Institute for Fiscal Studies

Characteristics of those directly affected by the 2014 Budget pension reforms

IFS Briefing Note BN147

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ISBN: 978-1-909463-40-0

[1] We are grateful to Paul Johnson, Jonathan Lipkin, Simon Sarkar, Ben Stafford, Maria Strudwick, and Sally West for providing comments on an earlier draft of this Briefing Note. We also gratefully acknowledge funding from the Economic and Social Research Council (ESRC) through the Centre for the Microeconomic Analysis of Public Policy at IFS (grant reference ES/H021221/1).

1. Overview

The 2014 Budget announced fundamental changes to private pensions in the UK, removing restrictions on how individuals could withdraw funds from their defined contribution (DC) pensions. Under the current rules, many people with a DC pension face strong incentives to use their accumulated pension to buy an annuity by the age of 75, or else face a 55% tax rate on the withdrawn income. From April 2015, such restrictions are now set to be removed, increasing flexibility for some individuals with DC pensions.

This Briefing Note summarises the characteristics of those who are most likely to be directly affected by these changes to the pensions system. We restrict our attention to those who might be affected in the immediate future, using survey data from the English Longitudinal Study of Ageing (ELSA).[2] The survey's rich mix of information on pensions, other types of wealth, demographics, other socio-economic characteristics and individuals' expectations allows us to estimate the proportion of people affected by the increase in flexibility. It also allows us to investigate the characteristics of those individuals most likely to be affected by the reforms, which should inform anyone trying to predict the short-term response to the policy changes.

Overall we find that those who will get more flexibility from the reforms are on average more highly educated, healthier, report a greater chance of living to older ages, are more likely to be owner-occupiers and have higher overall wealth than those who will be unaffected. These characteristics suggest that they might be relatively well-placed to receive, and to act appropriately upon, information, guidance and advice that they are given over how to manage their own finances. However, the fact that they are in

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[2] The ELSA data were made available through the UK Data Archive (UKDA). ELSA was developed by a team of researchers based at the NatCen Social Research, University College London and the Institute for Fiscal Studies. The data were collected by NatCen Social Research. The funding is provided by the National Institute of Aging in the United States, and a consortium of UK government departments co-ordinated by the Office for National Statistics. The developers and funders of ELSA and the Archive do not bear any responsibility for the analyses or interpretations presented here. Marmot, M. et al., English Longitudinal Study of Ageing: Waves 0-5, 1998-2011 [computer file]. 20th Edition. Colchester, Essex: UK Data Archive [distributor], October 2013. SN: 5050.

relatively good health and expect to have a greater than average chance of living to older ages may complicate their retirement planning and potentially increase the costs of making an inappropriate decision.

A wider discussion of the potential implications of extending flexibility over the withdrawal of DC pension funds and what light the evidence presented in this Briefing Note can shed on these issues is provided in a presentation by Carl Emmerson.[3]

2. Data and methodology

Data source

We use ELSA, a biennial survey covering a representative sample of the English household population aged 50 and over. The survey follows the same people over time, and includes information on both eligible individuals and their partners to get an impression of overall family circumstances. The most recent round of interviews was conducted in 2012. However, sufficiently detailed calculations of pension wealth have not yet been done for this wave of the data; therefore, in this Briefing Note we use data from the 2010 wave of interviews.

In the survey individuals are asked about their wealth portfolios in great detail, including private pensions, financial assets, housing wealth and debts. They are also asked detailed questions about their income, work behaviour, health, and expectations of the future, among other things. The remainder of this section describes the construction of the variables used in the remainder of this Briefing Note.

Wealth

Pension wealth

Broadly speaking, there are two different types of private pension wealth: defined benefit and defined contribution. In defined benefit pensions, the pension income that will be received is a function of some measure of salary, the number of years of membership of the scheme and an accrual fraction, while in defined contribution pensions contributions are paid into

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[3] Emmerson, C. (May 2014), "Your flexible friend? DC pensions post Budget 2014", presentation at a Strategic Society Centre event, http://www.ifs.org.uk/publications/7207.

a fund, which will earn some investment return and then (in most cases, under current legislation) be used at retirement to buy an annuity.

