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Increasing the value of saving in Personal Accounts:

rewarding modest amounts of pension saving

A PPI paper commissioned by B&CE

Increasing the value of saving in Personal Accounts: rewarding modest amounts of pension saving

A Discussion Paper on work in progress by
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Published by the Pensions Policy Institute

ISBN 978-1-906284-03-9
www.pensionspolicyinstitute.org.uk

This research has been commissioned by B&CE Benefit Schemes. The PPI is grateful for their support.

This paper is intended as a contribution to the policy debate on Personal Accounts. It should not be relied on by individuals or their advisors as the basis for financial decisions.

Introduction

The Government has proposed a series of reforms to private pensions in the UK. These include auto enrolling most employees into a work-based pension scheme from 2012. Although individuals would have the right to opt out, the Government will introduce compulsory employer contributions for those who remain opted in. Individuals could be auto enrolled into an existing pension scheme, provided it meets certain criteria, or into a new national system of Personal Accounts.

There is a broad degree of consensus for the principle of auto enrolment, as a way of overcoming inertia and increasing the number of people saving for their retirement. However, some stakeholders have expressed concern that some employees might be auto enrolled into a product that might not be suitable for them. Personal Accounts might not be considered suitable for an individual because of significant amounts of debt or the pension contributions being unaffordable, for instance, or it might be that individuals are likely to receive a low return on their saving as a result of the interaction with means-tested benefits in retirement.

Several policy options have been discussed as ways of reducing the risk that employees are auto enrolled into saving when it is not suitable:
1. Provide generic advice and information to help individuals make the right decision about whether to stay in or opt out of pension saving.
2. Not auto enrol some groups of people who are more likely to be at risk of low returns, such as low earners and today's older people.
3. Increase the trivial commutation limit to allow more individuals to take small amounts of pension saving as a lump sum.
4. Allow individuals to have a limited amount of pension income, without it affecting their entitlement to means-tested benefits. This option is often referred to as a pension income disregard, because a limited amount of saving is disregarded for the purposes of calculating entitlement to means-tested benefits.

This paper is an initial, independent assessment of a pension income disregard, commissioned by B&CE Benefit Schemes. The structure of the paper is:
- Chapter 1 gives some background to a pension income disregard and sets out the possible advantages and disadvantages.
- Chapter 2 analyses the implications of one version of the disregard for examples of individuals in terms of their returns from saving.
- Chapter 3 presents initial projections of the costs of this version of the disregard and its impact on the numbers entitled to Pension Credit.
- Chapter 4 sets out the design choices for the disregard more generally.

This is a scoping paper, which aims to identify the broad advantages and disadvantages of a pension income disregard. If it were decided that the disregard should be taken forward, further analysis would be needed to understand all the implications. Chapter 5 discusses possible next steps.

Summary of conclusions

The Government is proposing to auto enrol most employees into saving in a pension from 2012. Although the principle of auto enrolment has been broadly supported, some stakeholders have expressed concerns about the suitability of pension saving for some employees who will be auto enrolled.

B&CE Benefit Schemes has commissioned the Pensions Policy Institute to provide an independent assessment of one option for increasing the suitability of pension saving: the introduction of a 'pension income disregard'. This would allow individuals to have a limited amount of private pension income, without it affecting their entitlement to means-tested benefits in retirement. There was a pension income disregard in National Assistance when it was introduced in 1948, and it remained until 1980, so it is not an entirely new idea.

A pension income disregard could remove a discrepancy between the treatment of private pension saving and other forms of saving. Currently, the first £6,000 of 'capital' (such as saving in a bank account or ISA) is disregarded in the calculation of entitlement to means-tested benefits. In contrast, currently, all private pension income is taken into account.

This paper analyses a pension income disregard set at £12 a week. This would mean that a single person could have at least £6,000 in pension saving before it begins to reduce their entitlement to means-tested benefits. A pension income disregard set at this level would therefore be at least as generous as the existing disregard for saving in a bank account or ISA. However, there are choices for how a pension income disregard would work in practice. As well as the level of the disregard, there are options for how it interacts with Savings Credit and the existing disregard for capital, how it is uprated and its treatment of any income that results from contracting-out of the State Second Pension.

Returns from saving in Personal Accounts

People will have different returns from saving in Personal Accounts, depending on how they are affected by the state pension, tax and means-tested benefit systems. Some people might have relatively high returns, such as people in their twenties in 2012 with full working and saving histories, or older people if they already have some retirement saving.

It is not possible to say whether a given level of return is 'good enough' to make saving in Personal Accounts a suitable choice for any particular individual. This is because other factors could be relevant, such as the affordability of pension contributions, the extent of personal debt and individuals' preferences for smoothing consumption over the lifetime. However, some people could receive lower returns from their saving than others, and so be at higher risk of Personal Accounts being unsuitable.

The pension income disregard could increase the returns for people who would otherwise be at risk of lower returns, including:

- People with low earnings and broken working histories.
- Today's older people with low earnings and no prior savings.
- The self-employed.
- People who rent accommodation in retirement.

People who plan to rent accommodation in retirement could be at high risk of Personal Accounts being unsuitable for them, meaning that they might not receive back at least the value of their own contributions. This is because they could see significant reductions in their entitlements to Housing Benefit as a consequence of saving. Currently, around 20% of pensioner households are eligible for Housing Benefit. This level could reduce in future, if the number of pensioners who own their own homes continues to increase, although long-term trends are uncertain.

None of the individuals analysed would be in the high-risk group if the pension income disregard were introduced, meaning they are all likely to receive back at least the value of their own contributions. This could mean that generic advice can be clearer about the value of pension saving.

Government expenditure
A pension income disregard set at £12 a week could increase Government expenditure on means-tested benefits for pensioners by around £600m in 2012, from a projected £14.6bn without reform to £15.2bn with the pension income disregard, an increase of 4%.

Preliminary analysis suggests that the costs could remain relatively stable over the long term, relative to average earnings. If the policy enabled a clear message to be given about the value of saving in a pension, and the amount of pension saving increased as a result, this might tend to reduce Government expenditure on means-tested benefits in the long term.

The reforms could be paid for by increasing taxation, diverting state spending from other areas, or by making other changes to means-tested benefits. The reforms would not remove the need for Savings Credit altogether but could reduce the amount that Savings Credit needs to do to incentivise pension saving. One option for paying for the reforms is to make Savings Credit less generous by increasing its withdrawal taper from the current 40%. This option, however, would need to be analysed carefully in terms of the winners and losers relative to the current system.

The disregard could also increase the proportion of pensioners eligible for Pension Credit in 2012 by less than 5% from its projected level without reform of around 45%. A series of trade-offs therefore have to be made, including a trade-off between improving the suitability of pension saving and cost. The design of the disregard would affect its cost and benefits, so more research would be needed if the reform were to be taken forward.

Chapter 1: A pension income disregard

Although the principle of auto enrolment has been broadly supported, it raises questions about the suitability of pension saving for the employees who are auto enrolled. Stakeholders have identified several possible policy responses to this potential problem, including the introduction of a pension income disregard.

A disregard would mean that the first part of an individual's private pension income would not affect his or her entitlement to means-tested benefits. The concept dates back to the foundation of modern Social Security in 1948 and was Government policy until 1980.

This chapter gives some background to a pension income disregard and sets out the possible advantages and disadvantages of the approach.

Personal Accounts and concerns about suitability

The Government has proposed a series of reforms to private pensions in the UK. These include auto enrolling most employees into a work-based pension scheme from 2012. Although individuals would have the right to opt out, the Government will introduce compulsory employer contributions for those who remain opted in. Individuals could be auto enrolled into an existing pension scheme, provided it meets certain criteria, or alternatively into a new national system of Personal Accounts.

The Government has proposed that there will be a minimum contribution to Personal Accounts (or an approved equivalent[1]) for individuals who remain opted in. This will be set as a proportion of a band of earnings, from around £5,000 to around £33,500 a year. The combined minimum contribution will be set at 8% of band earnings, which will comprise 4% from the individual, a minimum of 3% from the employer, and at least 1% from the state through tax relief. Contributions are expected to be phased in over a three year period.

