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Pensions and Savings in the UK

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Outline

- Why an economic policy issue?
- Responding to the ageing population
- Pressures on UK pensions system
- Does system create problems?
- Conceptual framework
- What this suggests about taxing saving
- Theory & evidence on tax breaks for saving
- Conclusions

Why an economic policy issue?

Allocation of scarce resources

- Between consumers in population
- Across an individual's lifetime

Reasons for policy intervention?

- Equity
- Efficiency/market failures
- Paternalism

Why 'hot' policy issue **now**?

Ageing population

- Financial pressure on (state) provision
- Ensure elderly get adequate resources

Ageing Population

Elderly Dependency Ratios

Country	1990	2000	2020	2050
France	21.3	24.5	32.7	46.7
Germany	21.7	24.1	34.4	54.7
Italy	22.3	26.7	36.8	68.1
Japan	17.2	25.2	46.9	71.3
UK	24.1	24.1	31.1	47.3
US	18.9	18.6	25.0	34.9

Source: OECD.

Projected spending

Projected pension spending (% of GDP)

Country	2000	2010	2020	2030
France	9.8	9.7	11.6	13.5
Germany	11.5	11.8	12.3	16.5
Italy	12.6	13.2	15.3	20.3
Japan	7.5	9.6	12.4	13.4
UK	4.5	5.2	5.1	5.5
US	4.2	4.5	5.2	6.6

Source: Disney & Johnson (2001).