Individuals may contribute to multiple pension schemes over their lifetimes, resulting potentially in a portfolio of multiple DC pension 'pots' and/or claims to pensions from DB schemes. Unlike administrative data held by pension providers, household surveys will not be able to capture perfectly the precise current value of pension entitlements; some respondents will not remember or perhaps even never knew the relevant information for calculating their pension value. However, responses to questions asked in ELSA can be used to estimate the pension wealth of individuals, and household survey data has two distinct advantages over administrative data from pension providers. First, we observe all pensions (and other forms of wealth) held by each individual – rather than having a very accurate measure of only one aspect of an individual's portfolio. Second, we observe a range of other characteristics of individuals and their partners, which is not available from data held by pension providers. Most obviously we are able to add to together the pension, and other wealth, holdings of both members of a couple.

ELSA asks a detailed set of questions about pension entitlements that can be used, together with some assumptions, to estimate the value of individuals' pension wealth.[4] It is important for our analysis to note that in some cases our assumptions may overstate the value of defined contribution pension wealth, which will tend to increase the fraction of people we estimate would be directly affected by the increased flexibility. Our estimates of the proportion affected may therefore be seen as an upper bound. On the other hand, this form of bias will tend to lead to an *understatement* of the estimated differences between the characteristics of those affected and those unaffected – these differences are, therefore, likely to be a lower bound.

We describe pension wealth in two different contexts in this Briefing Note. The first is when we summarise total non-annuitised DC pot sizes, where the values presented can be compared directly to the legislative limits on DC 'trivial' pot sizes under the pre-reform system.

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[4] For more information on the assumptions made, see Crawford, R. (2012), "ELSA Pension Wealth Derived Variables (Waves 2 to 5): Methodology", http://www.esds.ac.uk/doc/5050/mrdoc/pdf/5050_ELSA_PW_methodology.pdf.

Separately, we describe total wealth holdings of individuals, including the value of their private pensions. In this context, in order to value DB and DC pension wealth on a comparable basis, the measure of pension wealth we use is the present discounted value of the future pension income expected from each scheme. For un-annuitised DC pensions this essentially entails adjusting DC pension pot sizes by a factor that takes into account annuity prices. For annuitised DC pensions, DB pensions and state pensions we value the future stream of pension income using an annual real discount rate of 2.5%.

Other forms of wealth

Other forms of wealth include self-reported owner-occupied housing wealth (net of any outstanding mortgage), wealth held in financial assets (net of any other debts), and other physical wealth (including second homes, business assets, antiques and jewellery). These other forms of wealth are often difficult to allocate to an individual within a couple, as most couples manage their finances and hold assets jointly. Therefore, throughout this Briefing Note we describe total wealth at the level of the benefit unit, where a benefit unit is a single individual or a married or cohabiting couple, as appropriate.

In this Briefing Note all wealth and income figures are expressed in 2010 prices.

Other characteristics

We report the distribution of education, health and work status for those affected and unaffected by the pension reforms. Someone is defined as having 'low education' if they left school at the compulsory school leaving age or earlier (age 15 for the sample we use here), 'medium' education if they left school after the compulsory school leaving age but before age 19, and 'high' if they left at age 19 or later.

Self-reported health is given as the answer to the question, 'would you say your health is excellent, very good, good, fair, or poor?'

Work status is based on individuals' reported behaviour the last month. Respondents are classified as being in paid work if they report having done some work for pay in the last month or that they were temporarily away from or waiting to take up paid work.

Defining who is potentially affected by the reforms

The 2014 Budget effectively removed all restrictions on individuals wanting to withdraw their defined contribution pension as a lump-sum once they reach the age of 55. Prior to the reforms, many individuals were strongly incentivised to annuitise their DC pension pots by the age of 75 as otherwise they faced a 55% tax on withdrawals. Using the fund to purchase an annuity instead allowed the individual to take a quarter of it as a tax-free lump-sum, with the annuity income taxed at the individual's marginal income tax rate.

However, there were some exceptions to the 55% tax rate. Some groups – notably those with very low DC pension wealth or those with very high pension income from other sources – already had full flexibility over how they used their DC pension pots.

Those unaffected by the 2014 Budget reforms can therefore be broadly split into three categories. First, those with no DC pension at all, who will remain unaffected by any DC pension flexibility, or lack thereof. Second, those over the age of 60 with sufficiently low levels of DC pension wealth had full flexibility even prior to the reforms. 'Sufficiently low' was defined as having up to three pension pots with no more than £2,000 in each, or having total pension rights (DB and DC) worth £18,000 or less.

