

RECENT PENSIONS POLICY AND THE PENSION CREDIT

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A. The overall picture

In the November 2000 Pre-Budget Report, the government announced a major range of measures for pensioners. Some come into operation in April 2001, while others follow in 2002 and 2003. The most important aspects of the package comprised: above-inflation increases in the retirement pension; substantially above-inflation increases in the means-tested minimum income guarantee (MIG); and the introduction of a new element into the means-tested benefit system for pensioners, known as the pension credit. Overall, the package means the government will pay over £4 billion a year extra to pensioners (2000 prices) by 2003–04. It represents a very substantial redistribution in favour of pensioners, and particularly those on low incomes.

This paper, first, costs the various elements of the government's proposals and analyses who will gain from them. Second, it focuses in on the structural pension credit reform, explaining its rationale and basic workings before outlining the design issues it raises. Finally, it concludes by asking what this package of measures indicates about the longer-term strategy underlying pensions policy.

1. How the money will be spent

As certain details of the proposed reforms are not yet determined, costing them requires assumptions. The government must decide how – if at all – its package will reform housing and council tax benefits. It also needs to decide how to modify its proposals to meet its pledge to avoid creating losers. These are both pension credit design issues that will be dealt with in depth in Section B. But in this section we assume the simplest reform possible. In particular, we assume that 'needs' in housing benefit – the income allowed before withdrawal of benefit begins – remains, as now, pinned to the level of the MIG. We also assume that, once the capital rules are replaced with an income test, there will continue to be no disregard for unearned income, even though this would mean creating some losers. Overall, our baseline assumptions represent the cheapest way in which the pension credit could be introduced. We have also assumed full take-up of benefit entitlement throughout.

Table 1 shows how the substantial increase in spending is split between different types of measure and between that coming into effect immediately and that being phased in over the next two years.

Table 1: How the extra money will be spent

<i>Part of tax–benefit system</i>	<i>Immediate cost (£ million)</i>	<i>Extra cost from 2003 (£ million)</i>
Basic state pension	1,190	1,690
Winter fuel payment	375	—
Means-tested benefits	1,140	2,575
Extra tax revenue	80	25
Net total exchequer cost	2,625	4,240

Note: All costings in 2000 prices.

Source: IFS tax and benefit model, TAXBEN, run on 1998–99 Family Resources Survey.

Most spending in the April 2001 package is through benefits that are not income-tested – the winter fuel payment and the basic state pension. But around 45% goes on increasing means-tested benefits. The extra tax revenue that is netted off the exchequer cost arises because the increased basic state pension is taxable for better-off pensioners.

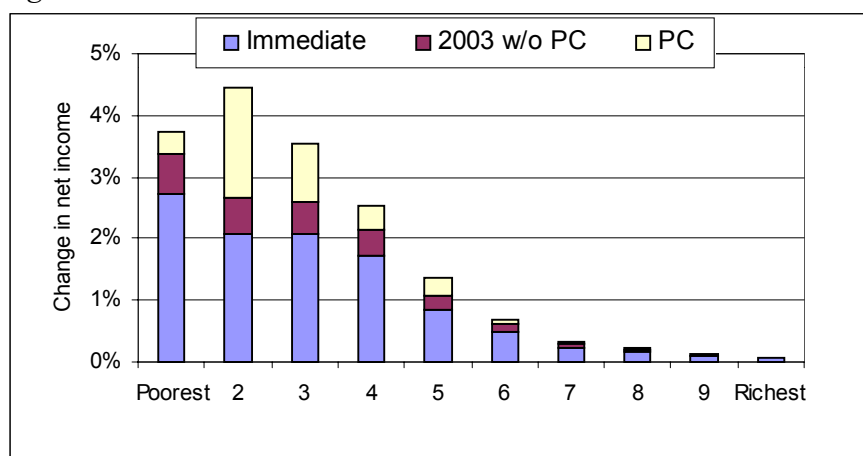
By 2003, the balance of spending has changed: 60% of the total cost arises through extra means-tested benefit expenditure. Pensioner entitlement to these benefits is set to rise by £2.5 billion (2000 prices) relative to current entitlement. This reflects two things –the projected real-terms increases in the MIG and the introduction of the pension credit.

Spending on other benefits will also rise, but by less. Real-terms spending on the basic pension will increase by another £500 million – reflecting the increase planned for 2002 – but spending on the winter fuel allowance is set to fall back, as the increase in winter 2000–01 is for one year only. (Indeed, this scores in the government’s accounts for fiscal 2000–01, not 2001–02.) Finally, the amount of tax revenue raised falls back, as the government plans to increase pensioner tax allowances in real terms.

2. Distributional effect

The effects of these measures on the overall income distribution are strongly progressive. Figure 1 breaks them down into three elements: first, the changes due with effect from April 2001; second, the changes due with effect from April 2003 *excluding* the structural change required to introduce the pension credit; and third, the effect of those structural changes themselves. The pattern of these results is not just determined by the nature of the reforms. It also reflects the fact that pensioners are predominantly found in the lower to middle deciles of the income distribution, so that is where the gains are concentrated. This graph is uninformative about whether richer or poorer pensioners are gaining.

Figure 1: Gains across the overall income distribution



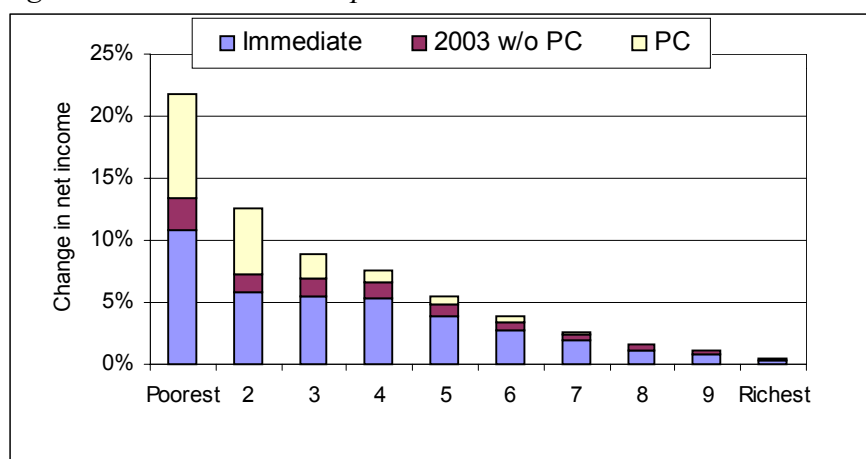
Note: PC = pension credit.

