform their employees about stakeholder pensions. We now discuss each of these in more detail.[1]

Charging structure

Stakeholder pension schemes are only allowed to charge a percentage of the fund (i.e. no charges either upfront, on contributions to the scheme or on withdrawals from the scheme). The charge must not be greater than 1% a year. The idea of this simple charging structure is to make it easy to compare the relative costs of different schemes. Schemes also have to allow individuals to stop or start their contributions at any point and have to accept all contributions of £20 or more. The fact that individuals can move their funds from one stakeholder pension scheme to another without incurring any charge is intended to help promote competition in the marketplace.

Employer obligations

Employers with five or more employees who do not offer an occupational scheme are obliged to nominate a stakeholder pension provider. They also have to offer to make arrangements so that employees can commit to a regular contribution straight from their wage packet. Employers are not – as yet – under any obligation to contribute to their employees' pensions. All individuals without any other private pension scheme can open and contribute to a stakeholder pension. Those who earn below £30,000 a year[2] who have a defined benefit pension scheme can, if they wish, also open a stakeholder pension.

What were stakeholder pensions designed to achieve?

The government has stated that stakeholder pensions are aimed at those middle earners, defined as those earning between around £9,000 and £18,500 a year, who do not already have a private pension.[3] An analysis of the characteristics

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[1] For more details on stakeholder pensions, see, for example, Financial Services Authority, *FSA Factsheet: Stakeholder Pensions and Decision Trees*, London, 2001 (www.fsa.gov.uk/pubs/public/stakeholder.pdf).

[2] Except for controlling directors.

[3] Department of Social Security, *A New Contract for Welfare: Partnership in Pensions*, Cm. 4179, London, 1998 (www.dwp.gov.uk/publications/dss/1998/pengp/index.htm).

of those in the target group for stakeholder pensions is shown in Table 1.[4] This takes those people who earned between £9,000 and £18,500 in at least one year during the period 1992–95 and compares the characteristics of those who already had a private pension with the characteristics of those who did not. The table shows that those in the target group who did not already have a private pension arrangement are much more likely to experience periods of unemployment and fluctuations in their earnings.

Table 1. Who is in the government's stakeholder pension target group?

	Annual earnings £9,000–£18,500; no private pension	*Annual earnings £9,000–£18,500; private pension*
% who were unemployed at least once	36%	15%
% who earned < £9,000 in at least one year	20%	14%
% who earned £9,000–£18,500 throughout	30%	41%
% with no savings	34%	22%
% with less than £500 savings	21%	18%
% with more than £500 savings	45%	60%

Note: Table includes those who earned between £9,000 and £18,500 in at least one year over a four-year period.
Source: R. Disney, C. Emmerson and S. Tanner, 'Radical pension reform? An assessment of the government's proposals', *Insurance Trends*, 1999, vol. 22, pp. 1–8, using data from the British Household Panel Survey, 1992–95.

The flexibility over contributions and the fact that the charges are levied as a percentage of the fund rather than incorporating a flat-rate element should help make stakeholder pensions an attractive option to the target group. This is because its members are more likely to want to change their contributions and may well want to make smaller contributions. However, the data presented in Table 1 also reveal that they are more likely to have no, or low levels of, savings. This, coupled with the fact that they are relatively more likely to experience periods of unemployment, might suggest that they should hold any savings in a more liquid form rather than tying them up for retirement. This would allow them to build a more liquid stock of savings that could be used as security if circumstances deteriorated – for example, during a period of unemployment.[5] One possibility is for them to save in an Individual Savings

[4] Further discussion of the characteristics of those in the government's target group for stakeholder pensions can be found in R. Disney, C. Emmerson and S. Tanner, *Partnership in Pensions: An Assessment*, Commentary no. 78, IFS, London, 1999, an executive summary of which is available at www.ifs.org.uk/pensions/partnership.shtml.

[5] The importance of building up this type of precautionary saving before saving for retirement is described in HM Treasury, *Saving and Assets for All*, London, 2001 (www.hm-treasury.gov.uk/mediastore/otherfiles/36.pdf).

Account. The relative advantages and disadvantages of this strategy are discussed in the next section.

3. ISAs and stakeholder pensions: liquidity and tax treatment

In considering the choice between different savings vehicles, investors will be affected both by how liquid their assets will be (i.e. the ease with which they can access them should the need arise) and by the total rate of return that they expect. An important determinant of the latter will be the generosity of tax relief available.[6] We discuss each factor in turn.

