

Department for Work and Pensions

Research Report No 562

Incentives to save for retirement: understanding, perceptions and behaviour

A literature review

Roger Wicks and Sarah Horack

A report of research carried out by PricewaterhouseCoopers on behalf of the
Department for Work and Pensions

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Contents

Acknowledgements	v
The Authors.....	vi
Summary	1
1 Introduction	7
1.1 Background	7
1.2 Purpose	7
1.3 Our approach	8
1.4 Report structure.....	8
2 Saving for retirement: The relationship between theory and practice	9
2.1 Introduction.....	9
2.2 The <i>life cycle</i> model	10
2.2.1 <i>Price motive</i>	11
2.3 Tensions between theory and practice	12
3 Barriers that limit the explanatory power of savings theory.....	15
3.1 Introduction	16
3.2 Informational and attitudinal barriers to saving	17
3.2.1 <i>Level of understanding and financial capability</i>	17
3.2.2 <i>Seeking information, guidance and advice</i>	23
3.2.3 <i>Other perceptions, misperceptions and decision processes that can act as barriers</i>	27

3.3	Structural barriers to saving	31
3.3.1	<i>Complexity of the pension system</i>	31
3.3.2	<i>Role of the tax/benefit system</i>	31
3.3.3	<i>Private sector pension coverage</i>	33
3.4	Behavioural barriers to saving	33
3.4.1	<i>Myopia</i>	33
3.4.2	<i>Cynicism</i>	35
3.4.3	<i>Inertia</i>	36
4	Overcoming barriers to saving	39
4.1	Introduction	39
4.2	Financial education, information and guidance	40
4.3	Financial incentives that affect the price of saving	41
4.3.1	<i>Tax relief</i>	42
4.3.2	<i>Employer contributions</i>	43
4.3.3	<i>Automatic enrolment and other reforms</i>	44
5	Conclusions	49
5.1	Précis of main findings.....	49
5.2	Quality of reviewed research	50
5.3	Conflicting findings and gaps in the reviewed research	50
	References	53
	 List of tables	
	Table 3.1 Perceptions of different savings and investments.....	28
	 List of figures	
	Figure 3.1 Links between different barriers to saving	16

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A review of 42 sources on an issue as technical and as subjective as incentives to save for retirement is bound to involve judgements and hence faults of omission, emphasis and interpretation. We have tried to minimise them but accept responsibility for those that remain. For our readers, we hope this makes the report more thought-provoking rather than less authoritative.

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Summary

Saving for retirement: The relationship between theory and practice

The *life cycle* model holds that the most common motivation for contributing to a pension during employment is the wish to smooth income from periods when earnings are high to periods when they are low – the income motive. This can be coupled with the concept of the price motive, which holds that contributing to a pension can make financial sense if the consumption forgone by saving now is less than the consumption gained in retirement.

Many people do behave as theory would predict. Financial incentives that have been shown to be effective in encouraging people to save into a pension include tax relief provided by the Government, investment growth, and, where available, contributions from employers.

However, these theories are not always borne out in practice. In the UK, Government estimates¹ show that seven million people are not making provision for a retirement that even they, themselves, would consider adequate.

Despite the Government's provision of financial incentives such as tax relief to improve the price motive and efforts to improve accessibility of savings vehicles for income smoothing, both the price and income motives can be compromised in practice by informational, structural and behavioural barriers.

Some barriers can be overcome. For example, when automatic enrolment into personal accounts and other qualifying schemes is established as from 2012, pension enrolment is expected to increase, not least because inertia will then favour scheme membership.

There exists a broad literature both on perceptions of saving and on actual savings behaviour. There is, however, relatively little compelling evidence on the interworking of the two and where there is evidence it reveals contradictions. For

¹ DWP White Paper (2006) *Security in retirement: towards a new pensions system*, http://www.dwp.gov.uk/pensionsreform/pdfs/white_paper_complete.pdf

example, for some a sense of confusion about pensions motivates them to seek out information and take advice in order to make informed decisions. For others feeling confused causes them to retreat from decisions about pensions without seeking information or taking advice.

