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## **Problems Providing Appropriate Pensions for All**

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Between 2004 and 2051 the UK population aged 20 to 64 is forecast to remain constant at around 36 million; in contrast, the number of people aged 65 and over is expected to increase by 78 percent from 9.6 million to 17.1 million. To the extent that this increase is driven by increases in (healthy) life expectancies, it is to be celebrated. Nonetheless, the dramatic shift in demographic structure raises the issue of how to fund retirement consumption for such a large group of retirees. Similar ageing is creating financial strain on public pension systems across much of the industrialised world. In the EU-15 the average cost of state pension benefits is expected to rise from 10.4% of national income in 2000, to 13.3% by 2050. The main focus of this article is that some reforms that were partly designed to contain this financial strain in the UK are now contributing to growing concerns that the pension system might fail to provide 'adequate' incomes for some future pensioners. We discuss one reason why the UK system may be ill suited to providing adequate retirement incomes for some individuals, and briefly consider some options for reform.

Even after including the cost of means-tested benefits that are paid to pensioners but not usually counted as 'pension benefits', both the level of and growth in the cost of transfer payments to UK pensioners are expected to remain relatively low. Transfer payments to pensioners accounted for 6.1% of national income in 2003/04, and this is expected to rise to 6.9% by 2053/54. If the UK system were functioning well, then many individuals would generate 'adequate' retirement incomes by topping up these relatively low public pensions with incomes derived from private savings. However, in its recent first report on "pensions: challenges and choices" the independent UK Pensions Commission estimated that as many as 12.1 million current workers might not be saving enough to ensure that their private pensions will top up their state benefits to adequate retirement incomes, (this detailed report is available via <http://www.pensionscommission.org.uk/>). If all these people are under saving, then that would still leave around 18 million people between age 25 and the state pension age who are making sensible provisions for retirement.

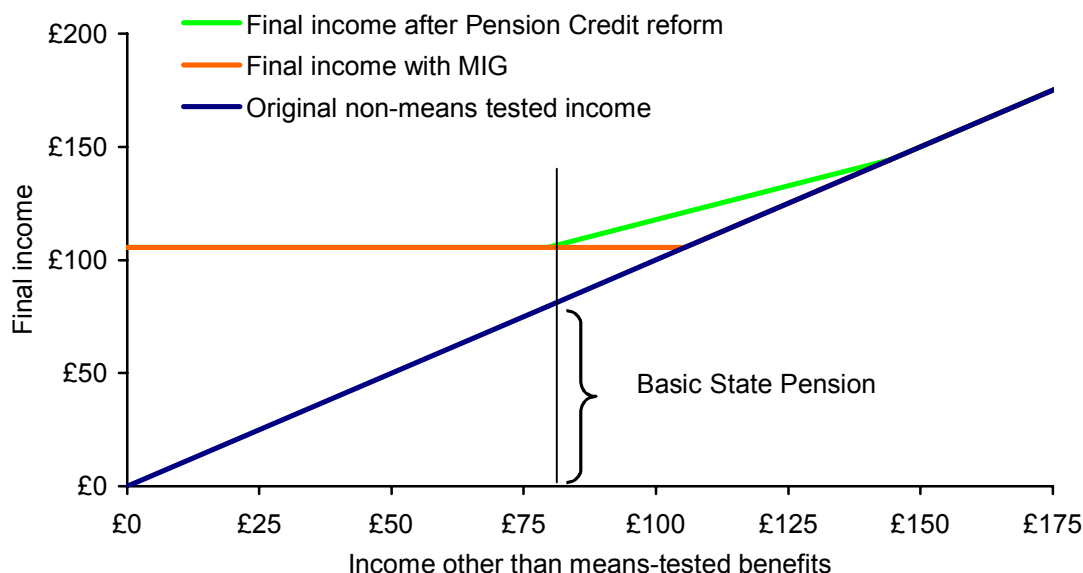
Furthermore, even if such projections are correct, this does not imply that all of those who are currently under saving will live in poverty during retirement. Indeed, the latest data indicate that, for the first time in almost 20 years, pensioners are now no more likely to live in poverty (defined as living on less than 60% of median income) than are people of working age. This is partly because means-tested benefits for pensioners have been increased substantially since April 1999. Rather than being formulated in terms of how many pensioners will live in poverty, the above projections are based on comparing actual levels of saving to predictions of the amounts that each individual would need to save to ensure that their pension income will fund an 'adequate' level of consumption in retirement. The economic *lifecycle model*, which assumes that individuals take all present and likely future costs and benefits into account when choosing current consumption and saving, predicts that individuals would choose to save these amounts.

