Taxes, benefits and Retirement Income Incentives

Paper prepared for

How does the interaction of state and private pensions affect incentives to work and save?

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Shaping a stable pensions solution

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Taxes, benefits and Retirement Income Incentives

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Questions for discussion

1. Is the current structure of support for pension saving the best way of meeting the Government's aims for encouraging private pension saving?
2. Does it matter if retirement saving is not always through pensions?
3. Would it be sensible to index means-tested support at a different rate to universal or contributory benefits over long periods of time?
4. Are future increases in pension ages inevitable if individual's healthy life expectancies continue to increase?

Summary of conclusions

This paper examines the changing incentives provided by the Government for individuals to save for retirement, and to work in older age.

In terms of private pension saving the incentives provided by the Government are complicated, and vary by a number of factors. For example the tax-free lump sum is a greater subsidy to those expecting to pay higher rate tax in retirement than those expecting to pay basic rate tax. In addition the tax advantages of contributing to a private pension depend not only on individual characteristics, but also whether the contribution is formally made by an employer or an individual. Both of these features are difficult to justify.

The increased pension contribution limits that come into being in April 2006 will give individuals greater scope to place retirement savings in an ISA and then move them into a private pension as they near retirement. This strategy would allow individuals greater flexibility – for example the amount that they eventually choose to move into a private pension could depend on how the means-tested system of support for pensioners evolves. For some individuals this increased flexibility complicates the optimal pension saving strategy considerably since pension contributions made during years in which they are higher rate taxpayers or on the taper of the WTC would be worth more in retirement than equivalent contributions (from net income) made in other periods.

In terms of retirement behaviour there are a number of reasons to expect retirement ages to increase over the next few years (as they have done over the last 10 years), not least as healthy life expectancies are likely to continue increasing. In addition the increase in the age at which individuals can qualify for the Pension Credit Guarantee will tend to increase work incentives, as would any move to increase pension ages in pension schemes such as those for public sector workers. Reforms to Incapacity Benefit and shifts from defined benefit pensions towards defined contribution pensions might well also increase the proportion of older working age individuals in employment. Given continued expected improvements to healthy life expectancy it might be that the state pension age should increase from 65 at some point in the future (which would further improve work incentives), in which case the earlier individuals can be informed of any change the better.

Taxes, benefits and incentives to work and save

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1. Introduction

This paper examines the changing incentives provided by the Government for individuals to save for retirement, and to work in older age. Section 2 examines the role of the tax, tax credit and benefit system on individuals incentives to contribute to a private pension relative to placing their savings in an ISA. In addition it looks at the role of the planned increases in contribution limits and what the effect this could have individual's incentives to make contributions to private pensions at particular points in their life. Section 3 looks at recent trends in employment rates among older workers and examines the possible impact of policy reforms and the shift from defined benefit to defined contribution pensions on future retirement ages.

2. The taxation of pension saving

2.1 Individual contributions and the role of the tax-free lump sum

The taxation of funds held private pensions in the UK is relatively more tax favoured than that of funds held in Individual Savings Accounts (ISAs). Indeed if this was not the case it would be difficult to see why anyone who is not constrained by the ISA contribution limits would choose to save in a private pension. Funds held in ISAs are much more liquid than those held in private pensions (since they can be withdrawn at any time with no loss of tax relief) and there is no requirement to purchase an annuity with the accumulated sum. In contrast funds held in a private pension cannot be

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withdrawn until the age of 50 (which is set to be increased to age 55)[1], at least three-quarters of the fund has to be used to purchase an annuity before the age of 75, and there are rules governing those choosing income drawdown rather than annuity purchase up to age 75.[2]

There are two potential incentives provided by the tax system for an individual to choose to contribute in a private pension rather than save in an ISA. First 25% of the funds accumulated in a private pension can be withdrawn as a tax-free lump sum. Second, an individual might expect to face a lower marginal rate of income tax during their retirement then during their working life (known as 'tax-rate smoothing'). For example many individuals who are higher rate income taxpayers during their working lives might expect to be basic rate income taxpayers during their retirement.

It has been argued that allowing individuals who are higher rate taxpayers during their working lives to benefit from tax-rate smoothing is unfair. However it is important to note that individuals will be paying income tax at the marginal rate they face when they receive the income. Were the Government to want to raise more tax revenue from individuals who are higher rate taxpayers then it would be far simpler to increase the higher rate of income tax then to change the pension tax system.[3] (Moreover increasing the higher rate of income tax would also increase tax on those who expected to remain higher rate taxpayers in retirement, whereas restricting relief on contributions to the basic rate of income tax would not affect these individuals. On average this group will have higher lifetime incomes than those higher rate taxpayers who expect to become basic rate taxpayers in retirement).[4]

In contrast there are some aspects of the tax-free lump sum which suggests that it might not be the best way of encouraging individuals to receive an adequate income

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[1] Currently, a small number of individuals in certain occupations – for example, models, professional footballers, skiers (downhill) and trapeze artists – can claim their private pension before 50 (at 35, 35, 30 and 40, respectively). From April 2006 this will no longer apply: in the new regime, all individuals (except for those with severe health problems) will have to be at least 55 before they can start to claim income from a private pension.

[2] Individuals who reach age 65 with total private pension funds worth no more than £10,000 are allowed to take the entire amount as a lump-sum payment, one-quarter of which is be tax free.

[3] While restricting relief on contributions to the basic rate of tax would be simple in defined contribution pensions it would be very difficult to do in final salary schemes where the accrual in a year depends on an individual's pension tenure and their final salary neither of which is known at the time the benefit accrues.

[4] This assumes that if relief on pension contributions was restricted to the basic rate of income tax then the tax levied on withdrawals from pensions was also restricted to the basic rate.

throughout their retirement. In 2002–03 the tax-free lump sum cost the exchequer an estimated £2.7 billion.[5] The amount that an individual benefits from being able to take 25% of their pension fund as a tax-free lump sum depends on two factors: the size of their pension fund and the marginal tax rate that they face in retirement. In terms of those paying income tax in retirement both of these will mean that in cash terms individuals on higher incomes will benefit more than individuals on lower incomes. An individual paying higher rate tax in retirement at 40% has their pension boosted by 16.7% as a result of the tax-free lump sum, while an individual paying basic rate tax retirement at a rate of 22% has their pension boosted by 7.1%.[6] It does not seem clear why the taxpayer subsidy to encourage pension saving should be at a greater rate for those individuals who are higher-rate taxpayers in retirement than for those individuals who are basic rate taxpayers in retirement. This could become more important in the future as greater numbers of pensioners are expected to be higher-rate taxpayers (whereas currently only very few pensioners have sufficiently incomes to be higher-rate taxpayers).