Source: IFS tax and benefit model, TAXBEN, run on 1998–99 Family Resources Survey.

In contrast, Figure 2 attempts to shed light on this. It is drawn for income deciles made up exclusively of families where at least one person is aged 60 or over. In

contrast to Figure 1, it is notable that the biggest impact is in the very poorest decile. This is most likely because pensioners are under-represented at the very bottom of the whole-population income distribution because of the more generous benefits that they already enjoy. So focusing on pensioners in isolation brings out the progressivity of the package even more starkly. Even the ‘immediate’ changes, which are largely non-targeted, are strongly progressive. This is because, although increases in the basic state pension and the winter fuel allowance are universal, as flat-rate increases they are worth more in proportional terms to poorer pensioners.

Figure 2: Gains across the pensioner income distribution



Note: PC = pension credit.

Source: IFS tax and benefit model, TAXBEN, run on 1998–99 Family Resources Survey.

Figure 2 also makes very clear the big percentage increases in pensioner incomes that the package should deliver. The poorest pensioner decile will see net income rise by an average 22% and those of each of the lowest five deciles will rise by more than 5%.¹

Table 2: Average weekly gain from all measures to 2003

Reforms	Single pensioner	Pensioner couple
In April 2001	£6.47	£6.67
April 2001–2003 excluding pension credit	£1.32	£2.18
Pension credit	£1.89	£2.20
Total	£9.68	£11.05

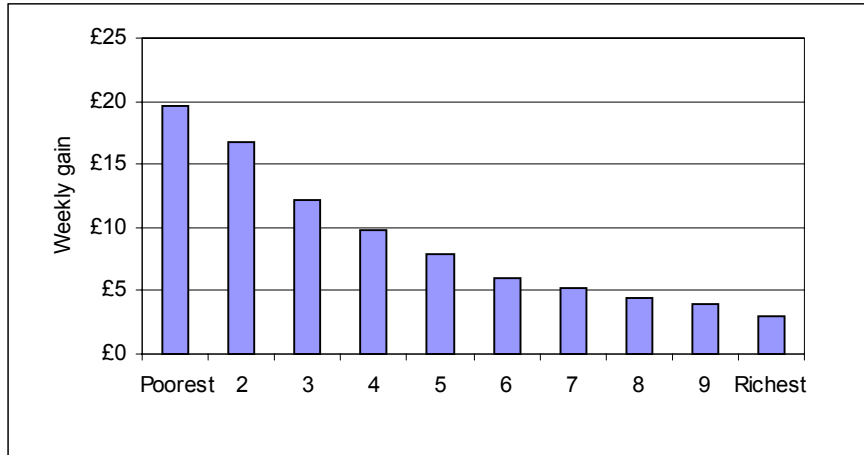
Source: IFS tax and benefit model, TAXBEN, run on 1998–99 Family Resources Survey.

Table 2 shows what these large proportional changes mean, on average, in cash terms to pensioner families. From the package as a whole, the average single pensioner stands to gain £9.68 per week, while the average couple should be better off by £11.05 per week.

¹ The particularly large increase in the bottom decile owing to the pension credit reform seems surprising – the credit is aimed at those pensioners just above the bottom with modest private incomes. It is, in fact, the product of the changes to the capital rules – 15% of those in the bottom pensioner decile have savings of over £12,000, and pre-reform they therefore had zero entitlement. For them, the average gains are very big, some £44 on average.

Figure 3 shows how average cash gains vary between pensioners living at different points on the overall (i.e. including non-pensioners) income distribution. It shows that there are significant gains for pensioners even at income levels that are high by the standards of the population overall.

Figure 3: Average cash gains to pensioners at different income levels



Source: IFS tax and benefit model, TAXBEN, run on 1998–99 Family Resources Survey.

All results given have been on the basis of full take-up. The DSS estimates that up to a third of pensioners entitled to means-tested benefits do not receive them.² Critics of the policy of extending means testing would point to this as implying that the reforms will deliver less generous results in practice than in theory.

² Department of Social Security, *Income-Related Benefits: Estimates of Take-Up in 1998/99, 2000*, available from DSS website: www.dss.gov.uk.

B. The pension credit: rationale and design issues

1. Why is the pension credit being introduced?

The pension credit represents a major restructuring of targeted support for pensioners. Its aim is to address perceived shortcomings in the current system. So to understand its intended purpose, it is necessary to grasp the existing structure of benefits for pensioners.

The majority of pensioners currently receive the flat-rate basic state pension. This is a contributory benefit paid to all those with sufficient National Insurance credits, regardless of their financial circumstances. In April 2003, the basic state pension is projected to stand at about £77 per week for single people and around £124 for couples.³ Since the early 1980s, the pension has generally been indexed only in line with prices, so it has fallen behind earnings and thus provides for a standard of living that is increasingly meagre in relative terms. For this reason, the current government and, to a lesser extent, its predecessors have targeted extra resources to pensioners who would otherwise have had to survive on the basic pension alone. This has been achieved by increasing benefits that provide an income 'safety net' - the MIG and its predecessor, income support.

The MIG is to be set at £100 (£154 for couples) from April 2003. This means a single person whose only other income is a full basic state pension will receive £23 (the guaranteed minimum minus the basic pension). Those with very small private incomes, which even when added to their basic pension leave them on less than the MIG, also have their income 'topped up' to exactly the level of the MIG by the current system. It is the system's treatment of just such individuals that has come in for criticism: each extra £1 of private income that they have accrued simply reduces by £1 the amount of 'topping-up' that the MIG offers them. Their final income is left no higher than it would be without any private income.