Difference in liquidity

In terms of liquidity, ISAs are preferable to stakeholder pensions. Funds can be withdrawn from an ISA at any time without any tax penalty. In contrast, the tax relief available on stakeholder pensions is, for the majority of people, conditional on reaching age 50. If the expected return on the two types of asset is the same, therefore, then an ISA should be preferred on the grounds that saving for retirement can be undertaken without foregoing the opportunity of spending the money earlier should the need arise.

Of course, some individuals may prefer to hold funds in a stakeholder pension rather than in an ISA if they are concerned that they may, in future, lack the self-control necessary not to spend any savings before retirement. These individuals will value the fact that a pension locks away their funds.

Difference in tax treatment

In terms of overall tax treatment, though, private pensions typically have the upper hand. Table 2 sets out how tax affects the two types of savings vehicle at various stages. Employee contributions to stakeholder pensions are made from income net of tax, with the government then contributing the equivalent basic-rate tax. Higher-rate taxpayers can go on to claim more relief in line with their higher marginal income tax rate. This means that for non-higher-rate taxpayers, every 78p contributed to a stakeholder pension leads to the government contributing an additional 22p. This is regardless of whether the individual currently pays income tax on their marginal income at the basic rate (22p) or the starting rate (10p) or pays no income tax. Any returns on funds held in a stakeholder pension are not subject to any income or capital gains tax. On withdrawal, one-quarter of the fund can be taken as a lump sum that is free of tax. The remainder has to be used to purchase an annuity at some point before the individual reaches the age of 75. The income from this annuity is subject to income tax. Contributions made to pension schemes by employers are treated

[6] Many of these and related issues are discussed in Financial Services Authority, *FSA Guide to Saving for Retirement*, London, 2002 (www.fsa.gov.uk/pubs/public/retirement.pdf).

more generously, since they are not liable to either employer or employee National Insurance (NI) either at the point of contribution or on withdrawal.

Table 2. The taxation of stakeholder pensions and ISAs

	ISAs	*Stakeholder pensions — employee contributing*	*Stakeholder pension — employer contributing*
Contributions	Paid out of income net of income tax, employer NI and employee NI	Paid out of income net of employer NI and (reduced-rate) employee NI but exempt from income tax	Not liable to income tax, employer NI or employee NI
Returns (dividends)	Exempt, plus 10% dividend tax credit paid	Exempt	Exempt
Returns (capital gains)	Exempt	Exempt	Exempt
Withdrawal	Exempt	Taxed, except 25% tax-free lump sum; exempt from NI	Taxed, except 25% tax-free lump sum; exempt from NI

Notes: The exempt status of returns to ISAs has been guaranteed by the government until 2009. The 10% dividend tax credit is set to expire in April 2004 but could be extended in a future Finance Bill.
Source: C. Emmerson and S. Tanner, 'A note on the tax treatment of private pensions and Individual Savings Accounts', *Fiscal Studies*, 2000, vol. 21, pp. 65–74, a summary of which is available at www.ifs.org.uk/publications/fiscalstudies/fsabs21emmtan.shtml.

Contributions made to an ISA are made from income after tax. The tax treatment of any returns to the fund is currently more generous than that of funds held in a stakeholder pension. This is because, in addition to there being no income tax or capital gains tax, the government also pays a 10% tax credit on any dividends paid on UK equities held in the fund. Withdrawals from ISAs are exempt from income tax.

Many individuals will expect to pay income tax at the same marginal rate both when contributing to and when withdrawing from the savings account. For these groups, it makes no difference that funds held in a pension are taxed on withdrawal while those held in an ISA are paid from income after tax.[7] Many

[7] If there were no lump sum, then the amount available on withdrawal from an additional pound saved in a pension is $(1+R) \times (1-T)$, where R is the overall return on the fund and T is the individual's marginal tax rate. With the equivalent pound contributed to an ISA, the amount available is $(1-T) \times (1+R)$. For more details, see, for example, chapter 6 of J. Banks and S. Tanner, *Household Saving in the UK*, IFS, London, 1999, a summary of which is available at www.ifs.org.uk/pensions/saving1.shtml.

basic-rate income taxpayers might expect to remain basic-rate income taxpayers in retirement. But many individuals will expect their marginal income tax rate to fall once they reach retirement – either because their lower income puts them in a lower tax band or because it excludes them from tax entirely. Such people would prefer to pay tax on withdrawals from the fund. This is known as tax-rate smoothing and will mean that, for example, higher-rate taxpayers who expect to become basic-rate taxpayers in retirement are likely to find the tax treatment of ISAs less attractive than that of stakeholder pensions. (Individuals who expect their marginal rate to be higher in retirement would prefer to contribute from income after tax and have withdrawals that are free from tax.)

