PENSIONS POLICY INSTITUTE

PPI

Towards more effective savings incentives: a report of PPI modelling for AEGON

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A Technical Report by
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Executive summary

During 2010 AEGON has undertaken new research looking at the potential impact of saving incentives on the overall levels of pension saving, on the number of savers and the overall impact on Government expenditure, households, and the long-term pension and saving industry.

There were three stages to this research:

- An external stakeholder consultation exercise to help identify, scope and explore a set of coherent alternative scenarios for savings incentives that could be adopted by the Government;
- A consumer research project to help understand current savings behaviour, the consumer responses to policy changes and the possible behavioural changes that the policy scenarios could stimulate;
- A project to model the financial impact of these alternative scenarios and potential behavioural changes in the short and longer term on Government expenditure, household finances and the long-term pension and saving industry.

The PPI has been commissioned by AEGON to undertake the third part of this research project, to provide economic modelling to assess the potential impact of alternative policy scenarios on saving incentives. This has involved modelling the financial impact of a range of potential policy reform scenarios, and the impact of possible behavioural changes associated with those reforms.

The PPI models were initially used to model the financial implications of three different policy scenarios put forward by AEGON after the consultation and consumer research phases:

- A "central" scenario to act as a baseline to the research. This includes all settled policy, including some aspects that are not yet implemented. This includes auto-enrolment and compulsory employer contributions, the planned CPI indexation of S2P from April 2011, the Coalition's Budget announcement that BSP would be "triple locked" to rise in line with the highest of prices, earnings, or 2.5% from April 2011, and the planned increase in State Pension Age to 66 for both men and women from 2020.
- A "radical" scenario that moves all long term saving from an EET to a TEE[3] basis, incorporates the idea of tax-free annuities purchased from ISA funds, and allows early access to accumulating pension funds up to a sum equal to all employee contributions. In the first year after introduction, a retrospective tax of existing pension assets is levied, and all future payments of pensions are tax-free. It also incorporates a radical State

[3] Pensions and long term saving taxation is often described according to whether the contributions going into saving are taxed (T) or exempt (E), whether the funds rolling up are T or E and whether the proceeds of saving are T or E. So, pensions are broadly EET, and ISAs are TEE.

pension reform of a single-tier state pension of £140 per week,[4] increased in line with the triple lock, introduced for all existing and future pensioners in 2015, with entitlement on a near-universal basis (based on the current qualification criteria for the Basic State Pension).
- An “alternative” scenario that keeps the tax framework for pensions and other long term saving products such as ISAs separate but moves to a single 30% rate of contribution tax relief for pensions.[5] This scenario also includes a pension income disregard of £12 per week in Pensions Credit, and allows early access via a single withdrawal of up to 25% of the fund.

PPI projections of the central scenario for the UK pension system suggest that:
- Spending on state pensions is projected to increase substantially from under 5% of GDP in 2010 to 7.3% of GDP by 2055.
- The introduction of auto-enrolment will significantly increase the number of individuals saving in a pension from 14 million in 2012 to around 22 million by 2015.
- Auto-enrolment will also lead to a step change increase in pension contributions, although not as large as the increase in the number of pension savers, from around £80bn (2010 earnings terms) in 2012 to £90bn in 2015.
- The stock of pension funds (including the ‘notional’ assets of unfunded pension schemes) falls over time, mainly as a result of the assumed continued switch in employer pension provision from Defined Benefit to Defined Contribution.

PPI projections of the radical scenario for the UK pension system suggest that:
- Under the radical scenario, spending on state pensions would increase significantly compared to the central scenario, rising from under 5% in 2010 to 8.5% of GDP by 2055. This compares to spending on state pensions in the central scenario increasing to 7.3% by 2055.
- As a result of the tax system for private pensions moving from EET to TEE, contributions to private pensions fall in the radical scenario to £60bn in 2015, compared to contributions of over £85bn in the central scenario.
- The switch to TEE also means that the annual cost of tax relief[6] is much lower in the radical scenario, less than £5bn in 2015, compared to £15bn in 2015 in the current scenario.
- The fall in the amount being paid into pensions in the radical scenario also means that there is a fall in the stock of pension funds, partly as a

[4] Similar to the Foundation Pension proposed by the NAPF, see NAPF (2010) and PPI (2010). This option assumes, as in the NAPF work, that only those whose entitlement under the current system is less than the new single level would be topped up to this level, and that contracted-out pensions are counted as part of the state pension.
[5] The current system links pensions tax relief to people’s marginal rate of income tax. 30% was chosen for this single rate scenario because that had been put forward by Aviva and others, and because HMRC have indicated that 30% compared to the marginal rate approach was broadly cost-neutral to the Exchequer (see Hansard 17 Nov 2005 : Column WA169, Lord Oakeshott of Seagrove Bay).
[6] That is, in the EET the annual cost of relief given on contributions made in that year, relief on investment returns made in that year and net of the tax paid in pension contributions in that year. In the TEE system, with no relief on contributions and no tax paid on pensions, this is relief on investment returns.

result of an assumed one-off tax charge on existing pension funds, which would then allow for all future pension payments to be made free of tax, and partly as a result of no tax relief on pension contributions being paid into pension funds. In 2015, this tax charge would result in the stock of pension funds falling to under £1.6 trillion (2010 earnings terms) compared to almost £1.9 trillion in the central scenario.
- The stock of pension funds continues to decline in the radical scenario, falling to less than £1.2 trillion by 2055 compared to £1.7 trillion in 2055 in the central scenario. However, this fall in pension funds does not necessarily have a detrimental impact on retirement incomes, as the pensions derived from the pension funds are paid free of tax in the radical scenario.