The third group who had full flexibility prior to the reforms consists of those who could prove that they had at least £20,000 a year of 'secure income'. This group are already able to use what is known as "flexible drawdown". In this Briefing Note, we identify as "unaffected" those who we estimate will have at least £20,000 of secure income from DB pensions, the state pension and any DC pensions that have already been annuitised. There will also be some other individuals who would need to annuitise only some of their remaining DC wealth to qualify for flexible drawdown. However, we still classify this group as being "affected" since they will now have the flexibility not to annuitise any of their DC funds.

We classify everyone who does not fall into one of the above groups as being potentially affected by the reforms. These people will therefore have some DC pension, over the minimum 'trivial' threshold, but not enough annuitised, DB and state pension income to give them more than £20,000 a year of 'secure income'.

Our sample of interest

We restrict our attention below to those who might be affected in the short-run, only considering those who were between the ages of 55 and 74 in 2010. In much of the analysis we further restrict our attention only to those aged between 55 and 59. This age group should have done most of their pension accumulation, but few will yet have made the annuitisation decision.

In the long-term, as automatic enrolment brings more people into workplace pensions and the overall pensions landscape (at least among private sector employers) shifts further away from DB and towards DC, the number and characteristics of those affected by the reform is likely to be very different. Our analysis does not attempt to capture these long-run effects.

Throughout this Briefing Note we exclude from our sample those individuals who did not provide responses to questions about the key covariates of interest, specifically: education, self-reported health and work status. As a result we drop 105 individuals from our sample of those aged 55–59.

3. Tables and figures

Table 3.1. How many people might be affected by greater flexibility?

	Age band		
	55–59	**60–74**	**55–74**
All individuals (N)	2,015	5,215	7,230
% with no DC pension	59.5%	88.7%	79.1%
% with small pots only	8.5%	1.8%	4.0%
% with >£20,000 secure income	1.7%	1.3%	1.4%
% other	30.3%	8.3%	15.5%
	100%	100%	100%
All men (N)	899	2469	3368
% with no DC pension	51.2%	82.3%	72.0%
% with small pots only	6.5%	2.2%	3.6%
% with >£20,000 secure income	2.9%	2.4%	2.6%
% other	39.4%	13.1%	21.8%
	100%	100%	100%
All women (N)	1,116	2,746	3,862
% with no DC pension	67.5%	94.6%	85.8%
% with small pots only	10.4%	1.4%	4.3%
% with >£20,000 secure income	0.6%	0.2%	0.3%
% other	21.5%	3.8%	9.5%
	100%	100%	100%
Single men (N)	147	449	596
% with no DC pension	60.6%	86.3%	78.3%
% with small pots only	6.2%	1.3%	2.8%
% with >£20,000 secure income	1.2%	1.5%	1.4%
% other	32.1%	10.9%	17.5%
	100%	100%	100%
Single women (N)	262	846	1108
% with no DC pension	73.0%	96.4%	89.5%
% with small pots only	8.6%	0.8%	3.1%
% with >£20,000 secure income	0.9%	0.4%	0.6%
% other	17.4%	2.4%	6.8%
	100%	100%	100%

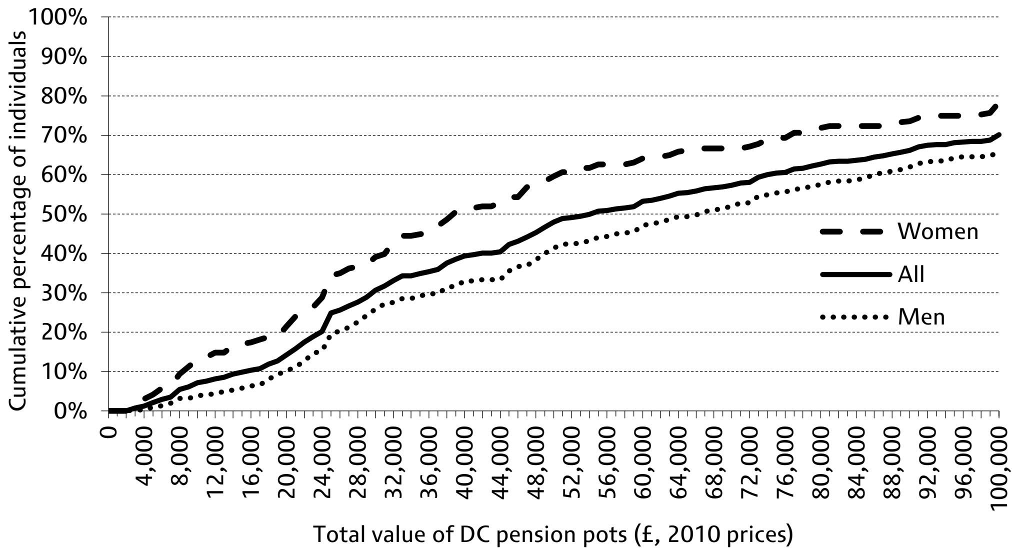
Notes: All figures are weighted.
Source: English Longitudinal Study of Ageing, Wave 5 (2010).