There is a broad degree of consensus for the principle of auto enrolment, as a way of overcoming inertia and increasing the number of people saving for their retirement. However, some stakeholders have expressed concern that some employees might be auto enrolled into a product that might not be suitable for them.[2] Pension saving might not be considered suitable for an individual because of significant amounts of personal debt or the pension contributions being unaffordable, or it might be that the individual is likely to receive a low return on their saving.[3]

[1] The exemption test for existing schemes (which defines whether a scheme is eligible to be used for auto enrolment in place of Personal Accounts) is yet to be fully decided. It is expected to require contributions of at least the minimum 8% level for Defined Contribution schemes, with at least 3% from the employer, but use the existing Reference Scheme Test for contracted-out Defined Benefit schemes. DWP (2006) page 118
[2] PPI (2006 BN34)
[3] PPI (2006)

Many factors will affect returns from saving in a pension such as Personal Accounts. Some factors, such as the proposed employer contribution, tax relief and investment returns, will tend to increase returns from saving. Others will reduce returns from saving, such as the charges levied for running Personal Accounts, any income tax paid on pension income in retirement and any reduction in eligibility for means-tested benefits. For some people, saving for a pension might mean lower entitlements to means-tested benefits in retirement and lower returns from saving.

Possible policy responses

The Pensions Policy Institute (PPI) has an ongoing programme of work to analyse the suitability of Personal Accounts and possible policy responses. The first research report, *Are Personal Accounts suitable for all?*, analysed returns for 210 examples of different individuals, to identify the characteristics that might put an individual at risk of lower returns from saving in Personal Accounts.[4]

The research found that the Government's reforms to state and private pensions could increase returns from saving in a Personal Account for many people. Some individuals would be at low risk of Personal Accounts being unsuitable for them, if for example, they are in their twenties in 2012 and have full working and saving histories.

The following groups were identified as being more at risk of Personal Accounts being unsuitable for them:

- People with low earnings and broken working histories.
- Today's older people with low earnings and no prior savings.
- The self-employed. Although the self-employed would not be auto enrolled under the Government's proposals, periods of self-employment can reduce the value of saving made during periods of employment.
- People who rent accommodation in retirement.

Having additional saving (on top of Personal Accounts) can improve returns from saving in Personal Accounts, as can being married in retirement. The factors that affect the effective rate of return from saving in Personal Accounts (or indeed any type of pension) are therefore complex. These factors are not fully expounded in this report, since full details are available in previous research.[5]

It is not possible to say definitively whether saving is suitable for an individual, because individuals' personal preferences are always relevant. Instead, previous research has grouped examples of individuals into different risk groups. These illustrate whether individuals are at high, medium or low risk of Personal Accounts being unsuitable for them.

[4] PPI (2006)
[5] PPI (2006)

It is not known how many people might fall into different risk groups. This analysis can only be carried out by use of dynamic models, such as those used by the Government. Ideally, the Government could project the number of individuals in each group and the possible range of outcomes from a policy of auto enrolment.

Some people who plan to rent accommodation in retirement are at high risk of Personal Accounts being unsuitable for them. This is because they could see significant reductions in their entitlements to Housing Benefit as a consequence of saving in a Personal Account. Currently, around 20% of pensioner households are eligible for Housing Benefit. This level could reduce in future, if the number of pensioners who own their own homes continues to increase, although long-term trends are uncertain.[6]

Four broad policy options could reduce the risk that employees are auto enrolled into saving when it is not suitable for them. Some of these have been the subject of previous PPI research.

> ***Option 1: Provide generic advice and information***
> Generic advice and information could help individuals to make the right decision about whether or not to stay in a Personal Account. PPI research suggests that some of the factors that affect the suitability of Personal Accounts may be more problematic than others to incorporate into a system of generic advice.
>
> The Government has appointed Otto Thoresen to carry out a review examining the feasibility of delivering a national approach to generic financial advice. This includes advice on retirement planning and a wide range of other financial topics such as budgeting, savings, insurance, borrowing, tax and social security benefits.[7]
>
> ***Option 2: Not auto enrol some groups***
> One option would be to not auto enrol the groups of people who might be at risk of lower returns, say, people earning below £10,000 or who are in their forties or fifties today. PPI research suggests the arguments for this option are finely balanced, since low earnings or being close to state pension age do not necessarily mean that individuals will receive a low return from Personal Accounts.[8] By not auto enrolling either of these two groups as a whole, there is a risk that individuals who would benefit from saving in a Personal Account would not save.

[6] PPI (2006) pages 24 - 27
[7] Thoresen Review (2007) page 48
[8] PPI (2007 WPR) pages 14 - 17

Option 3: Increase the trivial commutation limit
Increasing the trivial commutation limit would allow more individuals to take small amounts of pension saving as a lump sum. PPI research for the Equal Opportunities Commission has analysed this option in detail.[9] It found that the option could increase returns from saving for some people, at the cost of increased Government expenditure.

Option 4: Introduce a pension income disregard
A pension income disregard would mean that individuals are allowed to keep a limited amount of their pension income, without it affecting their entitlement to means-tested benefits.

This paper has been commissioned by B&CE Benefit Schemes as an initial, independent assessment of the fourth of these policy options: introducing a pension income disregard. The disregard would apply to all forms of private pension income, including both existing forms of pension provision and Personal Accounts.

The history of pension income disregards
A pension income disregard is not an entirely new idea and the concept dates back to the foundation of Social Security.

National Assistance was introduced in 1948 following the Beveridge report as a means-tested benefit that aimed to guarantee a minimum income. In the calculation, the first 10s.6d. of occupational pension income was disregarded. This compared to the minimum income received by a single pensioner householder of 24s. a week. Occupational pension income above the 10s.6d. disregard was subject to 100% withdrawal in National Assistance, until the household was above the level of the benefit.

The pension income disregard was amended several times before being abolished in 1980. This was part of a wider set of reforms to Social Security that also included the removal of the earnings-indexation of the Basic State Pension. The disregard was not routinely uprated between 1948 and 1980 and this reduced its real value significantly. By 1980, the low value of the disregard may have made its abolition easier.

The Government proposed in the 1998 Green Paper that Income Support for pensioners should be replaced with a much higher Minimum Income Guarantee (MIG).[10] The MIG was introduced in 1999 at a level significantly above the level of the Basic State Pension. This led to concerns about incentives to save in pensions. The Government subsequently proposed to reform means-tested benefits so that incentives to save were improved.

[9] PPI (2007)
[10] DSS (1998)

The Government introduced Savings Credit in 2003 as a way of improving returns from saving, at the same time as making some detailed reforms to MIG and renaming it the Guarantee Credit. A pension income disregard was suggested as an alternative to Savings Credit, in the 1998 Green Paper,[11] but was ultimately ruled out. The possibility of running both Savings Credit and a pension income disregard side-by-side does not appear to have been analysed.

Although there is currently no pension income disregard, there is a disregard for savings that are classified as 'capital' (such as saving in a bank account or ISA). Currently, the first £6,000 of capital is disregarded in the calculation of entitlement to means-tested benefits.[12]

Indirectly, the capital disregard can increase returns from saving in pensions. This is because it is possible to take part of pension saving as a lump sum in some circumstances,[13] rather than using it to provide an annuity income. Any lump sum that has not already been spent will be taken into account for means-tested benefits using the capital rules.[14]

Therefore, the current system treats small amounts of capital more advantageously than equivalent amounts of pension income in the calculation of entitlement to means-tested benefits.[15] This is not necessarily inappropriate and the Government has made a variety of arguments in favour of the current system, for example:

- A capital disregard allows pensioners to have some liquid assets in retirement without it affecting their entitlement to means-tested benefits. This may be seen as important for financial protection. Indeed, the stated aim of the capital disregard was *to avoid a situation where pensioners have to draw down on their capital in order to receive a regular income*.[16]
- The capital disregard was also seen as a way of simplifying the claims process, so that as many pensioners as possible would be taken out of the capital rules for Pension Credit. The Government estimated that setting the level of the capital disregard at £6,000 would mean that 85% of people entitled to Pension Credit would not be subject to the capital rules. It may never be feasible to set a pension income disregard high enough so that this amount of people are not affected at all by the rules in means-tested benefits for pension income.