If the rationale behind the tax-free lump sum is to increase retirement incomes in order to reduce expenditure on means-tested benefits then the current tax-free lump sum is poorly targeted. First individuals can benefit from the tax-free lump sum on pension funds whose value far exceeds that necessary to avoid falling back on means-tested benefits – for example the new pensions regime coming in April 2006 will allow individuals to take 25% of pension funds worth up to £1.5 million free of tax – i.e. a potential tax-free lump sum of £375,000. Second if the rationale is to encourage individuals to have sufficient incomes throughout their retirement it would seem more appropriate to subsidise the component of pension funds used to provide a retirement income rather than the part that can be taken as a lump sum.

2.2 Employer contributions

A further complication arises from the fact that employer contributions are relatively more tax advantaged than contributions made directly by an individual. This is because employer contributions to private pensions are exempt from both employers and

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5 HM Revenue and Customs estimate that £8.0 billion of income tax was paid on private pension income. Under the assumption that this tax is paid on 75% of withdrawals from accumulated pension funds taxing the remaining 25% would have raised an additional £8.0/3 billion = £2.7 billion.

6 $(\frac{1}{4} + \frac{3}{4}(1-0.40))/(1-0.40) = 16.7\%$; $(\frac{1}{4} + \frac{3}{4}(1-0.22))/(1-0.22) = 7.1\%$

employee's national insurance contributions (Emmerson and Tanner, 2000). The value of this additional support depends on the relevant employee and employer NI rate. Table 2.1 presents the tax-advantage of employer pension contributions relative to employee pension contributions. This shows that the tax advantages of an employer contributions are up to 24.2% more tax advantaged than employee contributions (i.e. for a given level of after tax funds flowing into a pension the retirement income will be up to 24.2% higher if the contributions are employer made rather than employee made).

Table 2.1. The value of employer contributions relative to employee contributions

Earnings and contracted-out status	Tax advantage of employer contributions relative to employee contributions
Earnings below the UEL (contracted out)	24.2%
Earnings above the UEL but below HRT	14.3%
Earnings above the HRT	14.7%

It seems very difficult to justify why employers pension contributions are more relatively tax favoured compared to employee pension contributions, let alone why any higher support for employer pension contributions should vary with an individual's National Insurance contribution rate. The Association of British Insurers have argued that since individuals whose employer contributes to a private pension are more likely to contribute themselves increased support for employer contributions might increase both employer and employee pension contributions.[7] However simply because employer contributions are often associated with higher employee contributions does not imply that there is a causal link. It could well be that individuals who want to contribute more to a private pension themselves are more attracted to employers that offer remuneration packages with more generous employer pension contributions. (Furthermore jobs that offer pensions are typically better paid than jobs that do not even after controlling for other characteristics).[8] Tax advantaging employer contributions relative to employee contributions provides strong incentives for individuals to arrange their affairs so that their pension contribution is made by their employer – for example through a salary

[7] "The ABI believes there is much to be gained from generating a climate in which more employers contribute more -if employers contribute, so too will their employees." (Association of British Insurers, 2003).

[8] Gustmann and Steinmeier (1993) present evidence on this from the US. For UK evidence see Table 5 of Disney and Emmerson (2002).

sacrifice arrangement. Interesting in the run-up to the 2005 general election the Conservatives proposed providing 10% additional support for (gross) individual contributions to private pensions that attract basic-rate tax-relief, which would have gone some way to removing this distortion.

2.3 The tax credit and benefit system faced by individuals in retirement

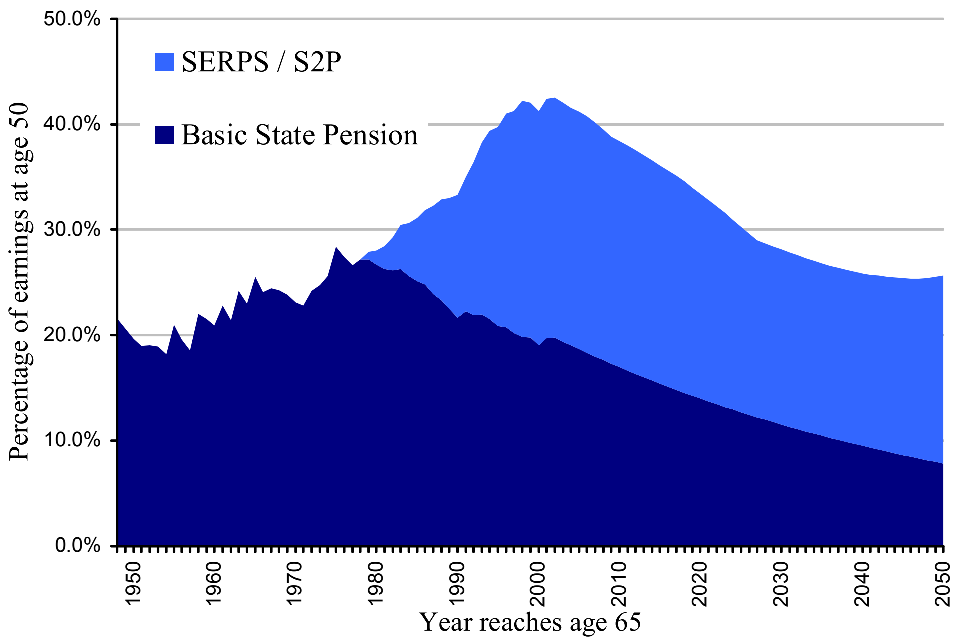
The analysis in this section so far has focussed purely on the role of the tax system in providing financial incentives for individuals to save in a private pension. An individual's need to save for retirement will also be affected by the level and nature of state support available in retirement. The latest DWP forecasts for spending on transfer payments to pensioners is that spending will increase from 6.2% of national income in 2004–05 to 6.5% of national income 2054–55.[9] If this forecast is correct then state spending on pensioners as a share of national income will fall to around two-thirds of its current per pensioner level by the middle of this century. For many this will provide a strong incentive to save for retirement. This is illustrated in figure 2.1 which shows how the state pension income at age 65 as a share of earnings at age 50 varies by year of birth for men who earn age specific male median earnings at all ages from 16 to 65. For individuals of this type (who are actually relatively rich since they are always in paid employment throughout their working life and earn male median earnings which is higher than female median earnings) this shows that the generosity of the state actually peaked in the last 5 years, and that estimated replacement rates will fall from just over 40% today to around 25% by 2050.