Barriers that limit the explanatory power of savings theory

Informational and attitudinal factors

The various inter-related informational and attitudinal barriers may include a lack of understanding and financial capability, problems with access to and take up of available information, and perceptions and misperceptions about saving.

- **Understanding** – Lack of understanding about the need to engage in effective planning for retirement and about pensions and alternative vehicles for long-term saving and investment is widespread and acts as a barrier to saving².
- While confusion and uncertainty about pensions can heighten inertia and people's sense of being at risk in the pensions arena and thus become a barrier to saving, uncertainty about future needs and resources can also motivate 'precautionary' saving.
- Inaccurate forecasting by the individual arises for many reasons, including:
 - complexity;
 - poor public understanding of savings products, financial concepts and benefit entitlement;
 - unpredictability of future needs and resources³.
- **Low financial capability** – Evidence on the effectiveness of financial education on pensions is limited. There is evidence that women feel less confident than men that they understand financial issues well⁴.
- **Seeking information and its availability** – Independent Financial Advisers (IFAs), who can give advice tailored to personal circumstances as well as provide information, are most frequently mentioned as a preferred source, but this was a preference for fewer than a quarter of respondents. Employers are regarded as a good source of information about pensions by some, but there is evidence that information from providers is often seen as being insufficiently helpful.

² See, for example, Clery, E., McKay, S., Phillips, M. and Robinson, C. (2006) *Attitudes to pensions: The 2006 survey*, DWP Research Report No. 434. <http://www.dwp.gov.uk/pensionsreform/pdfs/rrep434-1.pdf>

³ See, for example, Sykes, W., Hedges, A. and Kelly, J. (2008) *Understanding responses to pension forecasts: Qualitative research*, DWP Research Report No. 492, p.2.

⁴ *Attitudes to pensions: The 2006 survey*.

- There is limited evidence on the impact on retirement saving behaviour of making **generic information** about pensions and related financial matters readily available. While answers to hypothetical questions showed a relationship between the possibility of getting generic information and the possibility of saving more in one study⁵, this was not supported by a different study, which used a before-and-after test of making information and advice available in workplaces where employers contributed little to employees' pensions⁶. More evidence on provision of generic financial advice will become available from the Money Guidance pathfinder proposed in the Thoresen Review 2008⁷.
- **Perceptions about information and saving** – While many people may be dependent on information and advice provided by others, mistrust of the institutions from which it is most likely to come is high.
- Some regard it as the responsibility of the State to provide for people in retirement. In contrast, however, there is acceptance of the increasing need for self-reliance with respect to financial security in retirement.
- Despite their lack of understanding about pensions, people draw conclusions about the apparent safety and growth prospects of different kinds of investments, including pensions. Before 2008, investing in property was seen as the safest way to save for retirement and the best way to achieve high returns⁸. Saving into an occupational pension scheme was ranked second for safety among the six investments tested but only fourth for high returns. These relativities may change as market conditions change, but pensions compete against alternative means of saving, on a rational basis and otherwise.
- Perceptions also affect how information is processed and decisions are reached. For example, some individuals base saving choices on those made by their parents. Some use mental accounting as a means for organising their finances: they have different 'pots' of money reserved for things such as fuel, food and retirement. This can create difficulties if the 'pots' become too rigid, as in the case of someone continuing to save into a pension at a set level despite a growth in income.

⁵ HMT (2008), *Thoresen Review of generic financial advice: final report*, http://www.hm-treasury.gov.uk/d/thoresenreview_final.pdf

⁶ Leston, J. and Watmough, M. (2005) *Providing pensions information and advice in the workplace where there is little or no employer contribution: Pilot evaluation findings based on survey and qualitative research*, DWP Research Report No. 294. <http://www.dwp.gov.uk/asd/asd5/rports2005-2006/rrep294.pdf>, ch.4.

⁷ HMT *op cit*.

⁸ Clery, E., McKay, S., Phillips, M. and Robinson, C. (2006) *Attitudes to pensions: The 2006 survey*, DWP Research Report No. 434. <http://www.dwp.gov.uk/pensionsreform/pdfs/rrep434-1.pdf>, p.134.