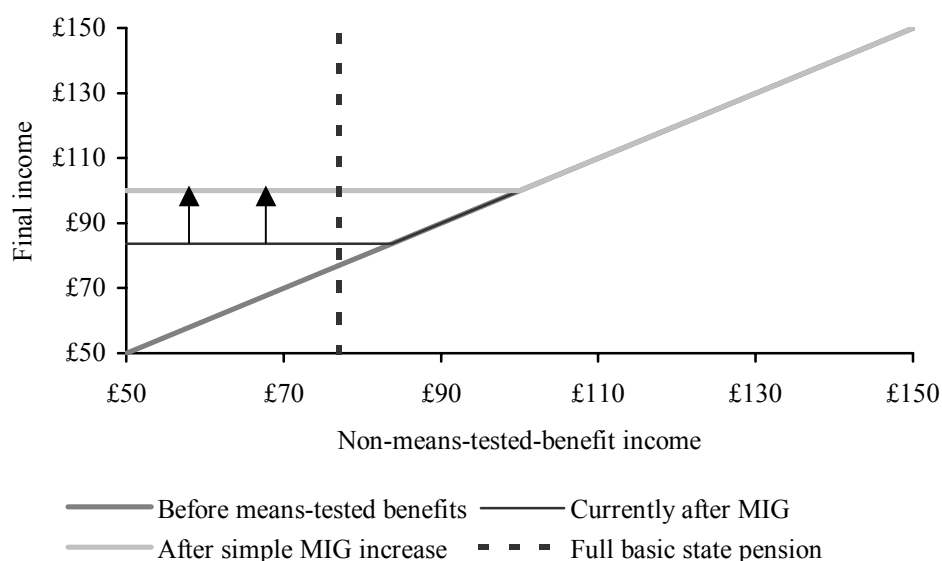
Figure 4 shows how the MIG system works for an illustrative 65-year-old. Until pre-means-tested benefit income reaches the level of the MIG, it has no effect on final income. Even with the MIG at its base level (the price-indexed 2000–01 figure), one's original income must exceed the full basic pension before it has any impact on living standards. The chart also shows the effect of the planned increase in the MIG for such an individual. The guaranteed minimum income will rise substantially, from £83.75 to £100. But this also means that pre-means-tested-benefit income would need to exceed £100 before it had any impact on living standards.

In years after 2003, the government hopes the MIG will rise with earnings, whereas the basic pension looks set to continue to rise with prices only. The growing gap between the two means ever-more people will find their income inadequate to float them out of MIG entitlement. The government's strategy of increasing the generosity

³ Precise figures will depend on the inflation rate. The couple rate applies where one partner is without a full National Insurance contribution record. If both have full records, they receive twice the single rate. Where one record is partial, the couple receives whichever is the greater of the couple rate and the sum of their individual entitlements.

of the MIG, then, means that, without structural reform, ever-more people would reap no reward from having amassed more private income.

Figure 4: Illustrative budget constraint under the MIG



Notes: All incomes in projected 2003 prices. Taxation and other means-tested benefits ignored. Income disregards also ignored.

Two particular concerns arise from this. First, it is felt to be unfair: those who have saved should be rewarded for their thrift. Second, it undermines the incentive of those expecting to be on a low income in retirement to save. An individual who foresees that they will not benefit from the modest amount that they can realistically expect to save is surely likely to decide that they may as well not save at all. Besides being an attitude that in-and-of-itself the government is unlikely to want to encourage, it also risks increasing welfare bills by increasing the numbers with zero savings, who require the maximal assistance from the MIG. The pension credit represents the government's attempt to deal with these concerns by reforming the benefit system to ensure that pensioners will always benefit from possession of private income.

Additional problems with the current system are seen in the process of means testing itself. The complex system of assessment means that anyone wishing to claim the MIG has to complete long, arguably intrusive forms. A particular concern is that this process, whether as a result of stigma or as a result of hassle, puts large numbers of pensioners off claiming their benefit entitlement entirely. The DSS estimates that between 19% and 32% of pensioner families with entitlement to income support (the former name for the MIG) failed to claim their entitlement.⁴ The government argues that the new pension credit system will improve on this state of affairs, by simplifying the claims process.

⁴ Department of Social Security, *Income-Related Benefits: Estimates of Take-Up in 1998/99, 2000*, available from DSS website: www.dss.gov.uk.

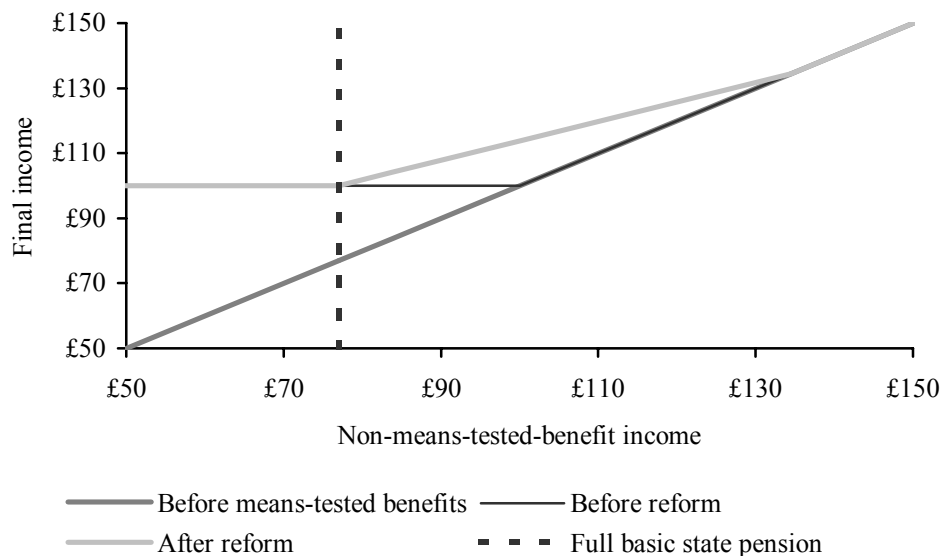
2. How will the pension credit work?