Table 3.1. How many people might be affected by greater flexibility? (cont.)

	Age band		
	55–59	**60–74**	**55–74**
Men in couples (N)	752	2,022	2,774
% with no DC pension	49.0%	81.2%	70.4%
% with small pots only	6.5%	2.4%	3.8%
% with >£20,000 secure income	3.3%	2.7%	2.9%
% other	41.1%	13.7%	22.9%
	100%	100%	100%
Women in couples (N)	855	1,902	2,757
% with no DC pension	65.5%	93.8%	84.4%
% with small pots only	11.0%	1.7%	4.8%
% with >£20,000 secure income	0.5%	0.1%	0.2%
% other	22.9%	4.3%	10.6%
	100%	100%	100%

Notes: All figures are weighted.
Source: Authors' calculations using English Longitudinal Study of Ageing, Wave 5 (2010).

Figure 3.1. Distribution of total DC pension wealth, excluding small pots, among those who might get greater flexibility



Notes: DC pension wealth is defined here as the total value of non-annuitised DC pension pots, excluding up to three 'small' pots (where small is defined as containing no more than £2,000). This is shown only for those who are likely to get more flexibility following the reforms, i.e. excluding those with up to three pots of £2,000 or less each, and those with more than £20,000 of 'secure income'. All figures are weighted. Sample size = 594.
Source: Authors' calculations using English Longitudinal Study of Ageing, Wave 5 (2010–11).

Table 3.2. Characteristics of those aged 55 to 59 who might get greater flexibility

		Would not get greater flexibility	Might get greater flexibility	All
Male		42.7%	63.9%	49.1%
Female		57.3%	36.1%	50.9%
		100%	100%	100%
Single		24.7%	17.3%	22.5%
Couple		75.3%	82.7%	77.5%
		100%	100%	100%
Education				
	Low	34.0%	25.3%	31.4%
	Medium	42.7%	47.4%	44.2%
	High	23.2%	27.3%	24.5%
		100%	100%	100%
Self-reported health				
	Excellent	14.2%	19.0%	15.7%
	Very good	32.2%	38.9%	34.3%
	Good	27.9%	28.4%	28.1%
	Fair	15.6%	10.1%	13.9%
	Poor	10.0%	3.6%	8.0%
		100%	100%	100%
Work status*				
	Not in paid work	31.5%	14.7%	26.4%
	In paid work	68.5%	85.3%	73.6%
		100%	100%	100%
Tenure				
	Owner	78.5%	89.5%	81.9%
	Rents	20.5%	9.6%	17.2%
	Other	1.0%	0.9%	0.9%
		100%	100%	100%

* The version of this Briefing Note published originally had these rows mislabelled, as the 'in paid work' and 'not in paid work' categories were the wrong way round. This table contains the corrected version.

Notes: All figures are weighted. Sample size = 2,015.

Source: Authors' calculations using English Longitudinal Study of Ageing, Wave 5 (2010–11).

Table 3.3. Characteristics of those aged 55 to 59 who might get greater flexibility, split by whether their DC wealth is below or above average

		DC wealth below the median	DC wealth above the median
Male		55.8%	72.6%
Female		44.2%	27.4%
		100%	100%
Single		16.7%	18.0%
Couple		83.3%	82.0%
		100%	100%
Education			
	Low	30.0%	20.2%
	Medium	48.8%	45.9%
	High	21.2%	34.0%
		100%	100%
Self-reported health			
	Excellent	14.3%	24.0%
	Very good	37.7%	40.2%
	Good	31.9%	24.7%
	Fair	12.6%	7.4%
	Poor	3.4%	3.7%
		100%	100%
Work status*			
	Not in paid work	15.7%	13.5%
	In paid work	84.3%	86.5%
		100%	100%
Tenure			
	Owner	87.8%	91.4%
	Rents	11.9%	7.1%
	Other	0.3%	1.5%
		100%	100%

* The version of this Briefing Note originally published had these rows mislabelled, as the 'in paid work' and 'not in paid work' categories were the wrong way round. This table contains the corrected version.
Note: Median DC wealth is defined among those who are likely to get more flexibility following the reforms (see notes to Figure 3.1). All figures are weighted. Sample size = 594.
Source: Authors' calculations using English Longitudinal Study of Ageing, Wave 5 (2010–11).