[11] DSS (1998) page 37
[12] £10,000 for individuals who live in a care home
[13] All individuals are permitted to take 25% of their pension saving as a tax-free lump sum. In addition, anybody whose pension saving is worth less than the 'trivial commutation limit' (£16,000 in 2007/8) can take all of their pension saving as a lump sum, though not all of it is tax-free.
[14] PPI (2007) pages 24 to 29
[15] This may not be the case for larger amounts of savings. Capital above the £6,000 capital disregard is converted into a 'deemed income' for the purposes of calculating entitlement to means-tested benefits, at the rate of £1 a week for each £500 of capital. This is a higher conversion rate than would typically be available through an annuity, so large amounts of capital can be treated less advantageously than equivalent amounts of pension income in the calculation. See PPI (2007) for more details.
[16] See the Government response in House of Commons Work and Pensions Select Committee (2002)

Although means-tested benefits currently treat small amounts of capital more advantageously than equivalent amounts of pension income, the tax treatment for pensions is generally more attractive, even compared to other tax-advantaged savings vehicles such as Individual Savings Accounts (ISAs).[17] The difference in tax treatment between pensions and capital has been justified by the Government because of their different roles: the Government has said it provides tax relief on pension contributions so that *people can save for an income in retirement, not for other purposes.*[18]

The result is that small amounts of pension income are treated less advantageously than other forms of saving when it comes to means-tested benefits but more advantageously for tax. Previous research has shown that, despite the tax advantage of pension saving relative to other forms of saving, some individuals may still have relatively low returns from saving in Personal Accounts.[19] The next section considers the potential advantages of introducing a pension income disregard.

Advantages of a pension income disregard

The Government proposes to auto enrol most employees into saving for a pension from 2012, either in a Personal Account or in an approved alternative. Individuals will have the choice to opt out of saving if they decide that it is not suitable for them. Generic advice and information is expected to be available to help individuals to make the right decisions. However, some stakeholders have highlighted the risks involved with auto enrolling employees into saving when saving is not suitable for them. There are particular risks that:

- People make sub-optimal decisions during working life. This may result, for example, from not accessing or acting on generic advice, or the design of generic advice not being able to accurately reflect every aspect of the savings decision.
- When people start to receive an income from Personal Accounts (or an approved alternative), they perceive retrospectively that saving was not a suitable option for them. This may lead to compensation claims and unexpected recourse from public funds.

The introduction of auto enrolment may mean that it is more important than ever to be able to give a clear message that it is worthwhile for people to save in a pension. A pension income disregard may be of interest, since it is one policy option for reducing the risk that employees are auto enrolled into saving in a pension when it is not suitable for them.

[17] This is because of the 25% tax-free lump sum in pension saving and also because individuals may face a lower marginal tax rate in retirement than during their working age. See Emmerson, C (2006) page 5.
[18] Inland Revenue (2002) page 5
[19] PPI (2006)

A pension income disregard could also mean that capital saved in a bank account or ISA is not treated more advantageously than pension saving in the calculation of entitlement to means-tested benefits. This may further encourage individuals to save for retirement in pensions rather than in other savings products.

A pension income disregard does not encourage individuals to take their pension saving as a lump sum in the way that some of the other policy options might (such as increases to the trivial commutation limit). This could be seen as more consistent with the rationale that the Government gives for providing tax relief on pension contributions, that people save for an income in retirement, not for other purposes.

If it were possible to align fully the disregards for capital and pension income, this may also make the current system simpler and easier to understand for individuals. Chapter 4 will discuss the options for how the capital and pension income disregard could interact and whether it is possible to align the two disregards fully.

Disadvantages of a pension income disregard
Alongside the potential advantages of a pension income disregard, there are a number of potential disadvantages.

A pension income disregard could increase the numbers of older people who are eligible for means-tested benefits. Although the disregard might improve returns from saving in a pension, there are some people who would not be eligible for means-tested benefits under the current system but who would be eligible with the disregard.

The decision about a pension income disregard therefore involves making a trade-off between the current system and an alternative with more people on means-tested benefits but with a lower risk of people saving into a pension when it is not suitable for them. In practice, individuals' decisions to stay in or opt out of pension saving will depend on their <u>perceptions</u> of the extent and effects of means-testing. A pension income disregard might:

- Improve perceptions about the value for saving in a pension, if the disregard allows the Government, advisors and other stakeholders to be clear about the value of saving in a pension.
- Worsen perceptions, if individuals consider themselves as more likely to be eligible for means-tested benefits as a result of the disregard.

The disregard could potentially reduce savings incentives through income effects: if people understand that they will receive more from the state through means-tested benefits, then they may decide it is necessary to make less provision themselves for their retirement. The same argument could be applied to work incentives.

Chapter 3 will present initial modelling of the potential impact of the pension income disregard on the number of people eligible for Pension Credit. It will also present initial figures for the cost implications of the disregard for Government. The disregard would increase expenditure on means-tested benefits for pensioners, although the size of the cost depends on a number of assumptions about how the disregard would work and the levels of take-up for means-tested benefits.

The extra cost may be seen as an appropriate targeting of state resources, if the extra spending goes to people with moderate amounts of pension saving and low overall retirement incomes. However, distributional analysis would be needed to understand where the extra spending would go. For example, how much of the extra resources would be spent on people who would otherwise have low returns from saving, and how much of it would benefit people who already have high returns?

The disregard could make means-tested benefits more complex to administer, since there would be an additional rule to apply in the calculation of entitlements. The additional complexity may increase administration costs. It could be argued that the extra complexity would make the system more difficult for individuals to understand.

The policy trade-offs

The decision about whether or not to introduce a pension income disregard therefore involves making a series of trade-offs:

- **Cost:** Between the desire to reduce the risks associated with auto enrolment and the cost of increasing expenditure on means-tested benefits.
- **Perceptions:** Between the desire to give a clear message about the value of saving in a pension and the risk that individuals perceive that they are more likely to be eligible for means-tested benefits.
- **Simplicity:** The simplicity of being able to give a clear message about the value of saving and further complicating the rules of the system.
- **Balance between different types of saving:** For example, between pension saving and other forms of saving.

To inform the debate about a pension income disregard, Chapters 2 and 3 will analyse its implications on individuals' returns from saving, its effect on the proportion of pensioner households entitled to Pension Credit, and its effect on Government expenditure on means-tested benefits for pensioners. This should give a better sense for the outcomes of a disregard and the balance between its advantages and disadvantages.

Chapters 2 and 3 will analyse one particular version of the disregard, which is described in Box 1. However, design of the disregard would affect its cost and benefits. Chapter 4 will therefore return to the design of the disregard to set out the design choices more generally.

Box 1: Details of the policy modelled

The modelling is based on current Government policy for state pensions remaining unchanged (the changes in the Pensions Act 2007 are allowed for). The start date for the indexation of the Basic State Pensions to average earnings is assumed to be 2012. In addition, the Government's proposals for private pensions are assumed to be implemented in full. The pension income disregard is assumed to be introduced in 2012.

1. How would it interact with Savings Credit?

Current Government policy on Savings Credit is assumed to continue, alongside the pension income disregard.

2. How would it interact with the capital disregard?

The pension income disregard is assumed to run side-by-side with the capital disregard. The alternative, which is to combine it with the existing capital disregard, will be discussed in Chapter 4.

3. What level?

The disregard is assumed to be set at £12 a week. This means that a person can have at least £6,000 of pension saving before the saving begins to reduce his or her entitlement to means-tested benefits. Most people would be able to have more than this without it affecting their entitlement (see Chapter 4).

The capital disregard is currently set at the same level for couples as for singles, so that £6,000 of a couple's combined capital is disregarded rather than £6,000 of each partner's capital separately. For consistency, the pension income disregard is assumed to be set at the same rate for couples as for singles.

4. How would it be uprated?

The pension income disregard is assumed to be uprated with average earnings from the time that Personal Accounts are introduced in 2012. The capital disregard is not formally uprated each year but in the past has been increased in an ad-hoc manner. It is also assumed to be uprated from 2012.

5. How would contracting-out be treated?

The disregard is assumed to apply to all private pension income, whether or not it is the result of contracting-out of the State Second Pension. This is one of three broad alternatives for how contracting-out could be treated. The other options are discussed in Chapter 4.

Chapter 2: Returns from Personal Accounts

This chapter analyses the returns that individuals could receive from saving in Personal Accounts. It shows that the pension income disregard could improve the return that some people receive. The benefits of the pension income disregard might be targeted, in the sense that it could have the greatest impact on returns from saving for the people who would have the lowest returns under the current system.

Although the pension income disregard could improve returns from saving in all forms of private pensions, this chapter analyses returns from saving in Personal Accounts, as one example. The analysis assumes the minimum level of contributions into Personal Accounts (see page 5).