The government has already outlined the basic way in which it intends the pension credit to work from its start date of April 2003.⁵ Treatment is described differently for pensioners with incomes (before means-tested benefits) that are above and below the MIG:

- For people with (pre-means-tested-benefit) incomes below the MIG, each £1 of income possessed over and above that provided by a full state pension leads to a 60p increase in the income level that the pension credit tops up to.
- For those with (pre-means-tested-benefit) incomes above the MIG, each extra £1 of income possessed reduces pension credit entitlement by 40p until pension credit entitlement is exhausted. (Under the current system, these pensioners receive no help from the MIG).

But, in practice, for both groups, possession of an extra £1 of private income leaves a pensioner 60p better off than they would have been without it. Figure 5 illustrates for an example single pensioner. Whereas before the reform each £1 of private income immediately above the basic pension left final income unchanged, afterwards each £1 increases final income by 60p; i.e. abstracting, for now, from taxes and other means-tested benefits, the effective marginal tax rate implied by the pension credit will thus be 40%, compared with the 100% rate that the MIG currently imposes.⁶ This 40% withdrawal continues until all entitlement is exhausted at around £135 per week. The chart shows that the lower withdrawal rate means single pensioners with non-means-tested-benefit income of anywhere between £77 and £135 will gain.

Figure 5: Effect of pension credit on single person's budget constraint



Notes: All incomes in projected 2003 prices. Taxation and other means-tested benefits ignored. Income disregards also ignored.

⁵ Department of Social Security, *The Pension Credit: A Consultation Paper*, Cm. 4900, The Stationery Office, 2000.

⁶ This is true of unearned income. The MIG disregard means that the first few pounds (standardly, £5 for a single person and £10 for a couple) of earnings are exempt from the 100% withdrawal rate.

Although the scheme sounds simple, a number of important details of how it will work in practice have yet to be worked out. Some of them will necessitate difficult choices, which threaten to undermine delivery of the aims of the reform, for some individuals at least. We now turn to these issues.

3. Interaction with other benefits

A major aim of the pension credit is to make saving more attractive by reducing the 100% effective tax rate that current MIG recipients face on income above the basic pension. But the reform's success in delivering this end will depend crucially on how the pension credit interacts with other benefits received by those entitled. In particular, interactions with the rest of the means-tested benefit system and with the basic pension are important.

The reduced 40% benefit withdrawal rate applies only to income above the basic pension. So anyone with a pre-means-tested-benefit income below the basic state pension will continue to face a marginal rate of 100%.

Potential interactions with means-tested benefits are more complex. Besides the MIG, the benefits system entitles many poorer pensioners to additional means-tested help to meet specific costs through housing and council tax benefits. For those currently receiving MIG, housing benefit awards full payment of rent, while council tax is also fully rebated.⁷ For those with slightly higher incomes (people who receive no help from the MIG under the current system), benefit is tapered away, proportionately with income. For each £1 of income possessed above the MIG, 65p in housing benefit and 20p in local tax rebate is lost.

Table 3: Effect of structural changes in April 2003

<i>Benefit</i>	<i>Cost (£ million)</i>
MIG / pension credit	1,350
Housing benefit	-270
Council tax benefit	-120
Net total exchequer cost	960

Note: All costings in 2000 prices.

Source: IFS tax and benefit model, TAXBEN, run on 1998–99 Family Resources Survey.

This means that if the pension credit is introduced without simultaneous changes in the rules to these benefits – which is our baseline assumption for estimating costs – a large proportion of the gains that certain individuals stand to make from it will be forgone in reduced entitlement to these other benefits. This comes across clearly in the breakdown of changes in means-tested benefit expenditure under our baseline assumption of no changes to these benefits. Table 3 shows that if the pension credit were introduced in this way, about a third of the extra MIG spending arising from the

⁷ Some of those with especially high rent or local taxes are ineligible to have the liability met in full. The maximum rent that housing benefit covers is capped by the 'rent restriction rules', while council tax benefit offers less than a 100% local tax rebate to residents in a house placed in council tax band F, G or H.

structural reform would be ‘clawed back’ in lost entitlement to housing and council tax benefits.

Potentially, this ‘clawback’ could undermine the aim of making saving more attractive. For its corollary is that some of those with modest private amounts of savings continue to face high effective marginal tax rates. If the amount of income allowed before withdrawal of housing and council tax benefits begins remains at the level of the MIG, then any pension credit recipient with any income above a full basic state pension who:

- receives council tax benefit will face an effective marginal tax rate of 52%;
- receives housing benefit will face an effective marginal tax rate of 79%;
- receives both housing benefit and council tax benefit will face an effective marginal tax rate of 91%.

For current MIG recipients on housing benefit, then, the reward to saving an extra £1 would remain modest. While this group would see only a modest decline in its effective marginal rates, others would actually see theirs increase. As Figure 5 showed, pensioners whose incomes are currently just sufficient to prevent MIG entitlement will be awarded pension credit. The inevitable consequence is that they will also be exposed, for the first time, to the increase in marginal tax rate produced by the benefit’s withdrawal.

How important are all these interactions, and what do they mean for the overall effect of the reform on pensioners’ marginal tax rates? Table 4 answers these questions by showing the number of pensioners in various bands of effective tax rate.

Table 4: Numbers (thousands) in pensioner families with high effective marginal rates

<i>Marginal rate</i>	<i>Before all reforms</i>	<i>2003 system without the pension credit</i>	<i>Full 2003 system</i>
100%	2,600	3,220	980
80%–99%	850	710	1,840
65%–80%	40	40	60
50%–65%	180	140	2,550
Total over 80%	3,450	3,930	2,820
Total over 50%	3,670	4,110	5,430

Notes: Marginal rates are calculated specifically for unearned, non-capital income (e.g. private pensions). Table includes all adults in families with someone aged 60 or over.