Those individuals who expect to be basic-rate taxpayers both during their working lives and in their retirement will need to consider whether the dividend tax credit is worth more than the tax-free lump sum available in a pension. The value of the dividend tax credit increases with the amount of dividends received. Currently, the dividend tax credit is set to be removed in April 2004. If this happens, then it is almost certainly the case that the tax treatment of stakeholder pensions will be more attractive than that of ISAs. If, however, the dividend tax credit is extended in perpetuity, then the relative generosity becomes less clear since real rates of return of around 10% could lead to the tax treatment of ISAs becoming more generous over a 30-year period.[8]

In summary, if the dividend tax credit is retained, then investment in a stakeholder pension will be more likely to be preferable where:

- rates of return are low;
- dividends are low relative to capital gains or interest income (reducing the value of the ISA's 10% dividend tax credit);
- saving periods are short (i.e. workers are close to retirement), so the expected cumulative return is lower;
- a lower marginal income tax rate is expected in retirement than during the working life.

Where these conditions do not obtain, then, if the dividend tax credit in ISAs is extended indefinitely, the decision can be finely balanced and some might find

[8] This crucially assumes that the rates of return, net of charges, to funds held in ISAs and stakeholder pensions are the same. This is discussed in more detail in C. Emmerson and S. Tanner, 'A note on the tax treatment of private pensions and Individual Savings Accounts', *Fiscal Studies*, 2000, vol. 21, pp. 65–74, a summary of which is available at www.ifs.org.uk/publications/fiscalstudies/fsabs21emmtan.shtml. Slightly more up-to-date numbers, reflecting the March 2000 Budget decision to cut the basic rate of income tax by 1p, can be found in C. Emmerson and S. Tanner, 'Saving for retirement: the tax effect', *Insurance Trends*, 2000, vol. 27, October, pp. 9–15.

saving in an ISA preferable. In particular, young workers are expecting to save for long periods when they are planning for retirement. This means that their expected cumulative return is high, increasing the importance of the dividend tax credit. At the same time, for them, putting money in a pension means locking it in longer than for older workers. So as well as receiving relatively less favourable tax treatment, they also sacrifice more liquidity when they join a pension scheme rather than investing in an ISA.

Where employers agree to contribute alongside their employees (for example, to match their contributions up to some limit), pensions are more likely to be preferable – most importantly because the existence of an employer contribution will increase the effective rate of return for the employee, but also because the tax relief available on employer contributions is more generous (they attract relief from both employer and employee National Insurance as well as income tax).

Drip-feeding savings into a pension in the immediate run-up to retirement

The analysis so far has compared saving for retirement in a stakeholder pension with saving for retirement in an Individual Savings Account. There is another possibility. Individuals can save in an ISA and then transfer the funds at some point in the future into a stakeholder pension. This means that they will benefit from the presence of the dividend tax credit and also from the tax-free lump sum. Hence, this route is clearly more tax advantaged than either saving in a stakeholder pension or saving in an ISA. It also has the advantage of keeping funds more liquid so that they could be used in the event of some unforeseen circumstance occurring before retirement.

An important potential constraint on individuals choosing to save in an ISA and then transferring the funds into a stakeholder pension is the contribution limits that apply to stakeholder pensions. To benefit fully from the tax-free lump sum, individuals would need to ensure that they had transferred all of their retirement funds into the stakeholder pension before withdrawal. Whether this would be possible will depend on the size of the fund, the size of any future expected saving and the number of years to retirement. Individuals may also want to consider that the tax-free status of funds held in an ISA is only guaranteed until April 2009. This means that they may want to ensure that they have transferred funds across to a stakeholder pension scheme before that date in case the government does not decide to extend the tax-free status of returns on funds held in an ISA further.