Returns from saving
As mentioned in Chapter 1, many factors will affect returns from saving in Personal Accounts. Some will tend to increase returns from saving, such as the proposed employer contribution, tax relief and investment returns. Others will reduce returns from saving, such as the charges levied for running Personal Accounts, any income tax paid on pension income in retirement, and any reduction in eligibility for means-tested benefits. For some people, saving for a pension might mean lower entitlements to means-tested benefits in retirement and therefore lower returns from saving.

There are currently three principle means-tested benefits for pensioners in Britain: Pension Credit, Council Tax Benefit and Housing Benefit. Official estimates of eligibility for means-tested benefits are presented as a range, due to the uncertainties involved in the calculation. In 2004/5:[20]

- Between 44% and 51% of 'pensioner benefit units'[21] were eligible to Pension Credit, while
- between 50% and 55% were eligible to Council Tax Benefit, and
- around 20% were eligible for Housing Benefit.

This paper uses the 'internal rate of return' to illustrate the complex interactions between Personal Accounts, state pensions and the tax and means-tested benefit systems. The internal rate of return is the nominal effective rate of return that an individual receives on his or her individual contributions, after allowing for the effects of tax relief, employer contributions, investment returns, charges, income tax and means-tested benefits. Note that the internal rate of return cannot be compared to investment returns on other forms of saving, because the internal rate of return takes into account the effects of all these different factors (Box 2).

[20] DWP (2006 IRB). Estimates for 2005/6 are not yet available.
[21] A 'pensioner benefit unit' is either a single pensioner or a couple that can apply for Pension Credit

Box 2: Internal rates of return and investment returns

It is important to realise that the internal rate of return cannot be compared with investment returns on other forms of saving. For example, it is **not** possible to say that, if an individual has an internal rate of return of 4% from saving in a Personal Account, and another savings product such as an Individual Savings Account (ISA) has an investment return of 5%, then saving in the ISA is preferable to saving in a Personal Account. This is because the 4% figure for the internal rate of return for saving in a Personal Account takes account of the interaction of saving with the tax and benefit system, while the 5% figure for the investment return in an ISA does not. The tax and benefit system can also affect the value of saving in an ISA and many other products.

The internal rate of return is a very useful tool for analysing the relative impact of policies. However, it is not possible to say whether a given level of return is 'good enough' to make saving in Personal Accounts a suitable choice for any particular individual. This is because other factors could affect individuals' decisions, such as the affordability of pension contributions, the extent of personal debt, and individuals' preferences for smoothing their consumption over their lifetime.

Instead of using a definitive benchmark for what is a 'good' return, previous PPI research has used three risk groups to illustrate the possible impact of the return on the suitability of saving in Personal Accounts:[22]

- Individuals are classified as being at 'low risk' of Personal Accounts being unsuitable for them if they are likely to receive a full investment return on their contributions. This is a real return, so the individuals receive a full investment return plus protection against inflation.
- People at 'medium risk' of Personal Accounts being unsuitable for them would receive back the value of their individual contributions, protected for inflation, and some investment returns on their contributions, although they may not receive full credit for the investment returns.
- People at 'high risk' of Personal Accounts being unsuitable for them are likely to receive back less than the value of their own contributions into Personal Accounts.

The level of the internal rate of return are used to assign individuals to the risk groups. On the assumptions used, an internal rate of return above 5.5% corresponds to the low-risk group, one between 2.5% and 5.5% corresponds to the medium-risk group, while an internal rate of return below 2.5% would mean that an individual is in the high-risk group.

This paper uses stylised examples of individuals to analyse the possible impact of the pension income disregard. In reality, people have many different characteristics so it is not possible for this analysis to be representative of the population as a whole. However, by choosing a few

[22] PPI (2006)

examples it is possible to analyse the broad impact of the proposals. Box 3 sets out the assumptions made on their working and saving histories.

Box 3: Details of the example individuals used

Paul: Paul is a single man, aged 25 in 2012. He works full-time from age 21 until state pension age (age 68), but is unemployed for two years in his twenties and works part-time between age 55 and age 60. When in full-time work, he earns at median earnings for men of his age. He and his employer contribute to a Personal Account from 2012, while he is working. He takes his Personal Account at state pension age and is an owner-occupier (age 68).

Rita: Rita a single woman, aged 25 in 2012. She is employed full-time from age 21 until she takes six years out of work in her late twenties to care for her child. She receives state pension credits during this period. She returns to work part-time for five years and then works full-time until her mid-fifties. At this point, she has to care for an elderly relative and spends five years out of work. She does not qualify for credits for BSP or S2P during this second period of caring, perhaps because she does not care for the required 20 hours per week. After the five years, she returns to full-time work until state pension age (age 68). When in full-time work, she earns at the third decile of earnings for women of her age. She contributes to a Personal Account from 2012 when she is in work and earning more than the lower threshold for contributions.

Kate: Kate has the same history as Rita, only she is aged 40 in 2012 and earns at median earnings for women. She and her employer contribute the minimum amount to a Personal Account from 2012, while she is working. She takes her Personal Account at state pension age (age 67).

Jasmine: Jasmine is a single woman, aged 25 in 2012. She is employed full-time from age 21 until age 40. She is then self-employed for seven years until age 47, when she becomes an employee. She becomes ill at age 55 and is unable to work, so is on Incapacity Benefit until age 60. At this point, she returns to part-time work until retiring at state pension age (age 68). When in full-time work, she earns at the third decile of earnings for women of her age. She and her employer contribute the minimum amount to a Personal Account from 2012, while she is employed and working full-time. She does not save in a Personal Account when she is self-employed or when she is working part-time (when she decides she cannot afford the contributions).

Mike: Mike has the same history, age and earnings as Paul, only he rents his accommodation in retirement.

Gary: Gary is a single man, aged 45 in 2012. He works full-time from age 21, except for three years of unemployment in his twenties. He is self-employed for seven years in his thirties. When in full-time work, he earns at the third decile of earnings for men of his age. He and his employer contribute the minimum amount to a Personal Account from 2012. He retires one year before his state pension age, at age 65, which is when he takes his Personal Account.

People in the low risk group
Personal Accounts could give many people access to a low-cost pension savings product with an employer contribution for the first time. Previous PPI research has shown that people in their twenties in 2012 with full working histories could build up substantial amounts of Personal Accounts saving and be in the low-risk category.[23]

In this paper, Paul is an example of someone in the low-risk group (see Box 3). He will be aged 25 in 2012. He works full-time from age 21 until age 68, with the exceptions of two years of unemployment and five years of part-time work. When in work, he earns median earnings for men.[24] He will be single in retirement.

Under the current system, he could have an internal rate of return of 5.8% from saving in a Personal Account and so could be in the low-risk category. The pension income disregard could increase his return marginally to 5.9%. This suggests that Paul would not be a major beneficiary of the pension income disregard.

People at risk of lower returns
Previous research has also shown that there are also some groups for whom returns from saving could be relatively low, including:[25]

- People with low earnings and broken working histories.
- Today's older people with low earnings and no prior savings.
- The self-employed. Although the self-employed would not be auto enrolled under the Government's proposals, periods of self-employment can reduce the value of saving made during periods of employment.
- People who rent accommodation in retirement.

The pension income disregard could help each of these groups.

People with low earnings and broken working histories
People with low earnings and broken working histories could have lower amounts of Personal Account saving and lower state pension entitlements than people with full working histories and higher earnings. The combination can therefore lead to a greater interaction between Personal Accounts and means-tested benefits and, potentially, a lower return from saving.

For example, Rita is a single woman aged 25 in 2012 (see Box 3). She has two short career breaks for caring and some part-time work. When in work, she earns at the third decile of earnings for women of her age.[26]

[23] PPI (2006)
[24] Around £18,500 at age 25, increasing to around £27,000 by age 40, declining at older ages (2006/7 earnings)
[25] PPI (2006)
[26] Around £14,000 at age 25, increasing to around £16,000 by age 40, declining at older ages (2006/7 earnings)

Under the current system, Rita could receive an internal rate of return of 5.4% from saving in a Personal Account, putting her in the medium-risk group. The pension income disregard could increase her return to 6.3% and move her to the low-risk group.

Today's older people with low earnings and no prior savings
People in their forties or fifties in 2012 who have not already started to save in a pension may be less able to build up substantial amounts of saving in Personal Accounts than younger people. They may also be helped less by recent changes to state pensions.

For example, Kate is a single woman who is aged 40 in 2012 (see Box 3). When in full-time work, she earns at the median level of earnings for women of her age, which are lower than average earnings across the whole population.[27] She has two short career breaks for caring and some part-time work.