In terms of evidence that individuals might respond to the changing level of the generosity of the state Attanasio and Rohwedder (2004) examine the impact of the introduction of the State Earnings-Related Pension Scheme (SERPS) on household expenditure. They find that middle-aged households offset around two-thirds of the increase in generosity of the pension system through other forms of saving (and that the offset was greater for older households). This suggests that income effects (and not just substitution effects) are important. Moreover, given that the increase in generosity of state support implied by SERPS (and illustrated in figure 2.1) was in part consumed by working age individuals this raises the possibility that individuals might respond to reductions in the generosity of the state pension system by choosing to save more.

[9] See table LT.3 of DWP Benefit Expenditure Tables (http://www.dwp.gov.uk/asd/asd4/long_term.asp).

However one important caveat to this finding is that while Attanasio and Rohwedder find a significant impact of the introduction of SERPS on saving (via consumption growth) they do not find any impact of the 1981 decision to price index the basic state pension (whereas previously it was indexed to the greater of growth in prices or earnings). One possibility is that the impact of the introduction of SERPS was more widely understood than the impact of the reduction in the generosity implied by changing indexation.

Figure 2.1. State pension and Pension Credit at 65 for male with median (age-specific) earnings, full employment history, and no private income, 1948 to 2050.

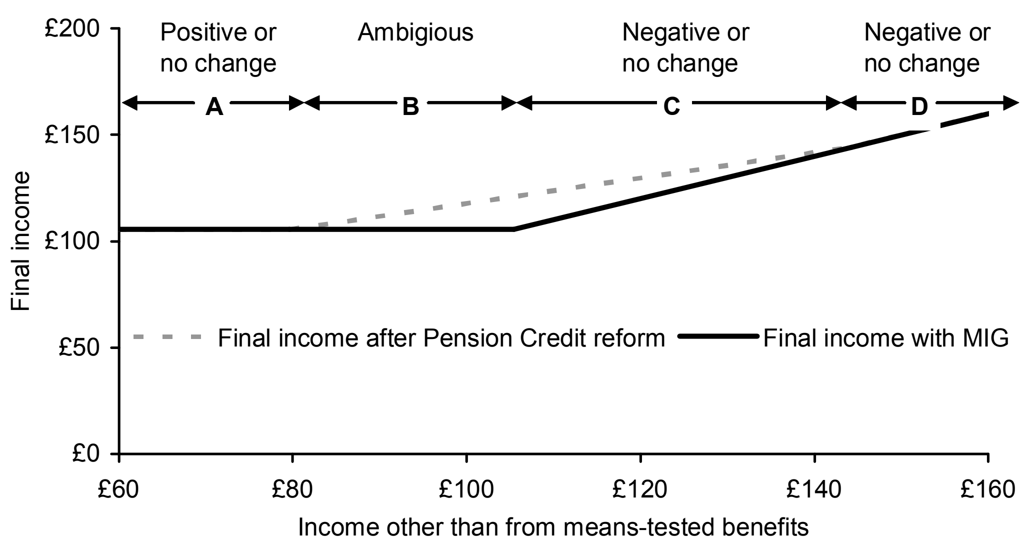


Notes: Calculations for individuals with full contribution history with median male age specific earnings and 2% annual economy-wide real earnings growth.
Source: Disney and Emmerson (2005).

The financial incentives will also be affected by the benefit and tax credit system since these can affect the marginal effective tax rates that individuals face when they are in receipt of their retirement income. Since April 1999 means-tested support for pensioners has been increased substantially. This has boosted the incomes of many lower income pensioners and the introduction of the Pension Credit has also provided them with some reward for having saved in the past (Brewer and Emmerson, 2003). However, it is not the case that the Pension Credit will necessarily encourage working age individuals to save more for their retirement. Figure 2.2 shows the budget constraint for a single individual aged 65 or over who is in receipt of a full Basic State Pension.

Those who expect to reach retirement in the area marked B will find that the return from saving has been boosted by the Pension Credit (the dotted line is steeper than the solid line in this segment). However they will also find that a given amount of retirement income can be received with a lower level of retirement saving (the doted line is above the solid line). Hence economic theory cannot tell us whether these individuals are likely to save more or less for their retirement as a result of the reform. For those expecting to retire in the area marked C on the figure economic theory is slightly less unambiguous. These individuals will find themselves eligible for means-tested benefits as a result of the reform. Hence they will find that the return from saving has been reduced by the reform (the dotted line is less steep that the solid line in this segment). Furthermore they will also find that a given amount of retirement income can be received with a lower level of retirement saving (the dotted line is above the solid line). Hence economic theory suggests that these individuals will either not change, or will reduce, the amount that they save for their retirement.

Figure 2.2 The key groups for whom economic theory suggests that the Pension Credit will alter retirement saving incentives.

