Retirement saving incentives: what is the impact of taxes, tax credits and the pension credit?

New IFS research published today and jointly funded by the Department for Work and Pensions and the Economic and Social Research Council, examines what is known about how the tax and benefit system influences retirement saving decisions. The report highlights that many individuals have an incentive to accumulate private pension funds prior to retirement and that some of these individuals face very strong incentives to make their pension contributions at particular times during their working lives.

The new tax credits may have an important role in affecting decisions about the timing of contributions to private pensions. Those who are on the taper of these tax credits have a relatively strong incentive to place funds in a private pension since for each 41p that they place in a private pension the Government effectively contributes a further 59p. This is more generous than the up-front relief available to higher rate taxpayers, and the research shows that there are currently more people eligible to be on the taper of the new tax credits than there are higher rate taxpayers. Those who are basic rate taxpayers who expect to move onto this taper in the future have an incentive to delay moving savings into a private pension until their circumstances have changed. Conversely those currently on this taper have an incentive to bring forward planned pension contributions. While we find little evidence that people are already taking advantage of this, the scope to do this will increase under the new pension tax arrangements that come into force on 6th April 2006.

Commenting on the research Matthew Wakefield, a senior research economist at the Institute for Fiscal Studies, and one of the authors of the report, said “The new pensions tax regime, combined with the new tax credits, provides many individuals with a strong incentive to place their retirement income into a pension at certain times in their lifetime. What is not yet clear is how many individuals will respond in this way.”

The research also summarises evidence from other reforms on how individual behaviour might adjust to changing retirement saving incentives and presents new evidence on the relative sizes of the groups whose retirement saving incentives are boosted or diminished by the pension credit. The main conclusions are as follows:

- When examining retirement saving it is important to consider both saving decisions and the choice of retirement age. We cite previous evidence that individuals tend to change saving behaviour and retirement date in the light of changed financial incentives. In particular there is evidence that spending by working age individuals increased in the light of the introduction of the State Earnings-Related Pension Scheme although there is no conclusive evidence that spending by working age individuals fell as a result of cuts to the Basic State Pension. In addition evidence from West Germany and the United
States shows that individuals’ retirement ages can be affected substantially by changing financial incentives.

- Examining the implications of the Pension Credit reform we find that many single pensioners will see an unambiguous increase in the incentive to increase their private retirement income – for example through increased saving or later retirement. There are still large numbers of single pensioners who see a reduction in the incentive to increase their retirement income, the majority of whom have private income which they might decide to reduce. Fewer individuals in pensioner couples are eligible for the Pension Credit. Despite this we find that a similar proportion faces a reduced incentive to acquire greater income as we did for single pensioners.

- If the expectations of individuals do not reflect the current rules of the system, then we cannot expect to observe responses fully in line with economic theory that is predicated on full information. Recent evidence from the English Longitudinal Study of Ageing suggests that on average individuals underestimate their longevity and overestimate the private pension income that they can expect to receive. On the other hand, expectations of being in paid employment at older ages are, on average, similar to the current proportions of older individuals who are in paid work and individuals’ expectations of remaining in the labour market at older ages appear to square up with the marginal financial incentives to remain in work that are created by different types of pension scheme.

- New evidence from the English Longitudinal Study of Ageing shows that low and high wealth individuals are the most likely to be out of the labour market prior to the State Pension Age, though often for very different stated reasons. Those with low incomes throughout their working lives have limited scope to increase the amount that they save each year and so if the retirement incomes of this low wealth group are to be increased then this is likely to involve longer working lives.

Carl Emmerson, a deputy director at the Institute for Fiscal Studies, emphasised this finding “It is low and high wealth individuals who are more likely to exit the labour market before they reach the state pension age. Should any trends or reforms persuade low wealth individuals to boost their retirement incomes, then they might have to do this by delaying their retirement rather than by saving more out of their typically low incomes.”

ENDS

Notes to editors:
1. The first (37%) taper of the Working Tax Credit / Child Tax Credit (WTC/CTC).
3. Financial support from the Department for Work and Pensions, and co-funding from the ESRC-funded Centre for the Microeconomic Analysis of Public Policy at IFS (grant number M535255111), is gratefully acknowledged.