Under the current system, Kate could receive an internal rate of return of 5.2% from saving in a Personal Account, putting her in the medium-risk group. The pension income disregard could increase her internal rate of return to 6.7% and move her to the low-risk group.

The self-employed
The self-employed would not be auto enrolled into Personal Accounts. However, spending time self-employed can reduce the value of saving made in a Personal Account while employed. This is because State Second Pension (S2P) is not built-up during periods of self-employment, so, unless voluntary provision is made to replace it, being self-employed could lead to lower state pension entitlements and more interaction with means-tested benefits.

Jasmine is a single woman who will be aged 25 in 2012 (see Box 3). She is employed full-time for most of her life, but spends seven years self-employed,[28] five years on Incapacity Benefit and is employed on a part-time basis for eight years. When in full-time work, she earns at the third decile of earnings for women.[29]

Under the current system, Jasmine could have an internal rate of return of 5.3% from saving in a Personal Account, putting her in the medium-risk group. The disregard could increase her return to 6.2% and move her to the low-risk group.

[27] Around £17,000 at age 25, increasing to around £20,000 by age 40, declining at older ages (2006/7 earnings). For comparison, the same survey as used for these figures shows that average full-time earnings across both men and women and across all ages were around £25,000, Labour Force Survey January to March 2006.
[28] This is approximately the average duration of a period of self-employment, Knight and McKay (2000)
[29] Around £14,000 at age 25, increasing to around £16,000 by age 40, declining at older ages (2006/7 earnings)

People who rent accommodation in retirement

People who rent accommodation in retirement are potentially eligible for Housing Benefit for help with rent. Saving in a Personal Account could result in a significant loss in Housing Benefit, which is withdrawn at the rate of 65p of entitlement for each £1 of income.

Mike will be aged 25 in 2012 (see Box 3). He works full-time from age 21 until age 68, with the exceptions of two years of unemployment and five years of part-time work. When in work, he earns median earnings for men.[30] He will be single in retirement and will not own his own home, so he will have to rent accommodation.

Under the current system, Mike could have an internal rate of return of 1.6% from saving in a Personal Account, putting him in the high-risk group. The pension income disregard could increase his return to 2.9% and move him to the medium-risk group.

People who are reflective of the B&CE client group

Gary is a single man who will be age 45 in 2012 (see Box 3). He is a builder and has some of the characteristics that are often typical of B&CE members. He has no savings and works almost always full-time, with three years of unemployment. He spent seven years self-employed in his thirties and retires at age 65. He earns at the third decile of earnings for men.[31]

Under the current system, Gary could have an internal rate of return of 5.2% from saving in a Personal Account, putting him in the medium-risk group. The pension income disregard could increase his return to 6.9% and move him to the low-risk group.

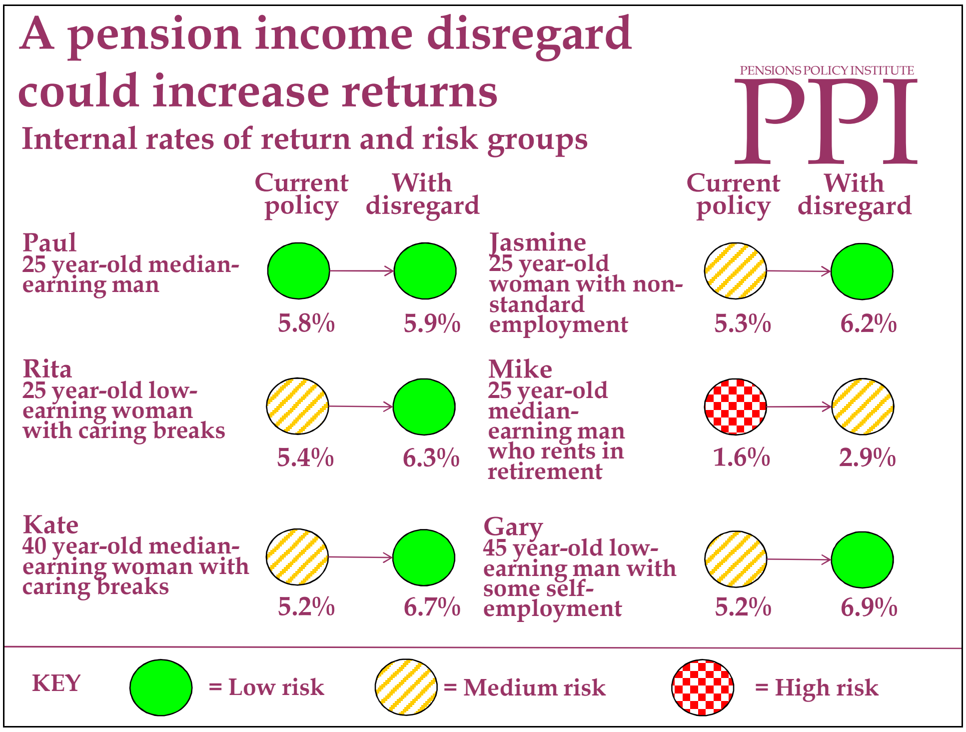
[30] Around £18,500 at age 25, increasing to around £27,000 by age 40, declining at older ages (2006/7 earnings)

[31] Around £15,300 at age 25, increasing to around £20,800 by age 40, declining at older ages (2006/7 earnings)

Summary

The pension income disregard could increase the rates of return that all of the examples receive from saving in Personal Accounts (Chart 1).

Chart 1[32]



As mentioned above, it is not possible to say whether a given return is 'good enough' to make saving in a pension worthwhile, since other factors beside the return are relevant. The decision about how high returns need to be before clear advice can be given about the value of saving, will always be subjective.

The increased rates of returns may or may not result in an increase in retirement saving, since evidence is mixed about how individuals actually respond to changes in the internal rate of return.[33] However, the results do show that individuals could receive higher returns from saving in a Personal Account if a pension income disregard were introduced. In turn, this might make it easier to be clear about the value of saving, for example in the generic advice that is expected to accompany the launch of Personal Accounts. If a clear message improves the perception that individuals have about the value of saving in a pension, then levels of saving may increase as a result.

[32] PPI analysis using the Individual Model

[33] See for example, Hawksworth (2006) pages 10-12

This chapter has shown that the pension income disregard could improve returns from saving in a Personal Account. People who are already at low-risk of Personal Accounts being unsuitable for them under current policy, such as Paul, might only see a modest improvement in their returns. Other individuals, who are in the medium or high-risk groups, could see a much larger increase in their returns. The benefits of the pension income disregard might be targeted, in the sense that it could have the greatest impact on returns from saving for the people who would have the lowest returns from saving under the current system.

This chapter is an initial analysis of the possible impact of a pension income disregard on returns from saving in a Personal Account. Further analysis could explore:

- The effects of the reforms on different examples of individuals and, ideally, an indication of how many individuals might fall into the different risk groups.
- Alternative designs for the pension income disregard, which will be discussed in Chapter 4. For example, while this chapter has assumed a pension income disregard set at £12 a week, it could be set at a higher or a lower level than this.

Chapter 3: Implications for Government finances

The introduction of a pension income disregard set at £12 a week could increase state expenditure on means-tested benefits for pensioners by around £600m a year if it were introduced in 2012, from a projected £14.6bn without reform to £15.2bn with the pension income disregard, an increase of 4%. Preliminary analysis suggests that the costs could remain relatively stable over the long term, relative to national average earnings.

The reforms could be paid for by increasing taxation, diverting state spending from other areas, or by making other changes to means-tested benefits. The reforms would not remove the need for Savings Credit but could reduce the amount that Savings Credit needs to do to incentivise pension saving. One option for paying for the reforms is therefore to make Savings Credit less generous by increasing its withdrawal taper from the current 40%, but this option would need to be analysed carefully to understand the winners and losers relative to the current system.

The disregard could also increase the proportion of pensioners eligible for Pension Credit in 2012 by less than 5% compared to its projected level without reform of around 45%.[34]

Cost

The pension income disregard would increase state expenditure on means-tested benefits. For this project, initial estimates have been produced of the possible cost in 2012, when the disregard is assumed to be introduced. The estimates have been produced using the PPI's Distributional Model.[35] They assume that the disregard applies to all forms of private pension income.