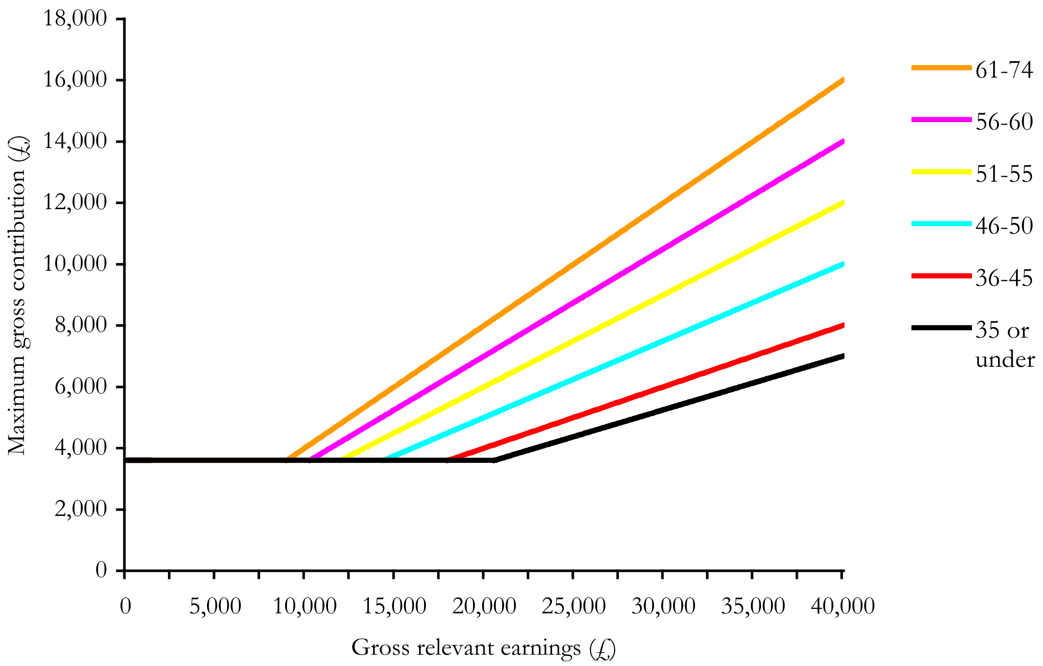
The amount that individuals can contribute to a stakeholder pension depends both on their earnings and on their age. All individuals are able to make gross contributions of up to £3,600 a year (which for a basic-rate taxpayer would require a net contribution of £2,808). Some individuals are allowed to contribute more than this, depending on their age and earnings; the percentages of earnings allowed are given in Table 3 and the resulting overall amounts are shown in Figure 1. These overall limits cover contributions made by employees and any contribution made on their behalf by employers.

Table 3. Amounts that individuals can contribute to a stakeholder pension if their contribution limit exceeds the £3,600 (gross) stakeholder pension minimum

Age at the start of the tax year	*Maximum contributions as a % of relevant earnings*
35 or under	17.5%
36–45	20.0%
46–50	25.0%
51–55	30.0%
56–60	35.0%
61–74	40.0%

Notes: Contributions are subject to an overall earnings cap. In 2002–03, this has been set at £97,200. Maximum contribution includes both employer and employee contributions.

Figure 1. Maximum gross contribution limit, by gross relevant earnings



Notes: As Table 3.

A numerical example of how somebody might benefit from this drip-feeding approach might make the process clearer. For example, take an individual who wanted to save £150 a month from April 2002 until their retirement in April 2009. They could contribute this £150 a month into an ISA for the next two years (2002–03 and 2003–04). This would allow them to benefit fully from the dividend tax credit (which is set to last until April 2004) and also from the additional liquidity of funds held in an ISA. For each of the years from 2004–05 onwards, they could contribute the £150 a month (£1,800 a year) to a stakeholder pension and also transfer £1,000 a year from their ISA into their stakeholder scheme. This is allowed regardless of their level of earnings, since their total pension contributions are below £2,808 a year (net of tax). By transferring £1,000 a year, they would have moved all of their savings out of their ISA into the stakeholder scheme by April 2009 (unless they were able to achieve a rate of return in their ISA of more than 10% a year). This would ensure that they had all of their funds in their stakeholder pension scheme by the date of retirement and thus benefit fully from the 25% tax-free lump sum.

Many individuals will find that the earnings-related contribution limits will allow them to transfer much more into a stakeholder pension than the lower limit of £3,600 (gross). For example, a 55-year-old person with an annual income of £20,000 could contribute up to £6,000 a year to their stakeholder pension scheme.

So far, we have discussed the effect of the tax system on incentives to save for retirement in different forms. For many lower-income individuals, some of whom are in the stakeholder pension target group, a more important consideration will be the effect of the benefit system. We now turn to this.

4. Benefits for pensioners

The means-tested benefit system has long dampened the incentive to save for those anticipating a low income in retirement. Recent reforms have ambiguously affected the extent to which saving is deterred.