There are several reasons why these predicted levels of saving may not be attained. Individuals may be constrained or less than fully 'rational' and so not exactly conform to the maximising principles of the lifecycle model. Or they may anticipate needing less cash in old age, or simply prefer to consume more while they are young. Alternatively, it may be that individuals are anticipating reforms to the pensions system that will reduce their need or incentive to have private savings. The possibility that we consider in detail concerns a reform that has already taken place: precisely the increase in means tested benefits that has shifted many pensioners out of poverty may also have adversely affected the incentives for many current workers to save for their retirement.

The main means-tested benefit which has been used to shift pensioners out of poverty is the Pension Credit. This benefit exists alongside the Basic State Pension (BSP) in the 'first tier' of pension provision in the UK. A single pensioner with a full entitlement to the BSP will currently receive £79.60 per week from this benefit. However, if her total income from the BSP and other sources amounts to less than £105.45 per week, then she will be entitled to have it topped up to this amount through the 'Pension Credit Guarantee'. Before October 2003 this top-up was known as the Minimum Income Guarantee (MIG) and it was withdrawn pound-for-pound with extra non-benefit income. This is illustrated by the orange line in figure 1, which shows the relationship between pre- and post-benefit income for pensioners affected by the MIG/Pension Credit Guarantee. Since October 2003, those over the age of 65 have also been entitled to the 'Pension Credit Savings Credit', which is effectively a taper on the Pension Credit Guarantee such that an individual can keep 60 pence of each extra pound

of non-means tested benefit income over and above the level of the BSP and until entitlement to the means tested benefit is exhausted. This is illustrated by the green line in figure 1.

**Figure 1: Budget constraint for a single person aged 65 or over, without any means-testing, under the MIG regime and under the Pension Credit regime**



Note: Income disregards, taxation and other means-tested benefits ignored.

The MIG, with its 100% withdrawal rate, created transparent disincentives to saving: workers who expected to receive this benefit throughout their retirement had no incentive to save in a pension as doing so would not yield any extra income in retirement. The fact that retirement savings might not generate any extra income was also thought to be unfair. Government statements on the transition from the MIG to the Pension Credit programme have tended to highlight that it has led to a large reduction in the number of individuals facing losing £1 of benefits for each £1 of private income. This is described by saying that the majority are now ‘rewarded’ for having retirement savings. However, this is not the same as saying that the effects of the reform on the incentives for current workers to save are unequivocally positive. Economic theory provides a useful framework within which to think about why this is so.

The reform has two different types of effects on incentives to save. The first is a *substitution effect*, which arises from the fact that the policy changes the amount of retirement income that an individual can buy with an extra pound of pension wealth. For example, an individual who would have been on the MIG but will now be on the

Pension Credit Savings Credit will now gain 60 pence of retirement income, rather than zero, for each extra pound of income from private savings. Since this amount is positive, the substitution effect will in this case tend to *increase* the incentive to save. The second effect is a *(lifetime) income effect*. This arises where the reform boosts the total amount of retirement income that an individual gets from a given amount of pension wealth; this is represented in figure 1 by areas in which the green line lies above the orange/blue lines. This means that after the reform an individual can achieve a given amount of retirement income from less private saving, and this explains why the income effect will tend to *reduce* the incentive to save.