The estimates are designed to be conservative and assume, for example, that everybody claims the additional entitlement to means-tested benefits that results from the reforms. In reality, only around 75% of Pension Credit entitlement is taken up, while equivalent figures for Housing Benefit and Council Tax Benefit are around 90% and 60%, respectively.[36] The estimates may therefore overestimate the possible cost of the policy.

A pension income disregard set at £12 a week could increase state expenditure on means-tested benefits by around £600m in 2012, of which £400m is in Pension Credit and £200m is made up of Housing Benefit and Council Tax Benefit. In comparison, total state spending on means-tested benefits for pensioners is projected to be £14.6bn in 2012 without reform.[37]

[34] For details of the without-reform projections, see PPI (2007 IS)
[35] See PPI (2005) for a description of the model
[36] Midpoint of range of estimates for expenditure take-up in DWP (2007)
[37] DWP long-term expenditure projections as at May 2007. Figures have been converted from 2005 prices to 2006 earnings terms assuming real earnings growth of 2% a year. Figures relate to 2010 as figures for 2012 are unavailable.

The reform would therefore increase this spending to £15.2bn, an increase of 4%. The cost of the reforms could also be compared to the cost of the existing system of incentives for saving in private pensions, such as tax and National Insurance relief. In 2005/6, the cost of these reliefs was around £22.2bn.[38]

If the rationale for introducing a pension income disregard concerns auto enrolment, then there may be a justification for introducing the policy gradually rather than as an overnight change in 2012. This is because, to improve the returns from pension saving made from 2012 onwards, it will only be necessary for the pension income disregard to be in place when that pension saving comes into payment, and this will happen gradually. Phasing the reforms in might reduce the costs in the short term.

Long-term projections have not been produced. Preliminary analysis suggests that the cost of introducing a pension income disregard could remain stable over the long term, relative to national average earnings. This is because the introduction of the pension income disregard in 2012 would affect pensioners of all ages, unlike, for example, the alternative of increasing the trivial commutation limits which would filter through the population more gradually.[39]

However, further modelling would be needed to assess the possible long-term costs of the policy. The long-term costs would be uncertain and would depend on how much is saved in pensions in the future and rates of opt out from auto enrolment. If the policy enabled a clear message to be given about the value of saving in a pension, and the amount of pension saving increased as a result, then this might tend to reduce Government expenditure on means-tested benefits in the long term.

As well as the potential cost of reform, there is also a potential cost of no reform. Some stakeholders have highlighted the risks involved with auto enrolling employees into saving, if saving is not suitable for all. There are particular risks that:

- People either do not access or act on generic advice, or the design of generic advice is not able to accurately reflect every aspect of the savings decision. This may lead to sub-optimal decisions.
- When people start to receive an income from Personal Accounts, they perceive retrospectively that saving was not a suitable option for them. This may lead to compensation claims and unexpected recourse from public funds.

[38] HMRC (2006) *Approved pension schemes: cost of tax relief* Table 7.9. The cost includes tax relief on employee and employer contributions, National Insurance relief on employer contributions and is net of the amount of income tax collected on private pensions in payment. Note that not all of this 'cost' could ever be recovered fully, even if the tax and National Insurance relief were completely abolished, because some individuals may change their behaviour and save more in alternative tax-advantaged savings vehicles, such as ISAs.
[39] See PPI (2007) pages 57-61 for projections of the cost of increasing the trivial commutation limits

Entitlement to Pension Credit
The initial projections suggest that the pension income disregard might increase the proportion of pensioner benefit units who are eligible for Pension Credit in 2012 by less than 5% from its projected level of 45% without reform.[40]

The pension income disregard would also affect the proportion of pensioner benefit units who are eligible for Housing Benefit and Council Tax Benefit. This effect has not been modelled at this stage but could be explored further.

Paying for the reforms
The cost of the reforms could be met through increasing taxation, diverting state spending from other areas, or by making changes to Savings Credit.

The next chapter will show that Savings Credit would still be needed with a pension income disregard, in order to maintain marginal withdrawal rates below 100% for people who receive more than £12 a week from private pensions. However, the reforms would reduce the amount that Savings Credit needs to do to incentivise pension saving.

One option for paying for the reforms is to simultaneously make Savings Credit less generous by increasing its withdrawal taper. This combined reform would need to be analysed further before its effects were fully understood. Depending on the degree of the change in withdrawal taper, it could result in some cash losers relative to the current system, and could affect people differently depending on whether they have private pension income, other forms of income or capital.

This chapter has presented some analysis of the potential aggregate effects of a pension income disregard. Further analysis could explore:
- The long-term costs, both in a central scenario and in other scenarios to explore the uncertainties surrounding the future level of cost.
- Alternative design choices for the pension income disregard, or changes to Savings Credit that could be introduced in parallel with a pension income disregard. For example, while this chapter has assumed a pension income disregard set at £12 a week, it could be set at a higher or a lower level than this.

[40] The modelling output suggests an increase in the proportion of pensioner benefit units eligible for Pension Credit of 2%, from 45% to 47%. However, the increase has been rounded upwards to "less than 5%" to reflect the uncertainties involved in the calculation. Projections of eligibility to means-tested benefits are uncertain, for example, even official estimates for 2004/5 are presented as a range due to the difficulty of estimating the current number of people who are eligible for Pension Credit but not claiming it (see page 14).

Chapter 4: Design choices

Chapters 2 and 3 analysed one particular version of a pension income disregard. However, there are a series of choices for how the disregard could be designed. Alternative designs for the pension income disregard would have different costs and benefits to those presented in Chapters 2 and 3. Alternative designs have not been modelled in this scoping paper, which aims to identify the broad advantages and disadvantages of a pension income disregard.

This chapter sets out five design choices for a pension income disregard, which could be explored in more detail if it were decided that the idea of a pension income disregard should be pursued further:
1. How would it interact with Savings Credit?
2. How would it interact with the capital disregard?
3. At what level would it be set?
4. How would it be uprated?
5. How would contracting-out be treated?

1. How would it interact with Savings Credit?
Savings Credit was introduced in 2003, with the aim of rewarding saving.[41] In some ways, Savings Credit is similar to a pension income disregard, with two significant differences:
- Savings Credit operates as a percentage rather than a flat-rate amount, effectively disregarding 60% of saving in some circumstances.
- Savings Credit does not apply specifically to any one type of income. It could be awarded on any state pension, private pension, earnings[42], or non-pension saving that takes the individual above the lower threshold.

A pension income disregard would not remove the need for Savings Credit, which helps avoid high marginal withdrawal rates on income from private pension saving. Savings Credit also encourages individuals to make non-pension saving and to continue working into their retirement.

However, a pension income disregard would further improve average withdrawal rates. Here, the average withdrawal rate is the proportion of the amount of income an individual receives from pension saving that replaces means-tested benefits rather than increases his or her overall retirement income. Chart 2 shows the possible impact of a pension income disregard of £12 a week, for someone with a state pension income of £125 a week.[43]

[41] DSS (2000)
[42] Unless the earnings have been disregarded
[43] The chart is based on the projected state pension outcomes at state pension age for Jasmine, who is an example modelled in Chapter 2 of this paper

The chart shows that people with higher amounts of private saving have lower average withdrawal rates under the current system, as they move above eligibility for Pension Credit. The pension income disregard could reduce average withdrawal rates less for these people than for people with higher average withdrawal rates under the current system.