The following are the main means-tested benefits currently received by pensioners:

- *Minimum income guarantee (MIG):* this guarantees all individuals aged 60 or over a particular income. It has long been fixed at a level above the basic state pension and so it 'tops up' the incomes of pensioners with a full basic pension but no private pension. Any private income that a pensioner does have gives rise to pound-for-pound reduction in MIG entitlement. (Until recently, it was known as income support for pensioners.)

- *Housing benefit:* this helps pay rent for low-income pensioners. Rent is covered in full for anyone reliant on the MIG. For those with slightly higher incomes, entitlement is reduced by 65p for each pound of income possessed, until it is exhausted.

- *Council tax benefit:* this helps pay council tax for low-income pensioners. Council tax is covered in full for anyone reliant on the MIG. For those with slightly higher incomes, entitlement is reduced by 20p for each pound of income possessed, until it is exhausted.

All these benefits tend to reduce the financial incentive to save, for two reasons. Firstly, the guarantee of a higher income in retirement leaves working-age people better off (in a lifetime sense) and so may persuade them that they can afford to spend more in the current period, and so consequently save less for retirement. Second, the fact that benefit entitlements are reduced in respect of private pensions reduces the value of acquiring private pension rights. This is most obviously true in the case of income support, where the reduction is pound-for-pound. Someone on a low income approaching retirement may see that any saving that they can do will be insufficient to secure them an income above the MIG. Consequently, their net income will be completely unaffected by any pension that they are able to build up, so they could rationally conclude that they would be better off spending their money on current consumption.

Many pensioners who are not on the MIG are entitled to both housing benefit and council tax benefit. For them, a pound of extra private pension income delivers relatively little gain, as 20p is lost in council tax benefit and 65p is lost in housing benefit. These reductions total 85p in the pound, meaning that only 15p of the private income is kept.

The British means-tested benefit system has traditionally penalised those holding their savings in capital form especially harshly. On these grounds, for workers expecting to retire on a low income, saving in an ISA might seem unattractive. Although £3,000 in cash or financial assets can be possessed without affecting benefit entitlement, any money held in excess of this rapidly reduces benefit entitlement. Each £250 of additional capital is assumed to be worth an extra £1 a week in income, implying an assumed interest rate of 20% a year, considerably in excess of what those on low incomes are likely to be able to secure. In addition, until April 2001, those with savings in excess of £8,000 lost *all* their MIG entitlement (in excess of £16,000 for housing benefit and council tax benefit). Now the lower (£3,000) threshold has increased to £6,000 and the higher (£8,000) threshold in the MIG has increased to £12,000.

The Labour government significantly increased the MIG, and thereby increased the number of pensioners entitled to it. In consequence, the extent to which the dampened financial incentives of those on this benefit were seen as a problem was sharpened. Perhaps motivated by these concerns, the government moved to replace the MIG with a new benefit, the pension credit.

Pension credit will be effective from Autumn 2003.[9] The main structural change is restricted to pensioners aged 65 or over. For them, instead of benefits being withdrawn pound-for-pound in respect of private income, they will be withdrawn at a rate of 40p for each pound of private income possessed above a full basic state pension. The more gradual withdrawal of benefits means that the system becomes more generous for those with small amounts of private

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[9] This description of the pension credit summarises the main points from T. Clark, *Recent Pensions Policy and the Pension Credit*, Briefing Note no. 17, IFS, London, 2001 (www.ifs.org.uk/pensions/bn17.pdf) and T. Clark, *Rewarding Saving and Alleviating Poverty? The Final Pension Credit Proposals*, Briefing Note no. 22, IFS, London, 2002 (www.ifs.org.uk/pensions/bn22.pdf). These should be consulted for a fuller description.

income.[10] It also means that higher incomes are required to exhaust entitlement entirely.

The effect on the decision about how much to save for retirement is different for three different groups:

- For those who would otherwise not have saved at all, saving becomes more attractive, as the reduced benefit withdrawal rate means that pension rights will now have more effect on final income in retirement.

- For those anticipating retiring with a pension so modest that they would otherwise have been on the MIG, the effect is ambiguous. On the one hand, the reduction in the benefit withdrawal rate makes saving in a pension 'better value'. On the other, the higher income that the reform means that they will enjoy in retirement decreases the urgency of saving for retirement.