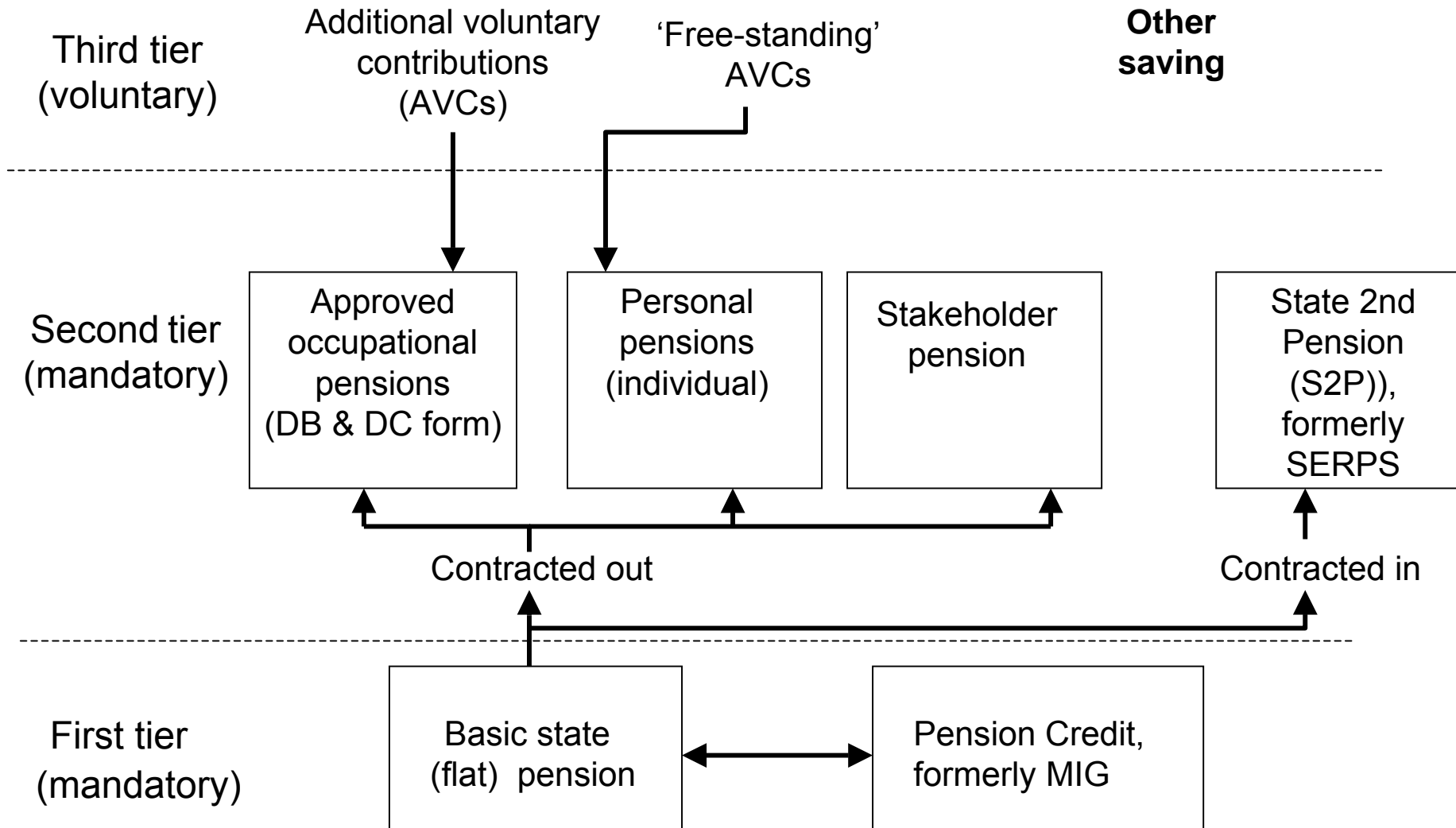
Pressures: Responses

- Increase pension age
- Reduce generosity of indexation
- Reduce generosity of benefit calculation
- Increased private (funded) provision

UK has done all four

The UK Pension system, 2004/5

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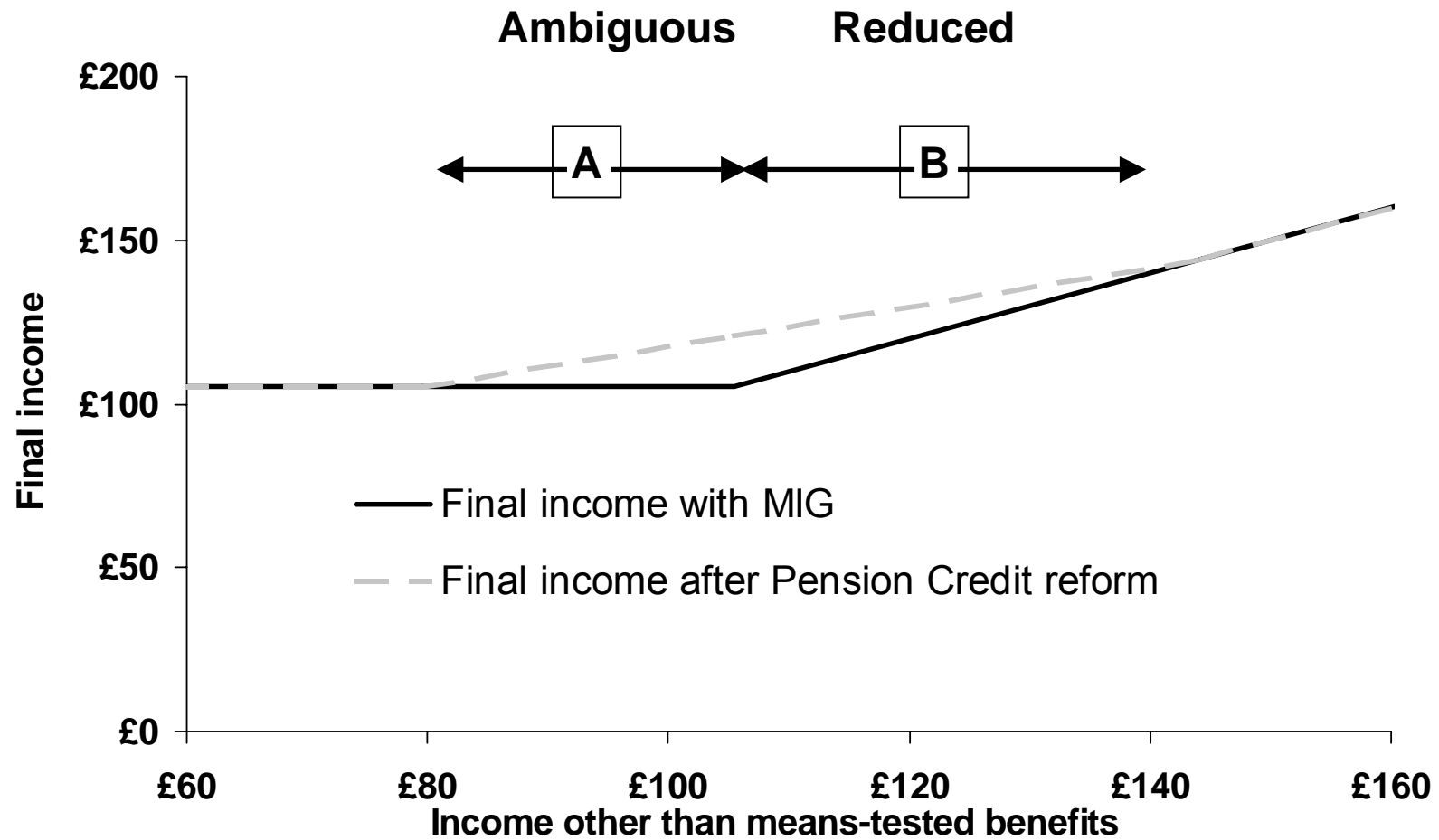
Reforms