Source: IFS tax and benefit model, TAXBEN, run on 1998–99 Family Resources Survey.

In spite of the potential problem of people with incomes below the basic state pension, it is clear that the pension credit will sharply reduce the numbers on a 100% taper, from over 2.5 million today to less than 1 million in April 2003. The importance of this is all the greater because the planned MIG increase would otherwise have substantially increased the numbers on a 100% taper.

Additional considerations underline the significance of the large numbers whose marginal tax rate has fallen from 100%. First, almost half of those the table shows as

facing a 100% rate will do so only because they are not yet in receipt of their full pension entitlement: either men of between 60 and 65, or couples where one partner remains below pensionable age. For these people, the attractiveness of saving for retirement will principally depend not on this temporary marginal rate, but on the marginal rate that will arise on retirement. Of the half million fully retired pensioners affected, a significant proportion are just slightly short of a full state pension, so the 100% marginal rate would only apply over a small income range. Finally, for the remaining group, the introduction of modest unearned income disregards would exempt the first few pounds of private income from the means test altogether, reducing the marginal rate to 0%. Such disregards are likely to form part of the final reform, as the government wishes to avoid creating losers. (See subsection 4 below.)

So, the numbers facing a 100% marginal rate will be reduced very sharply. To the extent that the policy aim is limited to reducing the large number for whom an extra £1 of private income makes no difference at all, the reform works well without additional modification.

On the other hand, the numbers on very high marginal rates (above 80%) under 100% will increase fairly sharply, suggesting large numbers of those seeing their marginal rate fall from 100% will experience only a modest reduction. There will be 2.8 million pensioners left with marginal rates above 80% but under 100%. The government may regard this as an unacceptably large group of people to be facing such high marginal rates. If so, it would need to consider modifying the ‘baseline’ reform, somehow making the benefit system more generous so that different benefits received by pensioners were not withdrawn simultaneously.

Alternatively, the government may be satisfied with the 600,000 reduction in the total numbers facing marginal rates above 80%. If so, it could draw support from an additional point that Table 4 makes clear: any gains that additional increases in the generosity of the means-tested benefit system can deliver in terms of reducing the highest marginal rates must be weighed against their effect of pushing ever-more people onto (at least) moderately high marginal rates. The ‘baseline’ reform reduces the numbers facing the very highest marginal rates, but it also increases the numbers facing withdrawal at between 50% and 65% some fourteen-fold. This increase is so large that the total number facing marginal rates of over 50% increases by almost 2 million. Fundamentally, this is because more-generous means-tested benefits will affect ever-larger numbers of people. Attempts to make other means-tested benefits more generous to reduce the numbers on marginal effects over 80% would run into the same trade-off.

Should the government none the less make the reduction in the highest marginal rates its priority, it faces a number of options. First, it could ‘passport’ all pension credit recipients onto full housing benefit and council tax benefit, just as anyone currently receiving any MIG is awarded full entitlement to both. That way, no pensioner would face simultaneous ‘tapering’ of pension credit and other benefits, which should keep marginal rates down. But, unfortunately, this option poses a further dilemma.

If ‘passporting’ were introduced without any additional changes, then ‘needs’ - the level of income the system allows claimants to have before withdrawal of housing benefit and council tax benefit begins – would remain fixed at the level of the MIG.

But, in this case, pensioners with private income just sufficient to prevent any pension credit entitlement would actually find themselves with lower net incomes than those whose slightly lower private incomes meant that they were entitled to a small amount of pension credit. For the first group would face withdrawal of housing benefit and council tax benefit in respect of *all* the private income that they had above the level of the MIG, while the second group would face no benefit withdrawal even though their private income was actually higher than the MIG. For a small income range, then, effective marginal tax rates would exceed 100%.

The theoretical alternative would be to couple ‘passporting’ with an increase in the threshold income to precisely the level that would ensure that housing and council tax benefit tapering began exactly when entitlement to the pension credit was exhausted. In 2003 prices, the MIG is due to be £100 per week, and this implies that pension credit entitlement would be completely exhausted at an income of about £135. ‘Needs’ would thus have to increase from £100 to £135 for a typical single pensioner to ensure that pensioners were exposed neither to the possibility of being made worse off by having a higher private income nor to the possibility of simultaneous withdrawal of the pension credit and other benefits. This would be a substantial increase in ‘needs’ in a dense part of the pensioner income distribution, so it would float considerable numbers into housing benefit and council tax benefit for the first time. These individuals would experience an increase in their marginal tax rate. At the same time, they would become subject to the hassle of means-tested benefit assessment for the first time. So, for them, reform would achieve the reverse of simplifying their financial affairs.

But *guaranteeing* that both interaction of benefit tapers and effective marginal tax rates over 100% were avoided would be more complex. For some single pensioners, the income where pension credit will be exhausted will be considerably higher than £135: those, for example, with care of children, with disabilities or with mortgage costs are all entitled to a higher MIG, which means that withdrawal of the pension credit at 40% would be completed only at an income level in excess of £135. The precise level would depend on the configuration of all the variables on which a pensioner’s MIG entitlement depended. The implication is that ‘needs’ would have to be calculated individually for each pensioner. Moving to a system where benefit parameters had to be calculated separately for each claimant is problematic. It would reduce transparency, so it would increase the scope for administrative error and undermine the ability of potential claimants to figure out their own entitlement, which in turn might damage take-up.

Alternative reforms to housing benefit and council tax benefit might be possible to ameliorate some of the problems of benefit interaction that have been identified, although none will offer a panacea. For example, the taper on these benefits might be reduced exclusively for the over-60s so that their simultaneous withdrawal with pension credit did not impose such high effective tax rates. But this option would still involve additional expenditure and increase the numbers of individuals entitled to means-tested benefits.