- Those whose current plans would give them a modest income in retirement that would previously have been just sufficient to take them out of means-tested benefits will now find themselves with some means-tested benefit entitlement. For them, saving becomes less attractive both because the higher income that they can look forward to in retirement blunts the urgency with which they need to save and because they will face the effects of benefit withdrawal for the first time.[11]

The fact that pension credit is typically withdrawn at 40% tells us little about the actual effective total withdrawal rate of its recipients. This is because many will be on other benefits as well. If they are also on housing benefit, then the total withdrawal rate becomes 79%; if they are also on council tax benefit *and* housing benefit, then the total withdrawal rate becomes 91%. In addition, because the reduced benefit withdrawal rate applies only to income in excess of the basic state pension, those who have only incomplete entitlement to that benefit and little other income will continue to face withdrawal at 100%.

In other words, for some recipients, the 'headline' reduction in the withdrawal rate from 100% to 40% may be a significant overestimate. In practice, however, it seems that in the short term at least, in spite of theoretical ambiguity, far fewer pensioners will be on combined deduction rates in excess of 70% than was previously the case. In part, this is because few pensioners

[10] Assuming that the basic pension is £77 in 2003 and that the MIG (to be relabelled the 'pension credit guarantee') will be £100, then the maximum gain for a single pensioner will accrue to someone with £23 of private pension income on top of their basic state pension. Previously, they would have received no MIG, but under the new system, they receive £13.80 in pension credit.

[11] In practice, changes to council tax benefit and housing benefit that will come in at the same time as pension credit mean that some individuals who are not on the MIG but will be on pension credit will find that their total effective marginal tax rate goes down.

have reduced basic pension entitlement; in part, it is because of changes that the government has made to housing benefit and council tax benefit.

Under pension credit, the rules regarding financial capital in the MIG will also be relaxed. Instead of assuming that each £250 of financial capital over and above £6,000 is equivalent to £1 a week of income, the new system will assume that each £500 over and above £6,000 is worth £1 a week in income. In addition, the £12,000 financial capital 'cliff edge', above which all benefit entitlement is lost, will be abolished. This change in the benefit system makes it relatively more attractive to hold one's savings in capital form as opposed to in pension rights. The fact that the £16,000 'cliff edge' will continue to apply in housing benefit and council tax benefit reduces the extent to which this is true for those anticipating being on these benefits in retirement.

5. How will the new system evolve?

The government's stated aspiration is that the pension credit guarantee (the relabelled MIG) will rise in line with earnings. In contrast, it is content that the basic state pension will increase only in line with prices. Maximum pension credit entitlement for someone with a full state pension is given by the gap between these two. If both the state pension and the pension credit grew in line with earnings, then the gap between the two would grow in line with real earnings; because the state pension is actually set to be frozen in real terms, the gap between the two must actually grow *faster* than real earnings. This implies that the private pension income required to exhaust entitlement (a multiple of this gap) will grow very rapidly over time, and that, as a result, it is likely that ever-more pensioners will be brought into the means-tested system.

Table 4 shows how the system looks set to evolve. The 'gap' is set to grow rapidly, initially at 8.7% a year in real terms, although this growth rate will very gradually tend back towards growth in average earnings in the very long run. The private pension required to keep one out of pension credit entitlement grows at the same rapid rate. As a result, the proportion of average earnings that one must have from a private pension to avoid being on pension credit grows from 12.3% in 2003 to 26.9% in 2025. It is likely that an increasing proportion of the population will not have savings on this scale.

If we are prepared to assume steady demographics, steady patterns of pension coverage and a steady shape to the earnings distribution, we can move from this analysis to an estimate of the proportion of pensioners who will be entitled to pension credit at various points in the future. Where future estimates of these trends are available (as in the case of demographics, where we have a robust prediction that the number of pensioners will rise), they can be used to colour interpretation of our results. Where such estimates are not available, or not considered reliable, they should be seen as reducing the accuracy of our results.

Table 4. Effects of differential indexation of MIG and the basic state pension

	Pension credit guarantee	*Basic state pension*	*Gap*	*Rate of growth in gap*	*Private pension required to exhaust entitlement*	*Required private pension as a fraction of contemporary average earnings*
2003	£100	£77	£23		£58	12.3%
2004	£102	£77	£25	8.7%	£63	13.1%
2005	£104	£77	£27	8.2%	£68	13.9%
2006	£106	£77	£29	7.7%	£73	14.7%
2007	£108	£77	£31	7.3%	£78	15.5%
2008	£110	£77	£33	6.9%	£84	16.2%
2009	£113	£77	£36	6.6%	£89	16.9%
2010	£115	£77	£38	6.3%	£95	17.6%
2011	£117	£77	£40	6.1%	£100	18.4%
2012	£120	£77	£43	5.8%	£106	19.0%
2013	£122	£77	£45	5.6%	£112	19.7%
2014	£124	£77	£47	5.4%	£118	20.4%
2015	£127	£77	£50	5.3%	£125	21.0%
2016	£129	£77	£52	5.1%	£131	21.7%
2017	£132	£77	£55	4.9%	£137	22.3%
2018	£135	£77	£58	4.8%	£144	22.9%
2019	£137	£77	£60	4.7%	£151	23.5%
2020	£140	£77	£63	4.6%	£158	24.1%
2021	£143	£77	£66	4.4%	£165	24.7%
2022	£146	£77	£69	4.3%	£172	25.2%
2023	£149	£77	£72	4.2%	£179	25.8%
2024	£152	£77	£75	4.2%	£186	26.3%
2025	£155	£77	£78	4.1%	£194	26.9%