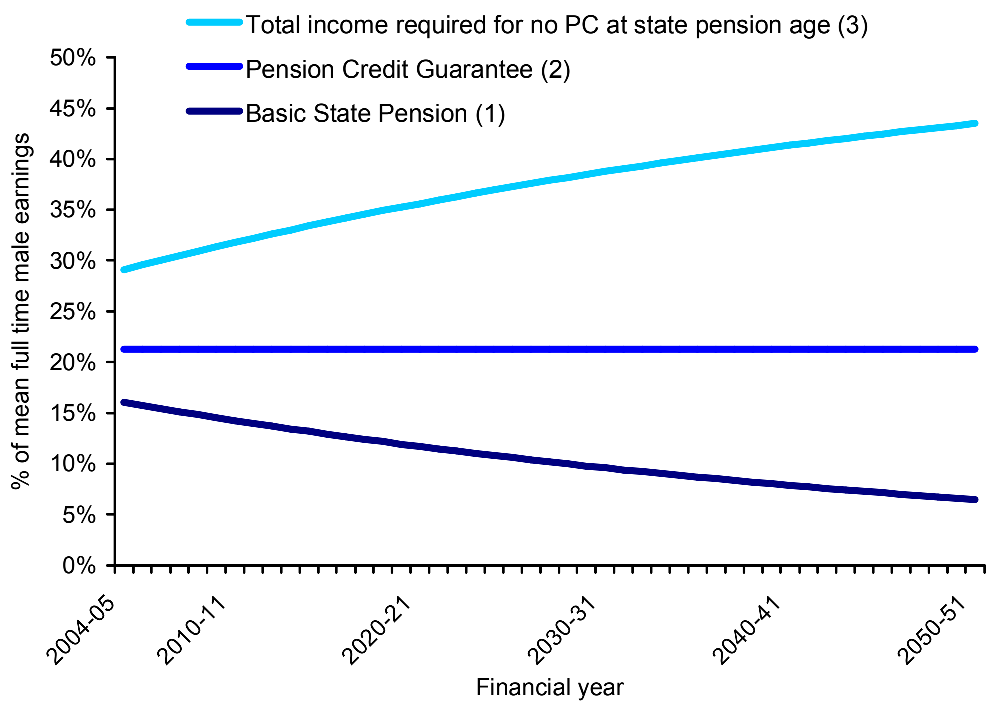


Note: Income disregards, taxation and other means-tested benefits ignored.
Source: Disney and Emmerson (2005).

Where individuals expect to be relative to the different areas parts of figure 2.2 will depend on both the amount of income of non-means tested income that they expect to receive in retirement and also how they believe that the current system is likely to be indexed between now and then. The current Government has stated that the Basic State

Pension will continue to be indexed at least in line with prices. It has also committed to earnings indexing the Pension Credit at least until 2007–08, and has a long-standing aspiration to earnings index the Pension Credit over the medium term. Figure 2.3 shows the level of the Basic State Pension (line 1) and the Pension Credit Guarantee (line 2) if this indexation strategy is pursued and if real earnings grow by 2% a year in real terms. The amount of non-means tested income needed for an individual entering retirement not to be eligible for the Pension Credit depends on the gap between the Basic State Pension and the Pension Credit Guarantee. In 2004–05 an individual with a non-means tested income of 29.1% of average earnings would not be eligible for the Pension Credit. As shown by line 3 in figure 2.3 if the current indexation strategy is continued this level of income will grow relative to average earnings. The level of private income required (i.e. income on top of a full Basic State Pension), as shown by the gap between lines 3 and 1 would grow even faster as a share of contemporary average earnings.

Figure 2.3. Basic state pension and Pension Credit guarantee over time, as a share of average earnings.



Note: Assumes real earnings growth of 2 per cent a year. Male average full-time earnings of £496 per week taken from the Spring 2004 Labour Force Survey.
Source: Disney and Emmerson (2005).

The percentage of current working age individuals who will be in receipt of the Pension Credit in their retirement will depend on both the amount of private income they receive and how the system is indexed. Assuming that the system evolves as in figure 2.3 and that other components of pensioner incomes grow in line with average earnings it is possible to use information on the current generation of pensioners to simulate the proportion of pensioners who might be eligible for the Pension Credit in the future. This is done by inflating all non basic state pension income in line with average earnings and applying suitably uprated future Pension Credit systems to this population (which means that it is showing what would happen should all other factors such as demographics, saving behaviour and employment rates remain constant). This calculation suggests that while 45.8% of individuals in families containing an individual aged 65 or over was eligible for the Pension Credit in 2004–05 this would increase to 63.6% in 2025–26 and to 71.1% in 2050–51.[10]

2.4 The tax credit and benefit system faced by individuals during their working lives

The financial incentives to save for retirement can also be affected by the withdrawal rates on benefit and the tax credits that are received when pension contributions are being made. For example the Working Tax Credit (WTC) is withdrawn at a rate of 37%, which when combined with basic rate income tax at 22% can give a much stronger (59%) incentive for individuals to contribute to a private pension. This is because the WTC is assessed on an individuals income net of contributions to private pensions. The same is true for the Child Tax Credit (CTC) which, for those on the taper, is withdrawn at a rate of £1 for every £15 of income (6.7%).

The Pension Commission report shows how individuals on the taper of the WTC can have a relatively good return from pension contributions (Pension Commission, 2004). This analysis takes into account aspects such as the pension management charges that individuals on different income levels might face. However it is far from clear that the level of Government support for private pension saving should depend on the costs of pension saving faced by different individuals. Therefore table 2.2 shows calculations for a similar exercise but focussing purely on the impact of the tax, tax credit and benefit system is on the reward to saving in a private pension relative to that from saving in an ISA.

Table 2.2 shows the size of different individual's pension fund relative to what it would have been had the saving been done in an ISA. For most, but not all, scenarios

[10] The author would like to thank Stuart Adam for assistance with this calculation.

individuals are found to have a higher fund if they had saved in a private pension than if they had saved in an ISA. For example an individual who earned below the UEL but was not in receipt of the WTC and who was a basic rate taxpayer in their retirement would find that their pension fund would be 7.1% larger if they contributed to an SHP or a PP than if they had saved in an ISA. This is entirely the impact of the tax-free lump sum (as discussed in section 2.1). As discussed in section 2.2 employer contributions receive even greater support, with this example individual seeing their fund boosted by 33.0% compared to what it would have been had it been invested in an ISA.

Table 2.2. The impact of the tax, tax credit and benefit system on incentives to save in a private pension relative to an ISA.