4. Capital rules

Under the MIG rules (inherited from income support), pensioners are not straightforwardly means-tested on income from savings. Instead, capital rules are applied. A pensioner family is allowed to possess capital up to £3,000 before income support entitlement is affected. After this, each extra £250 is treated as equivalent to £1 per week of extra income, until the 'upper limit' of £8,000 of savings is reached. For those with savings in excess of £8,000, no MIG is payable. To achieve an income of £1 per week from each extra £250 of capital requires a real interest rate of over 20%, likely to be far in excess of anything available to pensioners with modest savings. This makes the rules seem harsh when viewed as an income test.

At above £8,000, no MIG is payable, introducing a considerable discontinuity – pensioners with just less than £8,000 of savings could be left better off than those with slightly more than this amount. The capital rules for housing benefit and council tax benefit are the same, except that the upper limit, above which no benefit is payable, is higher, at £16,000.

The government believes that these rules punish, and so discourage, saving. It has thus already announced that the MIG's upper capital limit will rise to £12,000 in April 2001. At the same time, the lower limit in all means-tested benefits for pensioners will rise to £6,000. But in the longer term, the government wishes to go further and completely abolish the current system's capital limits for pensioners with the introduction of the pension credit.⁸ Instead of being assessed on the basis of wealth, pensioners will be assessed only on the basis of the income that it generates.

The proposal raises several issues. First, replacing wealth assessment with income assessment means disregarding the special benefits that possession of wealth implies for economic welfare. Wealth accords special freedom because it relieves its holders from cash constraints that other low-income individuals face. Further, wealth has value over and above any income it provides, because its holders always have the option of running down their capital stock and so increasing the amount of money they have to live on.

To the extent that ignoring these benefits is seen as an important loss of precision of targeting in the means-tested benefit system, the move to a pure income-testing system might be deemed problematic. This becomes clear in the case of a single pensioner whose only income was a full basic state pension and building society interest. Assuming an interest rate of 7% on her savings, her capital stock would need to exceed £42,500 before she was floated out of pension credit entitlement. This figure could be considerably higher if she had less than a full basic state pension to begin with. Although such cases may be judged to illustrate worryingly poor targeting, their significance should not be exaggerated, as most of those with high savings also have higher incomes. Estimates from Family Resources Survey data suggest that fewer than 300,000 pensioner families with savings of over £12,000 will actually qualify for any pension credit entitlement at all. Amongst this group, median entitlement is low, at around £12.

⁸ Department of Social Security, *The Pension Credit: A Consultation Paper*, Cm. 4900, The Stationery Office, 2000, p. 23. The proposal is to scrap the capital rules in housing benefit and council tax benefit for pensioners simultaneously with the introduction of the pension credit.

Second, and perhaps more serious, the reform may introduce a market distortion encouraging substitution of capital for income. In particular, annuities – a way of converting capital draw-down into guaranteed income – might become unattractive. Annuities offer pensioners security. Without them, people have to decide on a rate at which to run down their wealth. The rate chosen might prove inappropriate: in the case of unanticipated longevity, the risk is of being left with insufficient wealth to live comfortably. Annuities insure against this by providing a guaranteed income for every year lived. In other aspects of policy – notably the proposals to encourage stakeholder pensions – the government has encouraged the purchase of annuities for retirement by those on modest earnings. Those amongst this target group who now stand to benefit from the pension credit will now face a countervailing incentive to keep any savings in capital, thereby limiting their exposure to the means test.

More generally, pensioners with modest savings will face a strong incentive to move out of assets that provide a steady income into those that yield less income but offer greater capital gain. For example, stocks and shares will become more attractive, as only part of the return that they offer is in the form of income (dividends), the rest being in capital gains. Assets that pay out their return in the form of capital gains tend to be riskier, and it may be thought that encouraging pensioners with modest incomes to move into riskier assets is undesirable. If the MIG continues to rise with average earnings over time, then it is likely that a growing fraction of people will be exposed to these market distortions.⁹

A final issue with the switch-over to an income-testing system is the avoidance of any losers. From 2001, the lower capital limit means that the MIG effectively exempts from the means test any income that the first £6,000 of capital generates. The introduction of means testing on savings income thus means that those with the lowest levels of savings would actually be made worse off. Capital of £6,000 would give rise to £8.08 per week in savings income with a 7% interest rate, and this money would be subject to means testing for the first time when the capital limits are abolished. A pensioner with £6,000 in savings, who would otherwise have received the MIG at £100 in April 2003 (making net income of £108.08), would, after the capital rules change, have a net income of just £104.85.¹⁰

The fact that the MIG is due to increase with earnings should greatly reduce the number facing actual losses in April 2003. But the government has made a commitment that all pensioners will not only avoid losses but also see ‘the full gains of converting to the new system’. Certainly, the number of losers could, fairly easily, be reduced considerably further. The current system entirely disregards the first £5 of weekly earnings (£10 for a couple) in the means test. Introducing identical rules for unearned income would mean that interest at 7% on the first £3,700 of savings would be ignored for a single person. A higher disregard of £8 per week would exempt interest at 7% on the first £6,000 of earnings. The problem is that not all pensioners receive the same interest rate. Some will be receiving an unusually high return. Guaranteeing their full gain from the pension credit, without encumbering the system with permanent high unearned income disregards, which might otherwise be regarded

⁹ This is true even with constant earnings inequality, because if the MIG rises with earnings, the income required to exhaust pension credit entitlement will rise even more quickly. See Section C.

¹⁰ $£100 + £8.08 \times (1 - \text{Pension credit withdrawal rate})$.

as inefficiently high, means that some kind of transitional arrangement would be needed.