- 1981: Price index BSP
- 1988: Personal Pensions
- 2000: SERPs generosity reduced (1986/1990 legislation, both halved SERPs generosity, reforms to be phased in)
- 2001: Formal introd. of Stakeholder pensions
- 2002: State Second Pension (S2P)
- 2003: Pension Credit
- ?2007? S2P made into flat-rate benefit
- 2010-20: Retirement age for women to 65

Ongoing reform debate: Pensions Commission

- Reforms from 2002 GP still in process
- To look at “whether there is a case for moving beyond the current voluntarist approach” to ensure pension adequacy
- 1st report Autumn 2004
 - 9-12 million not providing enough for retirement
 - In line with GP
 - Combinations of saving, working and retiring poorer that might fill the gap
- Policy assessments Autumn 2005, but did raise incentive effects of Pension Credit

Pension credit and incentives



Pension credit and incentives: Responses

- Conservatives
 - Do not let gap between BSP and PCG grow larger
 - In long run reduce it?
- Liberal Democrats
 - A citizen's pension, initially for over 75s
- Also SNP
- Labour
 - Wait for Pension Commission

Conceptual Framework

- Lifecycle model
- Consumption (& saving) depend on:
 - total resources; prices (interest rate); preferences
- Save to facilitate **consumption smoothing**
- Also smooth through labour supply

The Taxation of Saving

Three points at which savings could be taxed:

- Initial deposits (tax on earnings)
- Returns on investment (tax on interest/ capital gains)
- Withdrawals (tax on withdrawals)

Regimes

- “Comprehensive income tax”: TTE (or ETT)
- “Comprehensive expend. tax”: EET or TEE

The Taxation of Savings in UK

- Interest bearing accounts: Taxed, Taxed, Exempt (TTE)
- Private Pensions (EET(E))
- ISAs (TESSAs & PEPS) (TEE)
- A tax perk for the rich?
- More help for the poor: a Saving Gateway?

A Saving Gateway?

Matched savings vehicle to lower-income adults

- Correct disincentives from benefit withdrawal
- Correct low savings due to lack of knowledge/habit

Problems

- Targeting: those who already save
- Targeting: those with good reasons not to save
- Borrow to 'save'

A tax regime to encourage saving?

- Big policy and academic debate:
 - How best to encourage saving
- Cut tax on returns?
 - TTE to TEE or EET: Latter regimes induce higher saving?
- Change increases effective interest rate (r)
 - **Substitution Effect**: saving £1 buys more future consumption: encourages saving
 - **Income Effect**: Same wealth for less saving: discourages saving
- So theoretically **ambiguous**: Empirical evidence?