Chart 2[44]

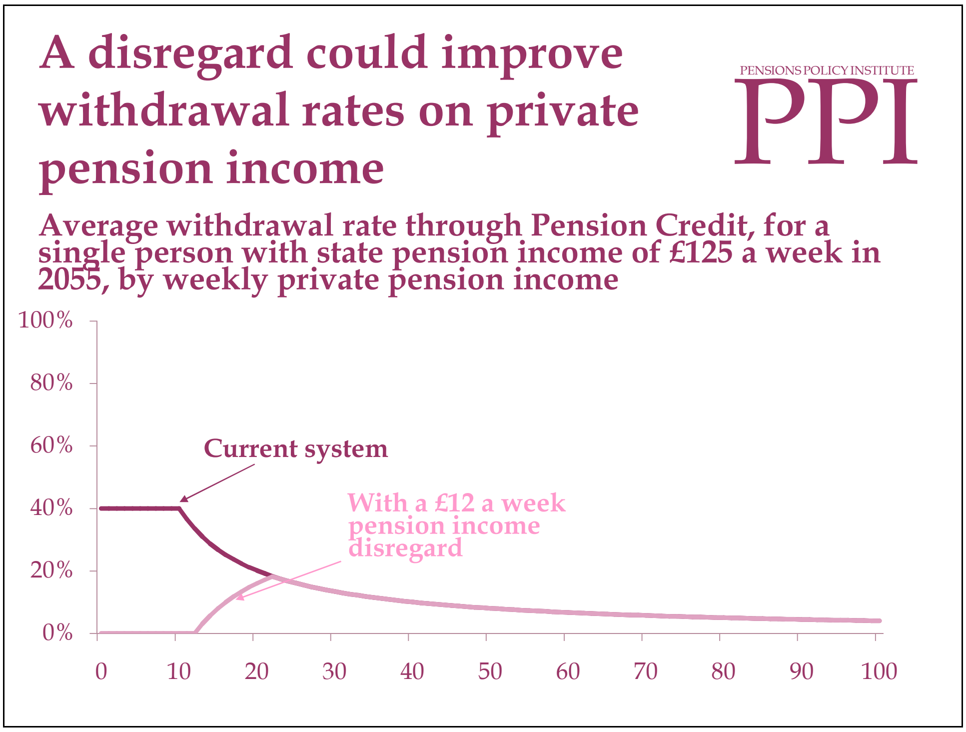
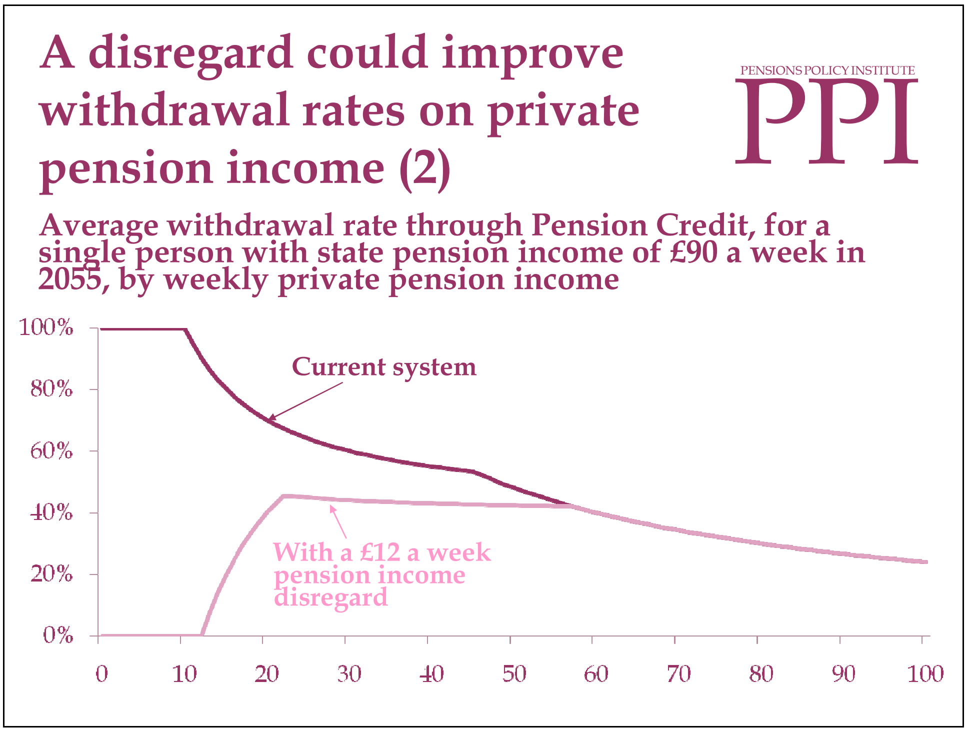


Chart 3 illustrates a more extreme situation, where the individual has a state pension of £90 a week. This would be a rare outcome, but could result in some circumstances from having less than the thirty qualifying years needed for a Basic State Pension (BSP) or from having a full BSP but limited income from State Second Pension, particularly at older ages.[45] This person could have a withdrawal rate of 100% in the current system, since he or she would be below the lower threshold for eligibility for Savings Credit. The pension income disregard could reduce withdrawal rates substantially, possibly to 0%.[46] This would be a very substantial improvement for a person who would otherwise experience the highest withdrawal rates possible under the current system.

[44] PPI analysis. Assumes a pension income disregard set at £12 a week in 2007/8. Assumes no lump sums are taken from pension saving.
[45] For more information on the current pensions system, see *The Pensions Primer*, which is available on the PPI's website www.pensionspolicyinstitute.org.uk
[46] Note however that people with low private pension incomes could trivially commute their pension saving and take all of it as a lump sum rather than as an income. This could reduce the interaction with means-tested benefits because of the capital disregard. See PPI (2007) for a discussion.

The two charts show that a pension income disregard would not remove the need for Savings Credit, which is needed to reward saving for people with larger amounts of pension saving. However, the combination of a pension income disregard and Savings Credit could benefit people with small amounts of pension income.

Chart 3[47]



2. How would it interact with the capital disregard?
The pension income disregard could run alongside the capital disregard, so that the first £6,000 of capital is disregarded and, say, the first £12 a week of pension income is disregarded.

Alternatively, it could be combined with the capital disregard, so that individuals have a combined allowance. If this were set at £12,000, say, it would mean that the first £12,000 of someone's combined pension and other saving would be disregarded. This could be seen as a further extension of the recent Lifetime Allowance tax reforms, by giving individuals a simple allowance for saving that would not affect entitlement to means-tested benefits.

However, there could be practical difficulties with a combined allowance. There are choices about which type of saving would be set against the combined allowance first. This could make a difference to entitlements, since means-tested benefits treat capital above the current £6,000 capital disregard in a different way to pension saving.

[47] PPI analysis. Assumes a pension income disregard set at £12 a week in 2007/8. Assumes no lump sums are taken from pension saving.

3. At what level would it be set?
Setting the disregard at a higher level would tend to increase its impact on returns from saving, at a cost of increasing Government expenditure on means-tested benefits. The appropriate level of the disregard will therefore depend on what is seen to be the right balance between returns and cost.

The capital disregard is currently set at £6,000. One option is to set the pension income disregard at an equivalent level, to try to bring the treatment of pension income in means-tested benefits closer to the treatment for capital. Aligning the two systems could simplify the system, although there are arguments why differential treatment of pension income and capital might be appropriate (pages 9-10).

There is more than one possible approach for deciding how much pension income is equivalent to the £6,000 capital disregard. Depending on the approach used, different amounts of pension income might be considered to be equivalent to £6,000 of capital.

One approach is to use the conversion terms that are already present in means-tested benefits. Any capital above £6,000 is currently converted to a 'deemed income' for the calculation of entitlement to means-tested benefits, at the rate of £1 a week of income for each £500 of capital. Using this approach would imply the £6,000 capital disregard is equivalent to a pension income disregard of £12 a week.[48]

An alternative approach uses the actual terms on which pension saving is converted into an income when an annuity is bought. However, annuity terms depend on a variety of factors, including age, gender, the type of annuity bought, smoking status and ill-health. Terms also vary over time.

Assuming the most common type of annuity is bought,[49] a pension income disregard of £12 a week would be equivalent to around £6,300 of pension saving at retirement for a man aged 74, or as much as £10,500 for a woman aged 55 (Table 1). It could be worth even more than this, if an individual bought an annuity that increased with the Retail Prices Index, up to £18,000 in some circumstances.

Table 1:[50] Amount of pension saving equivalent to £12 a week

	55	65	74
Woman	£10,500	£8,900	£7,000
Man	£10,200	£8,400	£6,300

[48] £6,000 x £1 / £500 = £12 a week of income
[49] A single-life, level annuity, Canon and Tonks (2006)
[50] Assumes a single-life, level annuity. Assumes the individual is a non-smoker with a pension fund of £100,000. Based on the second-best annuity rates from the FSA's Comparative Tables (www.fsa.gov.uk/tables) . © The Financial Services Authority.

A pension income disregard set at £12 a week would mean that a person can have at least £6,000 of pension saving before the saving begins to reduce entitlement to means-tested benefits, but most people could have more than this. A disregard set at this level could allow a similar message to be given as with the capital disregard, that the first £6,000 of saving would be disregarded, but it would not be an exact equivalence (using the annuity terms approach). It may therefore not be possible to exactly align a disregard for pension income with the existing disregard for capital.

The entitlement of couples to means-tested benefits is assessed by taking their joint income into account. The pension income disregard could be set at the same level for couples as for single pensioners, or at different levels. The capital disregard is currently set at the same rate for pensioner couples as it is for single pensioners.