Structural factors

Three structural factors are identified in the literature as barriers to saving:

- **Complexity** – Changes in the last 30 years to the legal framework of pensions in the UK have increased the complexity of a system that was already far from simple. Such changes have made it more difficult for people to understand old and new rules and products, and to predict overall outcomes with accuracy. It is understood that the aims of recent legislation are to simplify the rules governing private and State pensions.
- **The tax/benefit system** – For some, means-testing adds complexity and appears to contribute to confusion about pensions. Since means-testing targets those with relatively low income, and pension savings can increase one's income in retirement, the possible loss of benefits can create disincentives to save. People may be unclear whether they will become ineligible for means-tested benefits if they save into a pension and the rules may change over time. Knowledge sufficient to predict whether entitlement to benefits will be diminished by saving is not widespread.
- **Private sector pension coverage** – Even if some people wanted to contribute to a private pension, it is argued that the market under-provides to those on low to middle incomes in the current system.

Behavioural factors

A large number of behavioural factors are also covered in the literature and contribute to the interplay between savings theory and practice.

- **Myopia** – Sometimes also called the 'spend now focus', myopia means that many individuals are short sighted, thinking that retirement is in the distant future; some, in addition, simply do not want to think about the future. A low discretionary income and immediate financial demands have been found to cause some to decide against joining workplace schemes. The reality of current financial demands and reluctance to 'lose' currently available funds are more powerful for some than the wish to receive an uncertain reward to meet uncertain needs in the future. As is likely to be the case by its very definition, myopia as a barrier to saving is stronger amongst younger people.
- **Cynicism** – Some individuals are cynical about the pension system and the returns they can expect, particularly those who have had previous bad experiences. People are also influenced by negative coverage of financial issues in the media; some state they do not 'believe' what they are told⁹.

⁹ Pettigrew, N., Taylor, J., Simpson, C., Lancaster, J. and Madden, R. (2007) *Live now, save later? Young people, saving and pensions*, DWP Research Report No. 438. <http://www.dwp.gov.uk/asd/asd5/rports2007-2008/rrep438.pdf>, pp.26.

- **Inertia** – Also referred to as apathy and procrastination, inertia involves the view that planning for retirement is a task that should be done but is difficult and unpleasant to do. This makes it easier to put it off and reduces the desire to seek out or understand information on pensions. Fatalism and futility may be related reasons why some people find retirement planning overwhelming and feel helpless, believing that the task they would face in trying to make adequate provision would be impossible.

Overcoming barriers to saving

Financial education, information, advice and guidance

Evidence is mixed on the impact of financial education, information, advice, and guidance. However, on pensions, three findings appear to be sound:

- there remains a need for information and guidance regarding pension planning;
- confidence tends to increase as people are assisted in calculating their pension requirements and understanding how to build their pension funds;
- too much information and too many choices may lead to information overload and decision fatigue, or to overconfidence.

Financial incentives that affect the price of saving for individuals

The two most powerful financial incentives to saving for retirement that are identified in the literature are tax relief and employer contributions.

- Tax relief – it is common for individuals to cite the availability of tax relief on pensions and on other savings products such as Individual Savings Accounts (ISAs) as a key motive for their decisions to save. For some people tax relief is not enough, in itself, to be an incentive to save.
- Employer contributions – employer contributions to a workplace-based pension scheme are an attractive incentive and have a significant influence on uptake and on employee contribution levels.

Automatic enrolment

Automatic enrolment from 2012 is intended and expected, on evidence from the UK and elsewhere, to increase participation in workplace-based pension schemes by overcoming barriers of inertia, myopia and perceived complexity that have discouraged opt-in participation. In addition, the financial incentives of tax relief, investment growth and a mandatory minimum contribution from employers and government equal to that from employees are expected to persuade most of the auto-enrolled who are tempted to opt out to resist and remain enrolled.

Conflicting findings and gaps in the literature

Several conflicting findings and gaps in the literature have been identified during the review. These suggest questions that may need to be answered in future research.