5. Administrative issues

The government has made clear that it hopes that the pension credit means test will be simpler, less intrusive and less frequent than that of the existing system. It is hoped that part of the way in which the system will be simplified is by alignment of – and perhaps even steps towards the integration of – the tax and benefit systems. Indeed, the DSS explicitly condemns the current system's 'weekly means test' by contrast 'with the less intrusive, less burdensome annual requirements for wealthier pensioners in the tax system'.¹¹

The argument seems attractive. It seems likely that the substantial numbers currently failing to claim benefit could be reduced if the process of claiming became less onerous and intrusive. Furthermore, given that pensioner incomes are typically stable, there is less loss of precision in targeting in abandoning a weekly means test than would arise were the government to apply an annual means test to income support for those of working age.

But there are also problems with it. First, there is little in the plans for the pension credit that suggest that less information will be needed to establish benefit entitlement than in the past. It is true that claimants will no longer need to specify the value of their capital, but they will instead have to volunteer the amount of interest income they receive from any savings. For small savers in particular, it seems likely that more investigative work will be required to provide this information than that demanded by the old system, for interest payments will fluctuate with interest rates over the year, even where capital is constant.

Second, there might be doubts about the gains to be had from reforming the period of means assessment. Under one reform that the government is considering, benefits would be calculated upon retirement and fixed for a year, after which claimants would be asked to inform the authorities of any change in their circumstances.¹² Certainly, this would represent a significant improvement on a system where claimants were forced to fill out a form each week, but it should be borne in mind that the present system does not involve this. Rather, the current 'weekly' means test involves a form being filled in once, and then the onus being with the claimant to inform the authorities when their circumstances change. Removing the obligation to inform the authorities immediately of minor changes in the interest paid on minor investments with variable returns might none the less be worth while.

Third, a genuinely annual test would pose difficult problems. If, like the working families' tax credit, entitlement were based on income over a brief period and fixed for a longer time, then incentives to alter behaviour so as to gain from the benefit would arise. This is perhaps a particular risk with the pension credit, as it is available to many in semi-retirement who may remain attached to the labour market and for

¹¹ *The Pension Credit: A Consultation Paper*, Cm. 4900, The Stationery Office, 2000, p. 17.

¹² *The Pension Credit: A Consultation Paper*, Cm. 4900, The Stationery Office, 2000, p. 23.

whom alternation between periods of work and retirement may be an open and attractive option. Men aged 60 to 65 might be especially likely to be affected, as they are eligible for the pension credit even though they cannot yet draw their basic pension. For example, a teacher could retire at 60 and present themselves for pension credit assessment as being workless and therefore deserving of substantial entitlement. But once the award (if fixed for a year) was made, the same person could make themselves available for supply teaching and earn significant amounts.

It could be that, as with taxation, the government instead intends to assess entitlement on the basis of income and circumstance over the whole year. This would avoid cases such as that of the supply teacher – their high earnings after the initial assessment would then be effectively means-tested *ex post*, producing lower benefit entitlement for the following year. But, unlike the higher-rate taxpayers who are currently obliged to complete annual retrospective income tax returns, pension credit recipients are likely to be cash-constrained in the short term. For this reason, the government may wish to avoid assuming the role of debt collector in respect of benefit overpayment.

Finally, the question of the administrative interaction of pension credit with other benefits needs to be considered. Even if the credit's means test were successfully made simpler than that of the current system, many poorer pensioners would remain dependent on completion of council tax benefit and housing benefit forms, which are actually rather more complex than that for the MIG. Also, if the pension credit were introduced without 'passporting' full entitlement to these additional benefits, current MIG recipients would find themselves having to provide more details to claim these benefits than previously.

6. Behavioural effects: will the pension credit lead to more saving?

The pension credit has been presented as having two aims. One is to reward saving, as a point of fairness. The securing of this aim is not dependent on the effectiveness of the changes to economic incentives that the reform provides. But securing its other aim – to *encourage* saving, and perhaps thereby to save on welfare bills – does depend on the way that economic incentives are changed.

Economists characterise the aim of saving as being to consume in the future. So the individual's decision about how much to save can be analysed as them choosing between relative quantities of current consumption and future consumption. The rational person planning for retirement will save until the point where they would value £1 of extra current consumption equally with the amount of future consumption achieved by saving an extra £1. If the obtainable future consumption were worth more to them than an extra £1 consumed today, then surely they would save. If they would rather spend an extra £1 now, then it would clearly be better for them to reduce their saving and increase current consumption.

The current system means – as the government has implicitly recognised – that anyone planning for retirement who is likely to be on the MIG faces a high 'price' for future consumption in terms of the amount of current consumption that they have to forgo. Indeed, the 100% withdrawal rate means that the annuity income obtained by £1 of extra saving will produce no extra net retirement income at all – the 'price' of

future consumption is initially infinite. Only once saving buys enough future income to take it above the MIG does saving an additional £1 yield benefits.¹³

Ignoring, for now, the interaction with other benefits, the pension credit will help encourage such individuals to save by reducing the taper rate to 40%, which means that saving an extra £1 will, for the first time, yield some gain, and so will effectively reduce the price of buying future consumption with saving. As saving will thereby become better value, the amount of saving undertaken by such people should increase, if all else were equal. Depending on how the pension credit is implemented, other means-tested benefits could lessen the extent of this improvement in incentives by interacting with the pension credit to produce a high combined withdrawal rate, as described in subsection 3 above.

But for another group, this 'price' effect is different. Someone planning to retire with a full state pension in 2003 who has already amassed savings sufficient to generate, for example, £33 of weekly income would not be entitled to the MIG if there were no structural reform. Abstracting from tax and other benefits, this would mean that they could plan for retirement on the assumption that they would gain in full from any additional income they managed to accrue. But they will be entitled to the pension credit, so 40% of any such extra income will be lost in forgone benefit entitlement. The 'price' at which future consumption could be bought would then have increased. All else being equal, we would therefore expect the purchase of less future consumption, i.e. less saving.

The introduction of the 40% taper will make savings 'more expensive' for significant numbers – around 2 million pensioners – by creating entitlement where none existed before. This effect will be compounded by the fact that the government has increased the level of the MIG for pensioners. Even without the introduction of the pension credit, the increase in the rates of the MIG between 2001 and 2003 would have meant that an additional 500,000 would have been floated into means-tested entitlement, assuming that during this period the private incomes of these people remained constant.