4. How would it be uprated?
The disregard could be uprated each year to keep it in line with increases in the general level of prices or earnings. This uprating could either be put in legislation or an ad-hoc approach could be used. The first could result in more consistency over time, while the second ad-hoc approach could be more flexible and consistent with the approach used for the capital disregard.

If the rationale for introducing a pension income disregard concerns auto enrolment, then there may be a justification for introducing the policy gradually rather than as an overnight change. This is because, to improve the returns from pension saving made from 2012 onwards, it will only be necessary for the pension income disregard to be in place when that pension saving comes into payment, and this will happen gradually.

5. How would contracting-out be treated?
Contracting-out is when an individual waives all or part of the State Second Pension, in return for having part of their National Insurance contributions paid as a rebate to a private pension scheme.[51]

If someone contracts out for part of their working life, then their private pension scheme will pay the amount of income that results from contracting-out combined with the amount of income that results from any additional voluntary saving on top of the contracted-out rebate. There are three broad approaches to how contracting-out could be treated in a pension income disregard:

1. **Disregard only income from voluntary saving in private pensions (and not the amount that results from the rebate):** This approach would focus the benefits of the disregard on voluntary saving, where there are concerns around the suitability of saving for some people (see Chapter 1). However, this approach could make the disregard difficult to administer, since individuals may not know how much of their private pension income is the result of contracting-out when they come to claim a means-tested benefit.

2. **Disregard all private pension income, whether or not it is the result of contracting-out:** This approach would be more simple to administer. However, it could mean that a person who has contracted-out could receive more in means-tested benefits than someone who has not contracted-out. This might be considered unfair.

3. A third approach would be to introduce a **combined disregard for both private pension income and State Second Pension**. In this case, the disregard would apply both to private pension saving and to some social contributions. This could combine the advantages of fairness and simplicity, and would be more similar to the approach that was adopted when Savings Credit was introduced. However, it might have a greater cost than introducing a disregard that applies only to private pension income, since the disregard would need to be set at a higher level for it to have the same effect on returns from saving in pensions.

The recent Pensions Act will result in the abolition of contracting-out for Defined Contribution pension schemes, although not for Defined Benefit schemes. If the disregard were taken forward, then further work would be necessary to understand the options for treating both existing and new contracted out pensions.

[51] Depending on the type of private pension involved, the individual may either receive a rebate of his or her National Insurance contributions paid directly into the private pension or else may pay lower National Insurance contributions at source. See the PPI's *The Pensions Primer* for a description of the current pensions system (available on the PPI's website www.pensionspolicyinstitute.org.uk)

Chapter 5: Next steps

This paper has shown that a pension income disregard could improve returns from saving in Personal Accounts, although at the cost of increasing state expenditure on means-tested benefits for pensioners.

The decision about whether to introduce a pension income disregard involves a series of trade-offs, which will always be to some extent subjective:

- **Cost:** Between the desire to reduce the risks associated with auto enrolment and the cost of increasing expenditure on means-tested benefits.
- **Perceptions:** Between the desire to give a clear message about the value of saving in a pension and the risk that individuals perceive that they are more likely to be eligible for means-tested benefits.
- **Simplicity:** The simplicity of being able to give a clear message about the value of saving and further complicating the rules of the system.
- **Balance between different types of saving:** For example, between pension saving and other forms of saving.

This is a scoping paper, which aims to identify the broad advantages and disadvantages of a pension income disregard. It has illustrated the possible implications of one version of the pension income disregard.

However, there are other options for how a pension income disregard could work in practice. In particular, the implications of the following design choices would need to be understood fully before a pension income disregard could be introduced:

- How would it interact with Savings Credit?
- How would it interact with the capital disregard?
- At what level would it be set?
- How would it be uprated?
- How would contracting-out be treated?

If it were decided that the disregard should be taken forward, further analysis would be needed to understand all the implications. Analysis would be needed of:

- The effects of the reforms on different example individuals and, ideally, an indication of how many individuals might fall into the different risk groups used in Chapter 2.
- The long-term costs, both in a central scenario and in other scenarios to explore the uncertainties surrounding the future level of cost.
- The distributional effect of the reforms on the pensioners' incomes distribution, particularly if combined with other reforms concerning Savings Credit that might have an impact on the distribution.

Appendix: Technical details

This appendix describes modelling assumptions and methodologies used in the individual and aggregate modelling.

Individual modelling
The internal rate of return and net present value calculations are based on the following assumptions:

- Future annual price inflation of 2.5%.
- Future annual earnings growth of 2% in excess of prices.
- Expected investment returns of 3% in excess of prices, before charges, corresponding to a mixed equity/bond fund.[52]
- Annual charges in Personal Accounts of 0.5% of assets under management.
- Life expectancies are assumed to be in line with the 2004-based cohort life projections by the Government Actuary's Department.

All of the individuals analysed are assumed to use their Personal Account funds to buy a single-life, level annuity fixed in cash terms at retirement (unless they trivially commute their Personal Accounts saving). This means that their income from Personal Accounts would decline quickly during their retirement, especially when considered relative to average earnings.

Most annuities bought today are level annuities.[53] If the individuals analysed in this paper were assumed to use their Personal Account fund to buy an annuity which increased in line with the Retail Prices Index, rather than a level annuity, then the estimated internal rates of return could be lower. This is because a greater proportion of income from Personal Accounts would be taken later in life, when the individuals are likely to be in receipt of greater entitlements to means-tested benefits.

Assumptions are made regarding future annuity rates. The assumptions used are:

- Mortality follows the PMA92/PFA92 mortality tables, adjusted for future mortality improvements using the "medium cohort" projection.[54]
- Post-retirement investment returns are 1% in excess of prices.
- Calculated annuity rates are multiplied by a factor of 1.04 to allow for expense charges.

[52] This corresponds to assumed equity returns of 7% a year, assumed bond returns of 4% a year, and a portfolio of 60% equities and 40% gilts, PPI (2003) page 25
[53] Canon and Tonks (2006)
[54] CMIB (2002)

These assumptions are broadly similar to those required for the calculation of annuity rates for the purpose of Statutory Money Purchase Illustrations (SMPIs).[55] As noted above, a level annuity is assumed to be bought for the purpose of the case studies rather than an RPI annuity as required for SMPIs.

As an illustration, on the assumptions used in the case studies, the rate for a single-life, level annuity is 6.5% for men at age 65 in 2006. Equivalent available market rates are currently between 6.5% and 7.4%.

Aggregate modelling

For this project, initial estimates have been produced of the possible cost in 2012, when the disregard is assumed to be introduced. The estimates have been produced using the PPI's Distributional Model.[56]

Extra spending on means-tested benefits has been calculated assuming that 100% of pensioners will take up the extra entitlement they have as a result of the reforms. In reality, take-up is likely to be less than 100% and so the cost of the reforms will be lower than shown.

[55] Actuarial Profession (2006) TM1 Version 1.2. Note that TM1 requires annuities to be calculated using a market interest rate. This varies over time, and would be 1.2% real for illustrations dated between 6 April 2005 and 5 April 2006, and 0.8% real for illustrations dated between 6 April 2006 and 5 April 2007. The case studies use an assumption of 1.0% real.

[56] See PPI (2005) for a description of the model

Acknowledgements and Contact Details

The Pensions Policy Institute is grateful for input from many people in support of this paper, in particular:

Martin Campbell	Elaine McCauley	John Jory
Melanie Duffield	David Morley	

This paper makes use of the Family Resources Survey 2004/5, which was supplied by the UK Data Archive, University of Essex, and is funded by the Department for Work and Pensions (DWP); and the Quarterly Labour Force Survey, January to March 2006, which was supplied by the UK Data Archive, University of Essex, and is sponsored by the Office for National Statistics and Northern Ireland Department of Enterprise, Trade and Investment. The UK Data Archive and the sponsors bear no responsibility for further analysis and interpretation.

The authors take responsibility for remaining errors.

The Pensions Policy Institute is an educational charity promoting the study of retirement provision through research, analysis, discussion and publication. The PPI takes an independent view across the entire pensions system.

The PPI is funded by donations, grants and benefits-in-kind from a range of organisations, as well as being commissioned for research projects. To learn more about the PPI, see: www.pensionspolicyinstitute.org.uk

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www.pensionspolicyinstitute.org.uk
ISBN 978-1-906284-03-9