Notes: The government is going to relabel MIG as pension credit guarantee. All cash values are expressed in 2003 prices. Average weekly earnings for all persons was £409.20 in April 2000. Real earnings growth of 2% is assumed. Private pension income includes income from second-tier pensions such as the graduated pension, pensions from the State Earnings-Related Pension Scheme (SERPS) and the new state second pension (S2P).

We apply our (suitably indexed) tax and benefit model to the 1998–99 Family Resources Survey under the further assumption that all the incomes that pensioners receive from sources other than benefits rise in line with 2% real earnings growth. This crude assumption will approximate the actual outcome if pensioners' private incomes relate closely to their earnings over their working life and if demographics, patterns of pension coverage and the wage distribution are constant over time.

This methodology yields the following results:

- 52% of adults aged 65 or over would be (or have partners who would be) eligible for pension credit if it were introduced today.

- In 2025, this rises to 73%.

- By 2050, it rises again, to 82%.

The government's existing strategy, then, looks extremely likely to see a rapid increase in the proportion of pensioners on pension credit over the long term. Individuals who look forward to retirement and see that they are likely to be entitled to means-tested benefits face a less sharp incentive to save than individuals who will not receive means-tested benefits. For those expecting to be on means-tested benefits, the effects of benefit withdrawal mean that each pound of savings buys less net income in retirement than it otherwise would have done. Also, the increase in their expected retirement income decreases the urgency of their need to save.

The above figures ignore the introduction of the state second pension and, to that extent, overstate the number of families entitled to pension credit. Although it is unlikely that the state second pension will ever be sufficient on its own to keep a family off means-tested benefits, it might be sufficient if considered alongside private savings.[12]

Some families may find that they retire above the means-tested floor but subsequently become entitled to means-tested benefits as these increase in line with earnings during their retirement. This is due to the fact that much of an individual's retirement income, such as that from the basic state pension and state second pension, once they have reached the state pension age, will only increase in line with prices (as will the income from many private pension schemes). The future generosity of council tax benefit and housing benefit will also be important.

Another risk that will complicate saving decisions is that we cannot be sure that the current and future governments will maintain their current pension strategy. In the past, the pension system has been revised quite dramatically – for example, SERPS was introduced in 1978, was dramatically cut in 1986 and 1995 and has since been replaced with a different scheme.

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[12] For a discussion of the state second pension, see, for example, P. Agulnik, 'The proposed State Second Pension', *Fiscal Studies*, 1999, vol. 20, pp. 409–21 (a summary of which is available at www.ifs.org.uk/publications/fiscalstudies/fsabs20agul.shtml) or R. Disney, C. Emmerson and S. Tanner, *Partnership in Pensions: An Assessment*, Commentary no. 78, IFS, London, 1999 (an executive summary of which is available at www.ifs.org.uk/pensions/partnership.shtml).

Groups for whom benefits are most likely to reduce the attraction of saving

Essentially, people for whom means-tested benefits are most likely to reduce the incentive to save are those who either have a low capacity to save or have especially high entitlement to means-tested benefit. Both factors make it more unlikely that one's own saving will be sufficient to take one out of the means-tested system, and if one is in the benefit system, then withdrawal means that each extra pound of savings or pension income will cash-in at less than £1 of final income.

The following groups might seem especially likely to be affected on the grounds that they have limited capacity to save:

- Lifetime low earners, either due to persistent low pay or due to frequent periods of unemployment. Their low lifetime income reduces their capacity to save.

- Older workers with no existing pension rights or savings. They have a more limited time in which to accrue pension rights, making it less likely that these will be sufficient to take them off pension credit.

The following groups have especially high benefit entitlement, which means that a higher private income is needed to exhaust entitlement than in the standard case:

- Those disabled people who are entitled to an enhanced maximum level of pension credit.