Situation when in retirement in bold, and in working life in normal text:	Individual contribution to private pension	Employers pension contribution
Pension credit:		
WTC taper	94.8	142.1
Basic rate taxpayer, below UEL	–10.6	11.5
CTC taper	–0.6	23.5
Basic rate taxpayer, above UEL	–10.3	2.5
Higher rate taxpayer	16.7	33.8
Basic rate taxpayer:		
WTC taper	132.4	188.8
Basic rate taxpayer, below UEL	7.1	33.0
CTC taper	18.6	47.4
Basic rate taxpayer, above UEL	7.1	22.3
Higher rate taxpayer	39.2	59.6
Higher rate taxpayer:		
WTC taper	94.8	142.1
Basic rate taxpayer, below UEL	–10.6	11.5
CTC taper	–0.6	23.5
Basic rate taxpayer, above UEL	–10.3	2.5
Higher rate taxpayer	16.7	33.8

Note: For those individuals in receipt of the Pension Credit in retirement the calculations assume that the tax-free lump sum does not reduce their entitlement to the Pension Credit. This will only be the case if the tax-free lump sum is consumed or is invested in durable goods that are not counted in the asset test. One obvious way in which individuals could achieve this is by investing the tax-free lump sum in owner-occupied housing, perhaps by paying off any outstanding mortgage.

Table 2.2 brings out the fact that among individuals who do not benefit from tax-rate smoothing (which as discussed in section 2.2 is simply paying income tax at the marginal rate applicable when the income is actually consumed) those who are higher rate taxpayers (in both their working age and their retirement) actually receive greater support than those who are basic rate taxpayers (in both their working life and their retirement). For example the former sees individual pension contributions boosted by 16.7% compared to an individual contribution to an ISA whereas the latter sees an increase of 7.1%. It seems difficult to justify why the former contributions should attract greater taxpayer support.

In contrast those basic rate taxpayers not on the WTC taper who expect to be in receipt of the Pension Credit in retirement will find that their fund has a smaller value if invested in a private pension than in an ISA. This is due to the fact that their marginal effective tax rate rises when they retire, and therefore rather than 'tax-rate smoothing' they are 'tax-rate climbing'.

It is also clear that the incentives to save in a pension provided by the tax, tax credit and benefit system are very complicated, which might hinder the extent to which they encourage the marginal saver to increase their pension saving. As argued in the Pension Commission report the extent to which this complexity is a problem will at least in part on the extent to which these incentives are understood by those advising individuals on their pension arrangements.

2.5 The role of contribution limits

Table 2.2 showed that the tax, tax credit and benefit system provides a financial incentive for many individuals to place their retirement savings in a pension rather than in an ISA. However there is also the issue of when individuals might wish to place their retirement saving into a private pension. Under the new contribution limits that come into force all individuals will be able to contribute the maximum of £3,600 (gross) and 100% of their earnings (subject to a cap of £215,000 a year).[11]

An individual who is and expects to remain a basic rate tax payer, not on the taper of the WTC, without access to an employer contribution throughout their life, would probably be best advised to save for their retirement in an ISA until they got closer to retirement. They could then transfer their funds from the ISA into a private pension with no loss of tax relief. This strategy gives them greater flexibility – for example if, perhaps in the light of changes to the generosity of the Pension Credit that they no

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[11] The relatively small number of individuals who accrue a private pension fund worth in excess of £1.5 million will have to pay a recovery charge.

longer wish to place the funds in a pension they have the option of not doing so (in particular given the disincentive to save in a private pension for these individuals that is shown in table 2.2). This could be particularly attractive given the implications of the Government's longstanding aspiration to earnings index the Pension Credit Guarantee while price indexing the Basic State Pension, as discussed in section 2.3. One important risk to this option is that should their earnings fall unexpectedly they could find themselves constrained by a lower pension contribution cap – hence they might not want to leave it too late in their working life before moving the funds into a private pension. (Other risks include the possibility that the pension contribution limits, or the tax regime for either ISAs or new contributions to private pensions, could be changed in the future).

Having only lifetime limits on pension contributions seems very sensible if the Government is not concerned about when individuals chose to place their savings in a private pension. So, for example, the Government might be happy to allow individuals the flexibility to accumulate saving in ISAs and then transfer the funds into private pensions near retirement. This aim is clearly stated in the 2002 Pensions Green Paper.[12] However if this is the case a further potential simplification of the current UK pension system would be for the Government to simply subsidise the purchase of annuities, rather than providing support through the existing tax-free lump sum. This would perhaps seem the most direct way of encouraging individuals to purchase a secure retirement income, since (as discussed in section 2.1) the lump sum which currently attracts taxpayer support does not need to be used to provide a retirement income.

However allowing individuals to move savings into private pensions in the later part of their working life is not without risks. In particular some individuals might not build appropriate levels of funds in liquid assets until it was too late, or alternatively some might decide to consume the funds rather than choosing to purchase an annuity. In which case the large increase in contribution limits that is coming into place in April 2006 could reduce the amounts that individuals eventually contribute to private pensions.

The incentives to save in a private pension that were presented in table 2.2 are further complicated by the increased ability for individuals to choose when to make their private

[12] See paragraph 27, page 39 of Department for Work and Pensions (2002).