**Figure 2: The key groups for whom economic theory suggests that the Pension Credit will alter retirement saving incentives.**

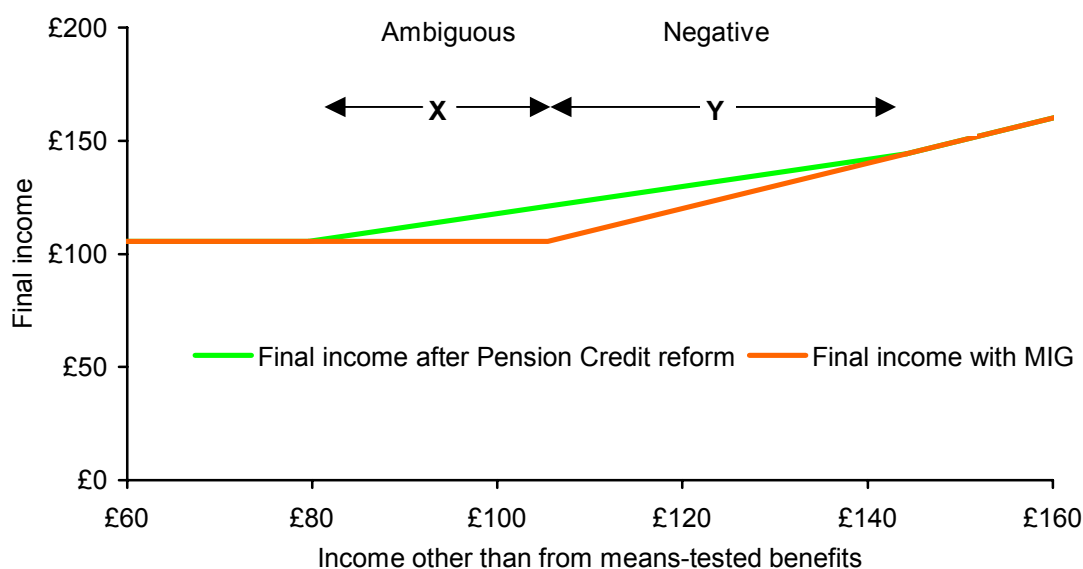


Figure 2 illustrates how these income and substitution effects have different overall impacts on different groups of people affected by the pension credit. For those who expect to be in group 'X' once they retire, both the substitution and income effects operate exactly as described above, with the former tending to increase saving and the latter tending to reduce it. Thus, for this group we cannot say *a priori* whether the reform has increased or decreased the incentive to save for retirement. For those expecting to be in group 'Y', theory is somewhat more conclusive. The income effect is again as described above. However, the substitution effect is now the opposite of that described previously. For this group the reform reduces the amount of extra income bought by an extra £1 of private income, from £1 to 60p. This means that the substitution effect now

reinforces the income effect and for this group the overall effect on retirement saving incentives is unambiguously negative.

What matters for retirement savings decisions are not the incentives to save for current retirees (who have already done their saving), but the expectations of the current working age population. The current intention of the Government is to continue making means tested benefits more generous relative to the BSP. If realised, then the proportion of those aged 65 and over entitled to the Pension Credit could increase further, from 46% today to around 71% by 2050. If people expect this, then a higher proportion of each successive generation will feel the adverse incentives for retirement saving affecting those in group 'Y'. These incentives will soon affect those who expect to be at the middle of the income distribution once they retire. This explains the existence of concerns that the UK system is set to give poor incentives for people in the middle of the income distribution to make adequate provisions for retirement.

During 2004, the Conservative and Liberal Democrat Parties proposed policies intended to tackle this problem in broadly the same way. They proposed reducing the gap between the value of the BSP and the Pension Credit, so that the scope of the means tested benefit (and its incentive effects) would be reduced. Implementing such a policy without making any current recipients of the Pension Credit worse off would be costly to the state, and it was precisely such costs which the present government sought to avoid when using means-tested benefits to tackle pensioner poverty. An alternative way to tackle incentive problems would be to make more retirement saving compulsory. However, compulsory saving would make worse off any people who have good reasons for not saving. Many of those who would be compelled to save more would be individuals with relatively low incomes who might prefer to save little and fall back on (means-tested) state retirement benefits.

While means-tested benefits have acted to reduce pensioner poverty, their expansion might not have been consistent with a goal of encouraging individuals to make private provision a greater part of an adequate retirement income. This is thus an example of the trade-offs between equity and efficiency found in many areas of public economics.