- People receiving help with mortgage interest payments through income support who anticipate that in retirement their maximum pension credit payment will also include help for mortgage interest.

Interactions with other benefits also need to be considered. Saving is especially likely to give rise to significant benefit withdrawal for the following groups:

- Families who have high council tax liabilities, which increase the chance of their being eligible for council tax benefit in retirement. Its withdrawal is additional to that of pension credit and so reduces the net value of an extra pound of savings or private pension income.

- Families who are renters and anticipate that they may be entitled to housing benefit in retirement. Its withdrawal is additional to that of pension credit and so reduces the net value of an extra pound of savings or private pension income. If a family has very high rent, then housing benefit may be available even after pension credit entitlement has been exhausted.

- People with limited entitlement to the new state second pension – for example, those who have spent many years out of the labour market while caring for children aged over five; this will reduce their entitlement to the state second pension and therefore could increase their entitlement to means-tested benefits such as the pension credit.

After the pension credit reform, people whose anticipated pre-means-tested-benefit income in retirement is less than the basic state pension will continue to face pound-for-pound benefit withdrawal. Obviously, such people must have incomplete state pension entitlement. They form a small group which is likely to dwindle in number over time because of higher labour market participation rates among women and because of reforms that will increase the number of people acquiring full state pension rights.[13] Unless they are able to secure private pension income to take them over the level of the basic state pension, they will face benefit withdrawal of 100%, making it extremely unlikely that they will want to save at the margin.

6. Future possible reforms?

This Briefing Note has assumed that the current pension system remains in place, and that the government's aspirations of increasing both pension credit and the minimum income guarantee in line with earnings are both met. We have also assumed that the basic state pension only increases in line with prices. As shown in Section 5, this might well lead to increasing proportions of people being eligible for means-tested benefits in retirement.

Of course, we do not know that this will necessarily turn out to be the case. Government policies change over time, which is quite natural given that different governments are generally unable to bind their successors. SERPS provides recent examples of changes in pensions policy: it was only introduced in 1978, was cut dramatically in the Social Security Acts of 1986 and 1995 and has since been replaced by the state second pension.

While there is a degree of risk attached to the future generosity of the state pension systems, it should not be assumed that this political risk does not also apply to the value of any individual savings that are held privately. For example, the July 1997 Budget decision to abolish the payment of dividend tax credits to pension funds reduced the value of incomes arising from any given level of contributions to private pension funds. It is possible that a future government could decide to move further in this direction – for example, by

[13] These include the introduction of home responsibilities protection, which allows time spent out of the labour force looking after children to reduce the number of years of contributions required to qualify for a full basic state pension. In addition, the right of married women to opt out of the basic state pension, in return for paying a lower rate of National Insurance, was abolished in 1978.

reducing the generosity of the tax-free lump sum or making employers' pension contributions liable to National Insurance.

These political risks are extremely difficult to predict and hard for individuals to insure against. All 'experts' can do is to point out to individuals that past experience suggests that the current system may not last indefinitely. In fact, one lesson from the last 25 years might be that the UK is never that far from a major pension reform. For example, the government embarked on 'radical pension reform' in its December 1998 Green Paper. This did not stop the same government from announcing in its November 2000 Pre-Budget Report that it was planning to introduce further changes with the introduction of the pension credit.

These general points aside, one specific proposal that the government has made about future policy – the Saving Gateway – could well have implications for the way that lower-income people choose to save. The Gateway account will be a subsidised bank account in which targeted individuals can save (up to a limit) and receive matching contributions from the government. It is likely that the generosity of matching will dominate the tax relief available in an ordinary ISA or in a stakeholder pension.[14] An individual eligible for the Saving Gateway would therefore be better off saving in this account rather than in a pension or any other vehicle as long as they have not yet exceeded the contribution limit. Furthermore, individuals who anticipate that they will be eligible for the Saving Gateway but that they will not be able to afford to save the maximum allowable amount in the account might now want to start thinking about building a stock of liquid assets so that they can transfer this cash over to the Gateway account when it becomes available. The prospect of this policy, then, provides another potential incentive for those on lower incomes to save in a liquid form rather than in a stakeholder pension.

[14] For more on the range of possible returns that the Saving Gateway could offer, as well as a broad review of the issues, see C. Emmerson and M. Wakefield, *The Saving Gateway and the Child Trust Fund: Is Asset-Based Welfare 'Well Fair'?*, Commentary no. 85, IFS, London, 2001 (www.ifs.org.uk/pensions/abw.shtml).