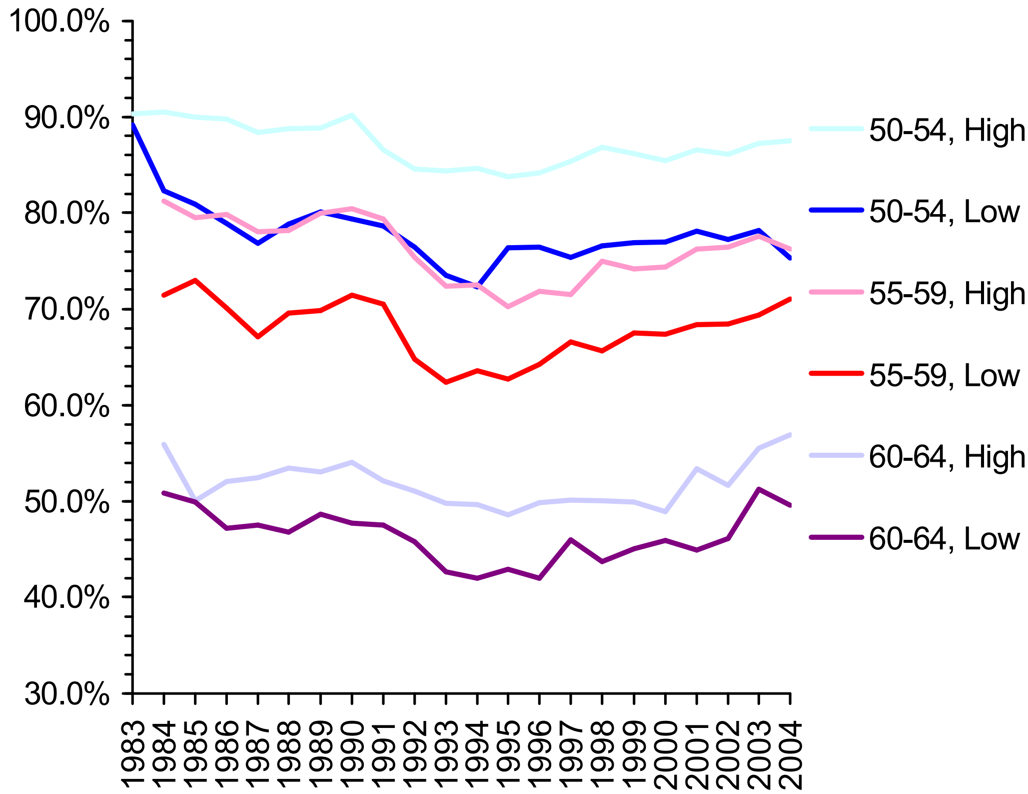
pension contributions. Individuals whose circumstances change during their working lives might be better off choosing to delay contributing to a private pension simply because their contributions will attract greater Government support if made later in their life. For example consider a basic rate taxpayer who is not on the taper of the WTC and who expects to be a basic rate taxpayer in retirement. Should they make an individual contribution to a Stakeholder Pension now they would receive up front tax relief of 22p for every 78p contributed. However if they expect to be either a higher rate taxpayer later in their working life then they would be better of saving in an ISA an making their pension contribution at this point where it would attract relief of 40p on every 60p contributed. Those who were able to delay until they were on the WTC taper would find that they would obtain support at the rate of 59p for every 41p contributed. Hence the greater flexibility over contributions should be expected to lead to some individuals focussing their pension contributions in the years where their marginal rates are highest. Individuals will also need to consider the possibility that marginal rates might be changed in the future – for example current higher rate taxpayers who expected the higher rate of income tax to be cut in the future might decide to contribute to a private pension sooner rather than later. These incentives over the timing of pension contributions potentially complicate an individuals appropriate retirement saving strategy considerably.

3. Incentives to work

3.1 The tax credit and benefit system faced by individuals in retirement

There are a number of reasons why changes to the tax and benefit system that have either occurred already, or will be introduced in the future, might provide greater incentives for older working age individual to retire later. As discussed in section 2.3 the current projections suggest that state spending on transfer payments to pensioners will only increase slightly as a share of national income over the next 50 years despite considerable growth in the number of pensioners. This suggests that many individuals will need increased private pension incomes, which could be boosted by individuals choosing to leave the labour market later. In fact there is some evidence that retirement ages have increased in the last 10 years. Figure 3.1 shows the percentage of men who were employed or self-employed from 1983 to 2004 by age and education from the Labour Force Survey. Employment rates fell for all of these groups between 1984 and 1994. However between 1994 and 2004 all of these groups have experienced an increase in their employment rates.

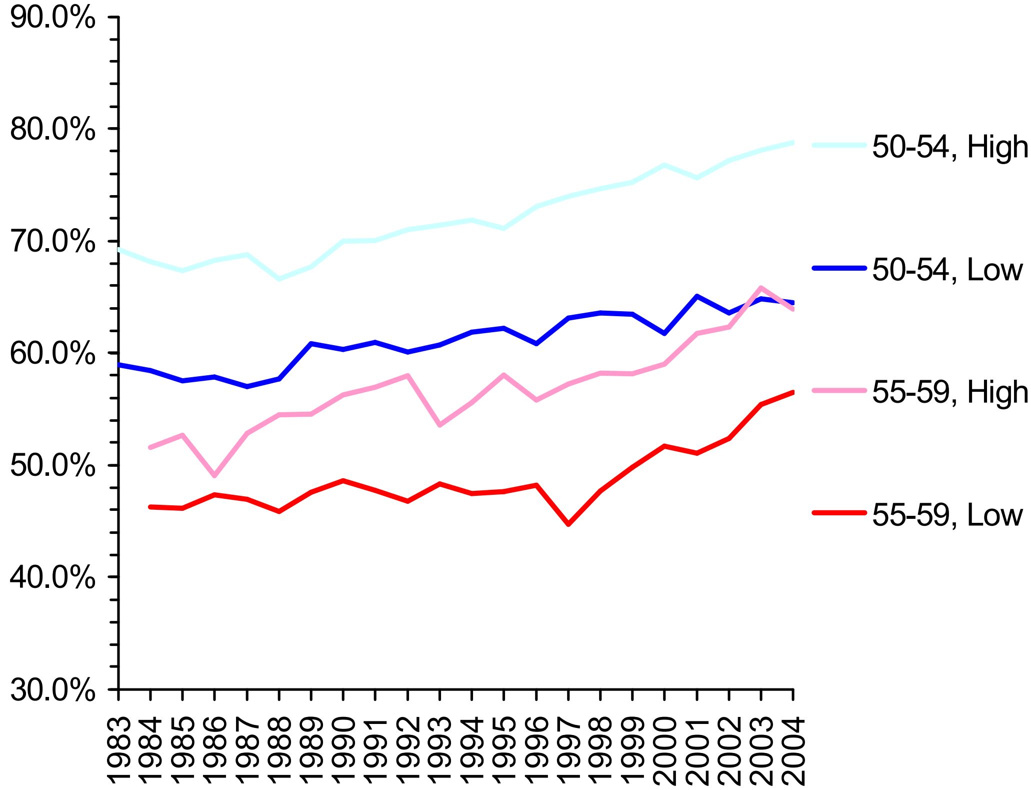
Figure 3.1 Percentage of men employed or self-employed by education and year



Source: Labour Force Survey.