Attanasio/DeLeire (1) Background & Theory

- Consider IRAs in USA
- Tax relief on returns (EET)
 - effective (r) increase
- Stylised 4 period theoretical model
 - Show effect on saving of r up is ambiguous (competing **subs.**, **income** and **wealth** effects)
 - Which dominates depends on IES
 - **If** policy is to increase saving, **new contributors** must have a **drop in consumption** change
 - Whether unexpected or anticipated

Attanasio/DeLeire (2)

Empirical strategy

- Use panel data on consumption
- Compare new and continuing contributors
- Do new contributors show smaller consumption change?
 - $\Delta C_i = \beta X_i + \gamma d(new)_i + \varepsilon_i$
 - Test for γ different from zero
 - Null hypothesis – No new saving
- Robustness checks regressions for (non-IRA) saving

Attanasio/Deleire (3)

Results

- Find **no robust evidence** that households reduce consumption when open IRA
- At most, 9% of total contributions of new contributors in period might have been new saving
 - Remainder reshuffling and tax loss (public debt)
 - Could 9% be enough to justify programme?
- Theory neatly informing empirics
- But note, other papers offer different finding!

Lessons for the UK?

- Less good data in UK
- Aggregate evidence on TESSAs
- Descriptive micro-evidence on ISAs
 - Consider alongside US evidence and theory:
policies unlikely to have created much new saving
- So comprehensive income tax after all?
 - Small behavioural change, small welfare effect?
 - Even small new saving could tip CBA
 - Worry that people save too little

Conclusions

- Ageing population, pressure on pensions
- UK system: complex and ongoing reforms
- Will people have adequate resources?
- Lifecycle framework for thinking about:
 - whether people are saving enough
 - how they will respond to policies
- Tax cuts on return
 - theoretical effect ambiguous
 - empirically effects seem small
- Still need strong justification for policies that could discourage saving

READINGS

Background: Facts and Figures

UK focus.

Banks, Blundell, Disney and Emmerson, (2002), *Retirement, Saving and the Adequacy of Saving: A Guide to the Debate*, IFS Briefing Note 29:

<http://www.ifs.org.uk/pensions/bn29.pdf>

Banks and Tanner (1999) *Household saving in the UK*, IFS report.

International:

Disney and Johnson (2001), *Pension Systems and Retirement Incomes across OECD Countries*: Edward Elgar.

Bateman, Kingston and Piggott (2001) *Forced Saving: Mandating Private Retirement Incomes*, Cambridge University Press.

Moderately up to date international evidence:

OECD web site (click on the Ageing Society link): <http://www.oecd.org>

World Bank pensions and pension reform web site:

<http://www.worldbank.org/pensions>

Taxation regimes for saving

Banks and Tanner (1999) *Household saving in the UK*, IFS report

Bateman, Kingston and Piggott (2001) (see above for full reference).

Options for reform: Private funding as the solution?

Disney (2000), 'Crises in Public Pension Programmes in the OECD: What are the reform options?', *Economic Journal Features*, pp.F1-F23.

Feldstein (1996), 'The missing piece of policy analysis: Social Security Reform', *American Economic Review, Papers and Proceedings*, vol 86 (May), pp.1-14.

Bateman, Kingston and Piggott (2001) (see above for full reference - focus is on how to implement private mandatory pension saving).

Asset-based welfare/ the Saving Gateway.

Emmerson and Wakefield, (2003) "Increasing support for those on lower-incomes: Is the Saving Gateway the best policy response?" *Fiscal Studies*, 24(2) pp.167-195.

Empirical evidence on tax 'incentives' to save

Attanasio, O., and T. DeLeire (July 2002), 'The effect of Individual retirement accounts on household consumption and national saving', *Economic Journal* 112, pp. 504-538

Attanasio, O., J. Banks and M. Wakefield (2004), *Effectiveness of tax incentives to boost retirement saving: Theoretical motivation and empirical evidence*, IFS Working Paper 04/33, <http://www.ifs.org.uk/wps/wp0433.pdf> (a version of this paper forthcoming in *OECD Economic Studies*).