- How to motivate people to take up and use readily accessible information about pensions and saving for retirement.
- The impact on savings behaviour of programmes intended to increase financial literacy.
- Can research show what form of guidance could be most acceptable, most useful and most strongly associated with the making of better decisions? Can research show those currently providing information and advice, e.g. pension providers and IFAs, how to improve their services and gain greater trust – a matter of some importance to them in a worsening economic climate.
- Feelings of risk are found to act as incentives and disincentives to saving for retirement. A better understanding of how risk affects individuals' financial decision-making would be useful.
- The motivating force of the wish to be self-reliant in the financial arena does not receive much coverage in the literature.
- Persistence in contributing to a pension, or pensions, through the course of working life is another phenomenon that is covered lightly.

1 Introduction

1.1 Background

In the May 2006 White Paper, *Security in retirement: towards a new pension system*, the Government set out its proposals for pensions reform. The first part of these reforms, implemented by the Pensions Act 2007, focused on strategic changes to the State pensions system, funded by a gradual increase in the State Pension age. These measures aim to improve people's outcomes in retirement and provide a firmer foundation upon which people can plan for their retirement.

The second part of the reforms aims to enable and encourage more people to save into a private pension to supplement income that may be received from a State Pension. A duty on employers to automatically enrol eligible employees into a workplace pension scheme is central to the reforms, as is the requirement for employers and employees to contribute at or above a certain level. A scheme of personal accounts, to give moderate to low earners access to a simple and low-cost pension if they do not already have access to a qualifying scheme, is set to be launched in 2012.

These changes to State and private pensions include the intention to create a system within which individuals will have the financial incentives to save for retirement while experiencing fewer of the current barriers to saving.

In order to ensure a shared understanding of these incentives, the Government is investigating saving incentives and their impact on behaviour and potential outcomes. A review of the evidence on the current understanding of saving incentives and behavioural impacts was incorporated into the investigation.

1.2 Purpose

This report aims to explore what we currently know about financial incentives to save for retirement, in terms of understanding and perceptions of incentives and motivations as well as actual behaviour.

1.3 Our approach

Forty-two sources are examined in this review. The areas covered in each source were systematically mapped against an agreed set of questions on understanding and behaviour.

Any review of 42 sources is bound to be selective and, to some extent, subjective. Different views can be taken, but we have tried to ensure the report highlights the main themes in the literature from the most interesting and reliable studies.

1.4 Report structure

The following section summarises the main findings of this review.

The theory of financial incentives to save is set out in Chapter 2.

The barriers to saving are explored in detail in Chapter 3. These cover informational/attitudinal, structural and behavioural barriers.

Chapter 4 discusses how barriers to saving can be overcome and reviews financial education, information and advice, additional saving incentives and automatic enrolment.

Conclusions appear in Chapter 5.

2 Saving for retirement: The relationship between theory and practice

Chapter summary

This chapter presents the theoretical background to saving. The concept of income smoothing, couched within the *life cycle* model, is introduced as the most commonly understood reason for contributing to a pension during employment. This is coupled with the price motive, which holds that saving into a pension makes financial sense if the money is worth more in retirement.

Even if it makes financial sense for the vast majority to save for retirement, thanks to income and price motives, many people do not do so consistently and adequately enough to provide financial security in old age. Estimates show that seven million people are not making the provision for retirement that they, themselves, would be likely to consider sufficient.

The principal factors that help to explain why many people do not respond to financial incentives are presented in the next chapter.

2.1 Introduction

Reliable estimates show that seven million people are not making provision for retirement that they, themselves, would be likely to consider sufficient.¹⁰

Yet in addition to the motive to ensure a sufficient income in retirement, there are clear financial incentives for people to save for retirement: tax relief, investment growth and, where available, contributions from employers. The latter will become a more prominent feature of the UK's pension system as automatic enrolment into

¹⁰ DWP White Paper, 2006.

personal accounts and other qualifying schemes is established from 2012, with the requirement on employers to contribute if employees remain opted in to the scheme. There are also a number of disincentives that may work in the other direction, such as administrative charges involved in pension funds, but overall and for the vast majority of people, it makes financial sense to save for retirement.¹¹

This chapter explores the rationale behind the two main theoretical pillars of financial incentives to save for retirement.