There has been a much clearer upwards trend in the percentage of women in paid employment throughout this period, as shown in figure 3.2. Moreover the State Pension Age for women is set to be increased from 60 in 2010 to 65 by 2020. This will have two direct financial impacts on the employment incentives of those women who are affected. First the reduction in Government expenditure will mean that women might decide to work more in order to limit the fall in their income. Second, potentially offsetting this to some extent, is that women aged 60 to 64 will have to pay employee National Insurance contributions on their earnings which will reduce the rewards from remaining in employment. This increase in the state pension age might also change attitudes towards paid work among employers (or indeed among women themselves) which could also have a positive impact on employment rates.

Figure 3.2 Percentage of women employed or self-employed by education and year

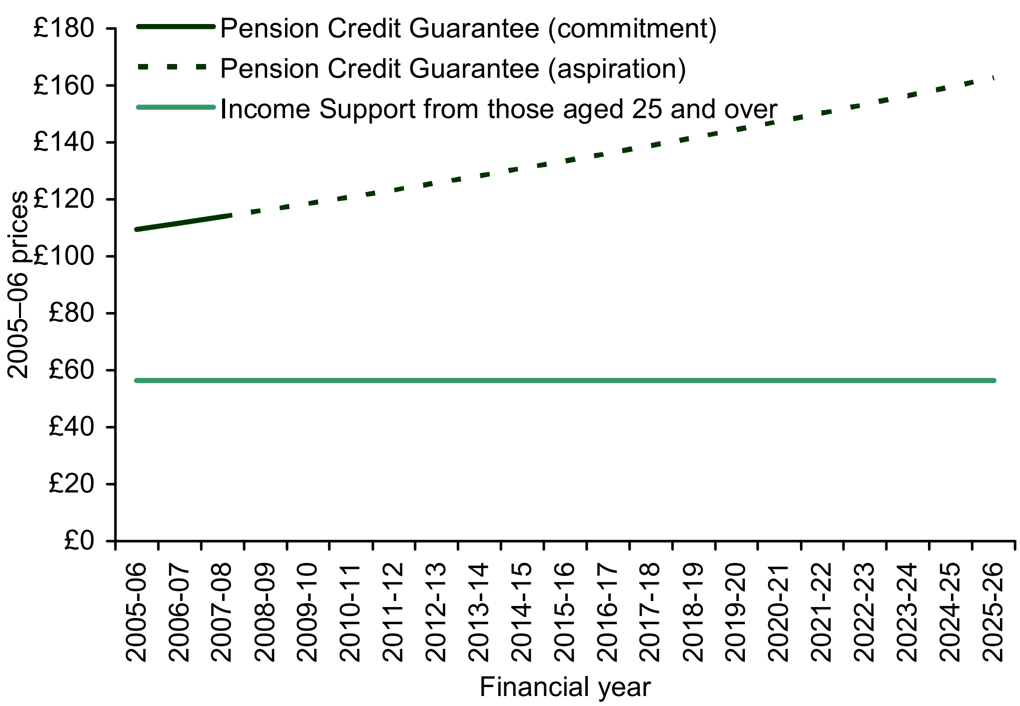


Source: Labour Force Survey.

In terms of the marginal effective tax rates faced by individuals the large increases in the Minimum Income Guarantee seen since April 1999 will have reduced incentives to work. This may have been particularly important for men aged 60 to 64 since despite not being pensioners these are potentially eligible for the MIG which is available to both men and women aged 60 or over. (Though there is no evidence in figure 3.1 that the employment rates of lower educated men aged 60–64 have grown less quickly than, for example, lower educated men aged 55–59 in the period since April 1999). The introduction of the Pension Credit Savings Credit in October 2003 could also have a detrimental impact on work incentives, although it is important to remember that it can only be received by families containing an individual aged 65 or over. Hence any disincentive to work will be limited, although it could still be important for individuals who have an older partner who is aged 65 or over.

The 2002 Green Paper (Department for Work and Pensions, 2002) proposed increasing the age at which individuals can receive the MIG from 60 to 65 between 2010 and 2020 (at the same time as the state pension age for women is set to be increased). In describing this reform the Green Paper states "During the transition and subsequently, both men and women aged between 60 and women's State Pension age will be entitled to the full range of job-search support and benefits available to others of working-age, through Jobcentre Plus." The reform can be expected to unambiguously increase the incentives for men and women aged 60 to 65 to remain in, or enter, paid employment. This is because the benefits to which they could receive would be much less generous, and they would also be subject to the same work search sanctions as younger individuals. In 2005–06 the Pension Credit Guarantee (formerly known as the MIG) is worth up to £109.45 per week while Income Support for those aged 25 or over is worth up to £56.20 a week. Moreover the Government has committed to earnings indexing the Pension Credit Guarantee at least until 2007–08 and has a longstanding aspiration to continue this, while Income Support is only automatically increased each year in line with prices. Figure 3.2 shows that should this indexation strategy be pursed then by 2020–21 the Pension Credit Guarantee would be 2.6 times higher than the level of Income Support for those aged over 25 compared to 1.9 times higher currently.

Figure 3.2 Level of the Pension Credit Guarantee and Income Support for a single person aged 25 or over, assuming price earnings indexation of the former and price indexation of the latter.



Note: Assumes real earnings growth of 2 per cent a year.

The Government's latest pensions green paper (DWP, 2002) did not propose any further increase in the state pension age on the basis that "Raising the State Pension age would impact most heavily on those most dependent on the State Pension. The first priority is to address the employment rates of those approaching 65" and that "it would disproportionately affect lower-income people who rely more on state benefits in retirement". However the increase in the age at which individuals can qualify for the Pension Credit Guarantee only makes lower-income individuals aged between 60 and 64 worse off, whereas increasing the State Pension Age would also affect those on relatively higher incomes. Interestingly the Green Paper does mention the possibility of linking the State Pension Age to the number of years in work. "This could allow those who had been working since school-leaving age to claim their State Pension earlier than those who had stayed in education far longer"[13] Increasing the State Pension Age only for those who had stayed in education beyond the compulsory school leaving age would mean that those on lower lifetime incomes would not lose as much as they would had the state pension age been increased universally.