The 'price' effects on the incentive to save are, then, mixed. For people currently on the MIG, they are undoubtedly improved. By contrast, for people floated onto benefit by the reform, securing future consumption becomes more expensive. Overall, the 'price' effect on saving is ambiguous. One group will save more, another less.

The overall effect of the package is complicated further by what economists call an 'income' effect. People's estimate of their overall lifetime income will affect their decision about how much they can afford to consume today (and how much, instead, to save for tomorrow). An individual who, before the reforms, would have had a total retirement income of £110 would, under the new system, be awarded £9.80 in pension credit, taking net income to £119.80. The sum of future and net incomes would thereby increase and the employee might decide, on this ground, that s/he could afford to consume more now, i.e. to save less.

¹³ In practice, even rational people in this category will make some savings, as uncertainty about future income and benefit rates means that they are unlikely to know whether or not they will retire on an income level below the MIG. Besides, ownership of private income might provide some freedom from the constraints imposed by benefit rules.

Consider, for example, someone who, for some reason, had fixed on £110 as their target income, which they were determined to attain at their retirement in 2003. Under the old system, they had to save sufficiently to generate £33 of income over and above a full state pension to secure this. Under the pension credit reform, smaller savings sufficient to generate £16.67 of private income would produce the same net income in retirement, as £16.33 would now be payable in pension credit. On these grounds, such a person would increase their pre-retirement spending, and so cut their saving.

The introduction of the pension credit (considered in isolation from the increase in the MIG) would not impose this negative income effect on those who initially lacked any savings, as they would not gain from the reform. But, in practice, its introduction will be coupled with an increase in the MIG, which means that these families too will face new reasons to continue to consume their current income.

The presence of this income effect will unambiguously have a negative impact on overall saving. Overall, though, economic theory does not tell us whether saving will increase or fall as a result of the pension credit, as we do not know what impact the 'price' effect will have (or even in what direction it will be).

For those who would currently save nothing and end up on full MIG entitlement, the structural reform that the pension credit represents will unambiguously encourage saving: the 'price' effect alone is effective and will make saving better value. Around 1.3 million pensioner families are in this position.¹⁴ For those who would otherwise be on the MIG and yet do possess some savings, income and price effects will work in countervailing directions, making the overall behavioural change ambiguous. We estimate that there are another 1.3 million pensioner families in this situation.¹⁵ For those floated onto benefit entitlement by the reform – around 1.6 million pensioner families – both effects discourage saving.

Thus there are three groups of relatively equal size – the incentive to save will be blunted for one, sharpened for another and affected in an ambiguous manner for the third. Overall, the effect of the pension credit on the financial incentive to save is left unclear, for the relative magnitudes of the different effects we have disentangled are not known. So

whether the pension credit will encourage or discourage saving is an empirical question on which future research may be enlightening.

In contrast, the increase in the rates of the MIG over the next few years will unambiguously discourage saving. All who will be affected will face a negative income effect, and the price effect will only apply – and in a negative direction – to the 500,000 floated onto benefits as a result of the reforms.

¹⁴ Pensioner families with no income except benefits who would have MIG entitlement in April 2003 without the pension credit reforms.

¹⁵ Pensioner families with some private income who none the less have MIG entitlement in April 2003 without the pension credit reforms.

C. The future direction of pensions policy

This government, like its predecessor, has previously been associated with the view that increases in spending on pensions should be delivered in a targeted manner. The November 2000 announcements could be seen as undermining this analysis, as the substantial package encompassed a significant increase in universal benefits, most particularly the basic state pension. But these measures should not divert attention from the central strategic thrust of policy, which remains evident even in these announcements. Means testing is being further expanded. The pension credit is a response to the problems of operating more expansive means testing. But in-and-of-itself, it also involves extending income assessment to more pensioners, as it involves making the system more generous.

The government's aim of increasing the MIG with earnings, while the basic pension looks set to continue to rise only in line with prices, makes it likely that increasing numbers of people will eventually be floated into income-based benefit entitlement. As earlier work at IFS has explained,¹⁶ pensioners whose income is made up of the basic pension and another component – even where this component is earnings-related, like, for example, the proposed state second pension – will see their total income rise by less than earnings. Over time, the MIG looks set to increase faster than such people's incomes, which means ever-more of them will be floated into entitlement.

The pension credit will strengthen the dynamic in the current system that is tending to push growing numbers onto the means test. This will surely pose further problems for the ability of policies such as the state second pension and 'stakeholder' schemes to contain the numbers on means-tested benefits. Future research could usefully estimate the time-scale and magnitude of such effects.

The conclusion that recent announcements on pensions look set to create a very substantial increase in means testing in the long term seems hard to avoid. The more difficult question to answer is whether this matters. To the extent that means testing is intrusive and onerous for recipients, and sufficiently unpleasant to prevent others with entitlement from claiming at all, then it surely does. But if the government's reforms succeed in simplifying and streamlining the system, these problems will become less relevant. As we have seen, however, simplifying the system without losing too much precision in targeting remains a major challenge. Further expansion of means testing raises additional problems as well: the incentive to save will be affected and people's choice between different types of assets will be distorted.

None of these thorny issues necessarily means that extending means testing is inappropriate. Alternative policies would deliver less progressive results and increase the costs of pension provision. But the realisation that the complexities and distortions that income assessment involves will affect ever-more people certainly means that thinking carefully about how the system can be reformed to minimise these problems becomes more urgent. Policymakers must acknowledge the long-term implications of their proposals for the scale of means testing amongst pensioners; and, having done

¹⁶ Richard Disney, Carl Emmerson and Sarah Tanner, *Partnership in Pensions: An Assessment*, Commentary no. 78, Institute for Fiscal Studies, London.

so, they should bear them in mind when planning reforms in other elements of pension provision. Only in this way will policy result that is both coherent and sufficiently credible to look durable to those considering how to plan for retirement.