2.2 The *life cycle* model

In theory, as long as people are earning more than is required to meet basic needs, they may choose to transfer funds from periods of high income to periods of low income. This so-called smoothing of lifetime income is probably the most commonly understood reason for contributing to a pension during employment. It is based on the idea that it is easier to save when there is more money from which a contribution may be put aside.¹²

This idea is important because there is a less than perfect correlation between people's expenditure and their income. At both ends of the adult life cycle, comparatively low incomes are topped up: through borrowing in younger years, and by drawing on savings, pensions and investments in retirement.

The *life cycle* model is built on several assumptions about human behaviour:

*'The lifecycle model hypothesizes that individuals are forward looking in choosing how much of the resources that they will receive over their lifetime they will consume in each period of their life.'*¹³

This brief statement incorporates four powerful assumptions about people:

- they are forward-looking across the span of their lifetimes;
- they can predict the financial resources they will have over their lifetime (i.e. lifetime income);
- they understand something about the financial resources they will need in successive periods of their lives;
- they make informed choices about the use of their financial resources.

¹¹ DWP Research Report No. 403, 2006, pp.14-16.

¹² The reader should note that there is a simplification being made in this report since the smoothing of income and consumption is used as a proxy for smoothing of utility. There is a distinction because it may ignore the possibility of changes in the need, desire, or ability to consume in later life. The discussion about price motive picks this up when the marginal utility of income is considered.

¹³ Blundell, R., Emmerson, C., Wakefield, M., 2006, p.5.

The *life cycle* model is also built on an assumption that willingness to accept delayed gratification is a common trait and a consistent factor in financial decision-making. Thus it requires individuals to possess a strategic sense that future consumption matters as much as current consumption and to accept the need to secure adequate future income by saving a portion of current income.

The *life cycle* model can also be placed into a wider social policy context. It amounts to redistributing earnings across the life cycle, a form of personalised insurance. This model also implicitly assumes that independence from the State (conceivably because a State income is lower than many want), self-sufficiency and personal autonomy are desirable to most people. Financial incentives that succeed in encouraging people to save over the long term to provide an income that is adequate in retirement also reward saving by helping people preserve autonomy and avoid dependency.

The *life cycle* model also suggests that, if individuals anticipate a decline in their financial situation, then they are likely to save more.

*'...such precautionary savings can be a key component of longer term private savings and requires individuals to have knowledge of the whole 'distribution' of uncertain incomes and needs, as well as understanding how to best use the financial markets to insure against them. Increasing uncertainty over long-term needs and over incomes provides a further reason for increased savings. Levels of awareness and understanding become a key ingredient to decision making, a potentially significant source of market failure and, consequently an important motivation for policy intervention.'*¹⁴

2.2.1 Price motive

The price motive for saving is based on the idea that contributing to a pension can make financial sense if the consumption forgone by saving now is less than the consumption gained in retirement. So while income smoothing relates to the transfer of consumption from one period to another, the price motive relates to the change in total consumption across all periods of life.

The notion that savings may be enhanced by investing them has become an adjunct to the *life cycle* model in mature, free market economies such as the UK. By analogy, individuals who engage in education and training, before and during employment, typically do so knowing that the training period will be marked by lower income than in the future, when income will be greater because an investment was made in education or training. Such trade-offs are made on the basis that measured financial sacrifice is likely to produce longer-term gain, financially and to general well-being.

The price, or substitution, motive holds that saving into a pension should represent good value to people.¹⁵ This value can be measured in the same way as for any

¹⁴ *Ibid*, p.6.

¹⁵ DWP Research Report No. 403, *op cit*, pp.15-16.

investment. If the funds that are committed produce more than the original contribution after correcting for the effect of inflation, there is seen to be real payback of £1 or more.

Further, if we assume that the marginal utility of an extra pound of income diminishes as income increases, then there may also be 'added value' by way of an important rider to this theory:

*'This [the above calculation] does not take into account the value of money to the individual at each stage of his life. Most people have a higher income during working life than in retirement, so £1 may be worth more to them in retirement than the same (real) amount in working life.'*¹⁶

Incentives to save that act primarily through the price motive include tax relief, investment growth, and, where available, contributions from employers, which will become a more prominent feature of the UK's pension system as automatic enrolment into personal accounts and other qualifying schemes are established from 2012.