While a state pension age greater than 65 might be difficult to justify now – in particular given the large proportion of men who have left the labour market before the age of 65 – this might be less clear in the future, particularly if healthy life expectancies continue to increase. In addition it would fit alongside other reforms aimed at extending working lives (as discussed in O'Connell, 2003). If the State Pension Age is to be increased further in the future then the earlier this decision could be announced the better.

From April 2005 the Government has also increased the generosity of incentives for individuals to defer receipt of the state pension. This has been increased from 1% for every seven of deferral to 1% for every five weeks. This should increase the number of individuals choosing to defer the state pension – in particular among those who expect to live for a relatively long time and those who expect to see their marginal tax rate fall in the future (PPI, 2005). It is not necessarily the case that all of these people will work for longer than they would have done if they had not deferred their state pension: individuals can retire before they start drawing state pensions or continue working after they have started to draw them. Some might even choose to retire earlier than they would otherwise have done, since the option of deferring earlier will now allow them to

[13] Department for Work and Pensions (2002).

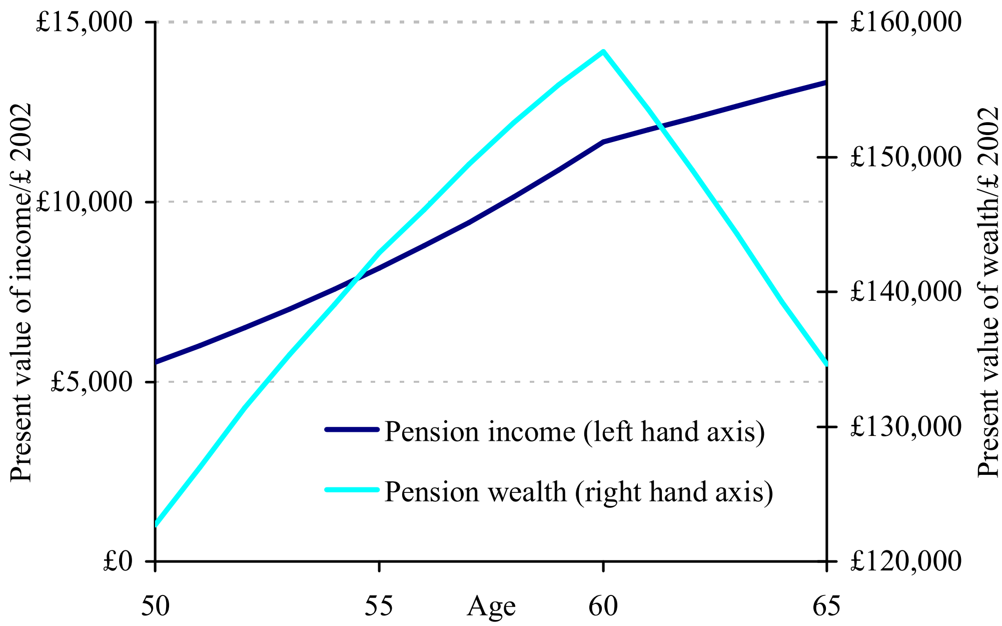
build up a given stock of wealth to fund their retirement by saving less when they are in work (Emmerson and Wakefield, 2003).

Further potential reforms that could improve work incentives relate to the large number of individuals who are in receipt of Incapacity Benefit. In particular the Government is piloting, and has commissioned an evaluation of, the "back to work bonus" which essentially allows Incapacity Benefit receipients to keep part of their benefit for the first 12 months of them re-entering work, and allows them to fall back onto the benefit more easily if they find themselves unable to work. In terms of further improvements to work incentives currently the Working Tax Credit is available from 16 hours of weekly work for families with children but only from 30 hours of weekly work for those without. The Government might want to consider whether the lower 16 hour threshold should also apply to older individuals whose partner is in receipt of incapacity benefit. (However while this would increase incentives to work at all, some individuals currently working 30 hours a week could choose to reduce their hours of work to 16 hours a week).

3.2 Changes to private and public sector pension provision

Potential changes to the generosity and nature of private and public sector pensions might also lead to individuals retiring later. Figure 3.3 highlights why defined benefit pension schemes have typically provided a strong disincentive for individuals to retire later. This shows the level of private pension income, and the level of private pension wealth (calculated as the discounted present value of the income stream) for an individual in a typical final salary pension scheme, by year of retirement. For retirements between age 50 and 60 (which is the assumed normal retirement age) both pension income in retirement and pension wealth increase with age. However for retirements beyond age 60 pension income increases at a slower rate and expected pension wealth actually falls. This provides a strong incentive for individuals to retirement at (or possibly before) the normal retirement age. This decline in pension wealth is caused by the fact that the upwards accrual on the annual pension income is not sufficiently large to compensate for the fact that by retiring one year later the individual will receive their pension for one less year. While this example is for a final salary pension scheme, because the example individual is assumed to have a flat earnings profile (in real terms), the same disincentives for later retirement would exist in a career average scheme (at least for this example individual).

Figure 3.3 - Pension wealth and nominal pension income of a representative individual for retirement between 50 and 65, assuming a 4% reduction applies to pension income for each year he retires before age 60



Note: Example man; joined scheme aged 25; accrual rate = 1/80th; earnings = £20,000 p.a. in 2002 prices; pension income in payment indexed to prices; 4% actuarial reduction for each year the individual retires before the NRA.
Source: Banks, Emmerson and Tetlow (2005).

The disincentive for individuals in final salary pension schemes to retire later will be diminished in the future for at least three reasons:

- First increases in normal pension ages (such as those which were recently proposed by the Government for public sector pension schemes) will shift the kink point to the right and therefore tend to induce individuals to remain in the labour market longer than they would have done.

- Second the shift away from final salary pension schemes towards defined contribution pensions schemes – with the latter tending to offer greater pension accrual at older ages.

- Third the Government is to allow individuals to draw an employers pension while continuing to work for that employer. This will mean that individuals could choose to draw their private pension at the schemes normal retirement age (when pension wealth might peak) but continue to work, possibly part-time.

All of these factors should work to increase the number of older working age individuals in paid employment. The impact on hours worked is, however, ambiguous since allowing individuals to continue to work while drawing their employers pension might lead to some individuals choosing to work part time rather than full time.

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