PPI projections of the alternative scenario for the UK pension system suggest that:
- The alternative scenario has little impact on spending on state pensions, adding an additional 0.1% of GDP to spending on state pensions in 2055 compared to the central scenario as a result of the introduction of the pension income disregard in Pension Credit.
- In the alternative policy scenario, there is no change to the aggregate level of pension contributions or to the stock of pension funds. This is because the change in tax relief to a single rate of 30% is specifically designed to be cost neutral, and no behaviour change is allowed for (so for example no individuals are assumed to start or stop making contributions as a result of the tax relief changes, or assumed to make any early access withdrawals).
- However, the introduction of a single tax rate of 30% on pension saving would be less generous than the central scenario for higher rate taxpayers and more generous for basic rate taxpayers. In reality there would almost certainly be a behavioural response to a policy change of this type. Later chapters in this report explore the potential impact of some possible behavioural responses.

While the consumer research can tell us about the possible direction of changes in savings behaviour – if there might be more or less saving among certain groups as a result of the introduction of a particular policy – the results should be interpreted with caution. The sample size of the research was small and was not fully representative of the population as a whole.

Some simplifications have had to be made when setting behavioural assumptions. Some of the policy scenarios elicited different reactions from different groups. For example, the move to a single rate of tax relief had some support among basic rate taxpayers, but was not liked by some (but not all) higher rate taxpayers. In situations such as this we have combined the different group responses into an aggregated response to give an overall indication of the possible high level outcome. This may mean that some differential impacts – for example the proportion of savers or amount saved from basic rate and higher rate taxpayers – are not explored in this analysis.

However, the findings of the consumer research have been used to construct some plausible, but still illustrative, assumed behavioural responses to policy changes, that are broadly consistent with the consumer research findings. The behavioural changes made in the model reflect possible changes in the numbers of people saving, the average pension contribution and levels of early access. PPI projections using these behavioural assumptions suggest that:

- The number of pension savers in the radical scenario could be 1 million higher or 1 million lower than in the central scenario, depending on the way in which behaviour changes in response to the change of policy.
- Pension contributions and the stock of pension funds increase in the radical behavioural scenarios modelled compared to the radical scenario assuming no behaviour change, but are still significantly lower than they are in the central scenario. Although the fall in contributions and the lower stock of pension funds may be important to the pensions industry (feeding through into lower funds under management), it does not necessarily have a detrimental impact on retirement income as the pensions derived from the smaller contributions and funds under management are paid free of tax.
- Both sets of behavioural assumptions used in the alternative scenario are positive, and lead to an increase in the numbers of people saving, the amount contributed to pensions and the stock of pension funds compared to the central scenario. However, the impacts of the behavioural change are relatively small.
- The alternative scenario behavioural assumptions have little impact on the overall costs to the exchequer, relative to the differences found between the central, radical and alternative scenarios before any behaviour change is allowed for.

Although aggregate analysis can give an indication of the impact of policy reforms and behavioural changes on Government spending and the pensions industry, it does not tell us much about the impact of the reforms on individuals and retirement incomes.

Using a small number of hypothetical individuals, PPI modelling suggests that in the central scenario:

- None of the individuals modelled achieve an adequate income in retirement, based on analysis of net replacement rates. However, this analysis only considers pension income, and individuals may have other income or assets that could be used in retirement, such as housing wealth or other savings.
- The low and median earning individuals receive the majority of their pension income from the state in the central scenario.
- The high earning man however, with higher pension contributions than the other examples and much higher earnings, gets the majority of his pension income from private pensions even though he does not meet his

adequacy target. But even the high earner, if he lives long enough, could see almost half of his annual pension income being provided by the state.

In the radical scenario, with a single-tier state pension of £140 a week increased in line with the 'triple lock', a single TEE tax regime for pensions and ISAs and allowing early access to pension saving:

- The low earner, median earner and high earner all receive higher retirement incomes under the radical scenario than in the central scenario.
- Incomes do not fall as much during retirement as in the central scenario or the alternative scenario, as a result of the £140 a week single state pension being increased by the 'triple lock'.

In the alternative scenario, based on current policy with the introduction of a pension income disregard in Pension Credit, a single rate of tax relief on pension contributions of 30% and allowing early access to pension saving:

- The low earner and median earner also have higher retirement income than in the central scenario.
- But the high earner has a lower income than in the central scenario as a result of the restriction of tax relief to 30%.

Even after reform scenarios are introduced, adequacy of pension income remains an issue. For a median earning woman,

- In all scenarios, and using the behavioural responses, retirement income is still lower than the replacement rate suggested by the Pensions Commission as an adequate retirement income.[7]
- Increasing contributions under the central scenario gets her closer to her desired replacement rate, but still does not achieve it.
- However, this analysis only considers pension income, and individuals may have other income or assets that could be used in retirement, such as housing wealth or other savings.

[7] Pensions Commission (2005). For a full discussion of adequacy measures see PPI (2009)