Table 3.4. Expectations of survival to age 75 (those aged 55 to 59 only)

% chance of surviving	**Self-report**	**Official estimates***
Men and women		
No more flexibility	66.5	80.6
More flexibility	69.2	78.9
All	67.3	80.1
Men		
No more flexibility	65.9	76.2
More flexibility	67.2	76.1
All	66.4	76.2
Women		
No more flexibility	66.9	83.8
More flexibility	72.7	83.8
All	68.2	83.8

* 'Official estimates' show the probability of surviving to age 75 calculated from Office for National Statistics 2010–2012 based life tables for England. These figures are indicative of the average survival probability for all individuals of a particular age and sex and are not necessarily the average that would apply to the subgroups shown here (i.e. those likely to get or not get greater flexibility).
Note: Figures reported are the mean response to the question: "what are the chances that you will live to be 75 or more?". 113 individuals who did not respond to this question are excluded from the sample. All figures are weighted. Sample size = 2,002.
Source: Authors' calculations using English Longitudinal Study of Ageing, Wave 5 (2010–11).

Table 3.5. Expectations of survival to age 85 (those aged 55 to 59 only)

% chance of surviving	Self-report	Official estimates
Men and women		
No more flexibility	51.3	49.7
More flexibility	53.5	46.9
All	52.0	48.8
Men		
No more flexibility	48.4	42.2
More flexibility	50.7	42.2
All	49.3	42.2
Women		
No more flexibility	53.5	55.2
More flexibility	58.5	55.2
All	54.6	55.2

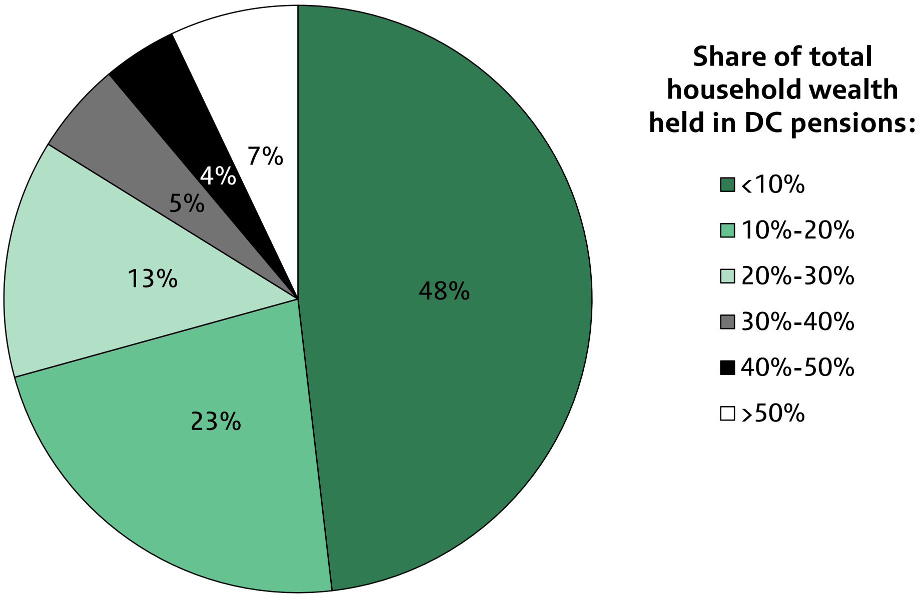
* 'Official estimates' show the probability of surviving to age 85 calculated from Office for National Statistics 2010–2012 based life tables for England. These figures are indicative of the average survival probability for all individuals of a particular age and sex and are not necessarily the average that would apply to the subgroups shown here (i.e. those likely to get or not get greater flexibility).
Note: Figures reported are the mean response to the question: "what are the chances that you will live to be 85 or more?". 114 individuals who did not respond to this question are excluded from the sample. All figures are weighted. Sample size = 2,001.
Source: Authors' calculations using English Longitudinal Study of Ageing, Wave 5 (2010–11).

Table 3.6. Average wealth among those aged 55 to 59 who might get greater flexibility

Time period	Would not get more flexibility	Might get greater flexibility	All
Mean total wealth (£)	742,900	917,300	795,500
of which:			
State pension wealth	194,600	201,000	196,500
Housing wealth	182,600	240,100	200,000
Private pension wealth	244,300	289,700	257,900
of which:			
DB wealth	141,500	82,900	123,800
DC wealth	30,500	181,400	76,000
Net financial wealth	74,100	82,200	76,500
Net physical wealth	48,700	103,100	65,100
Median total wealth (£)	549,500	676,100	582,600
Quintile of the distribution of total wealth (%)			
Least wealthy	25.0	8.4	20.0
2	18.9	22.5	20.0
3	19.6	20.8	20.0
4	18.8	23.1	20.0
Wealthiest	17.7	25.1	20.0

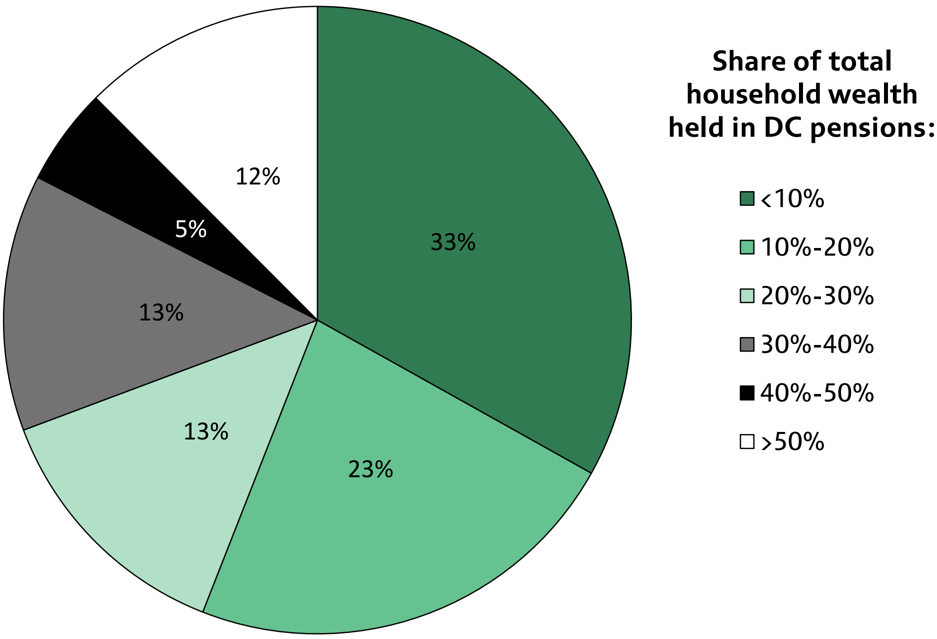
Note: Wealth figures are rounded to the nearest £100. Wealth quintiles are defined by ranking individuals on the basis of the total wealth of their benefit unit. All figures are weighted. Sample size = 2,015.
Source: Authors' calculations using English Longitudinal Study of Ageing, Wave 5 (2010–11).

Figure 3.2. Importance of DC wealth in households' portfolios, among those who might get more flexibility (those aged 55 to 59 only)



Note: All figures are weighted. Sample size = 594.
Source: Authors' calculations using English Longitudinal Study of Ageing, Wave 5 (2010–11).

Figure 3.3. Importance of DC wealth in households' non-housing wealth portfolios, among those who might get more flexibility (those aged 55 to 59 only)



Note: All figures are weighted. Sample size = 594.
Source: Authors' calculations using English Longitudinal Study of Ageing, Wave 5 (2010–11).

Table 3.7. Relative importance of DB and DC pensions within households' total private pension wealth (those aged 55 to 59 only)

%	Would not get more flexibility	Might get greater flexibility	All
No DB or DC pension wealth	41.2	0.0	28.8
Only DB pension wealth	31.6	0.0	22.0
Only DC pension wealth	17.0	56.8	29.0
More DC wealth than DB wealth	2.4	17.3	6.9
More DB wealth than DC wealth	7.9	25.9	13.3
	100	100	100

Note: All figures are weighted. Sample size = 2,015.
Source: Authors' calculations using English Longitudinal Study of Ageing, Wave 5 (2010–11).