2.3 Tensions between theory and practice

In reality, incentives and motivations to save function in a world of economic challenges, cultural trends and policy responses to these challenges and trends. As one source states, in *'the most stylized version of the life cycle theory, there is no uncertainty and no choices over retirement'*.¹⁷ In practice, a range of factors, in various combinations, impact forcefully on people's perceptions of saving and their actual behaviour.

Large numbers of people do not behave as the economic theory of incentives suggests they will. With nearly 20 per cent¹⁸ of the working population failing to ensure provision of a suitable pension, it is clear that the explanatory power of economic theory is limited. Analysis presented in this review suggests that much of this failure is related to the theory's flawed assumptions about information, behaviour and the system within which people operate.

The Pensions Commission summed up a broadly held view – before changes were made to both the private and State systems in the recent reforms – on the barriers that work against saving into a pension:

¹⁶ *Ibid*, p.32.

¹⁷ Blundell, R., Emmerson, C., Wakefield, M., *op cit*, p.6.

¹⁸ PricewaterhouseCoopers (PwC) calculation based on Office for National Statistics (ONS) population estimates and Department for Work and Pensions (DWP) White Paper, *op cit*.

*'...both the behavioural barriers to savings and the costs of provision have been made worse by the bewildering complexity of the UK pension system, state and private combined. This complexity reflects the impact of multiple decisions made over the last several decades, each of which appeared to make sense at the time, but the cumulative effect of which has been to create confusion and mistrust.'*¹⁹

That financial decisions do not always respond to incentives as theory suggests they should is well documented in the literature. The DWP report, *Financial incentives to save for retirement*, stated: *'while many people recognise the importance of retirement saving in principle, other considerations act as a barrier'*.²⁰

A comparable picture is revealed if we examine evidence on the country as a whole rather than individual circumstance. Macro-economic evidence provides a similar picture of a disconnect between theory and practice. Reporting on a study of incentives, the Institute for Fiscal Studies (IFS, 2006) drew the following conclusion:

*'...evidence on whether tax incentives to save can lead to significant increases in national savings is at best weak, and it seems that tax incentives may often be an expensive means to encourage new savings.'*²¹

The evidence shows that a range of barriers exist which can help explain the tension between theory and practice. The barriers are three-fold and involve informational/attitudinal barriers, behavioural effects and structural factors. These barriers are discussed in more detail in Chapter 3.

¹⁹ Pensions Commission, 2004, p.205.

²⁰ DWP Research Report No. 403, *op cit*, pp.17.

²¹ Blundell, R., Emmerson, C., Wakefield, M., *op cit*, p.29.

3 Barriers that limit the explanatory power of savings theory

Chapter summary

Barriers to save for retirement take three main forms: informational/attitudinal, structural and behavioural. They are closely inter-related. Complexity around pensions can lead to a lack of understanding and perceptions about availability of information and trust can mean that people do not seek out information to increase their understanding.

Because of an inherent uncertainty about the future, people find it difficult to determine their needs and resources in retirement and therefore, may poorly estimate their desired level of savings. Poor financial capability means that where given forecasts they may not be able to interpret these correctly.

Individuals use a range of sources to obtain information. While IFAs are people's first choice, this is only a minority preference. That the figure is not higher may be because of misperceptions about high charges or because of issues of trust.

There are various perceptions and misperceptions that inhibit saving. For example, some people may not trust the sources that could help them better plan for retirement, and the literature suggests that mistrust is spread across a range of possible sources. The literature also shows contrasting expectations held by individuals on whether Government will, or should, provide them with all of their retirement income. The parental template and mental accounting are also critical factors. It is common for individuals to base choices on those made by their parents. Some people use mental accounting as a means for organising their finances, using different 'pots' of money reserved for key needs and activities.

Continued

Structural reasons for people not saving emerge from people's interaction – or attempted interaction – with the pensions 'system', including the pensions industry and Government provisions. Here, a number of problems arise including the complexity of the pensions infrastructure, and the impact of the tax and benefit system.

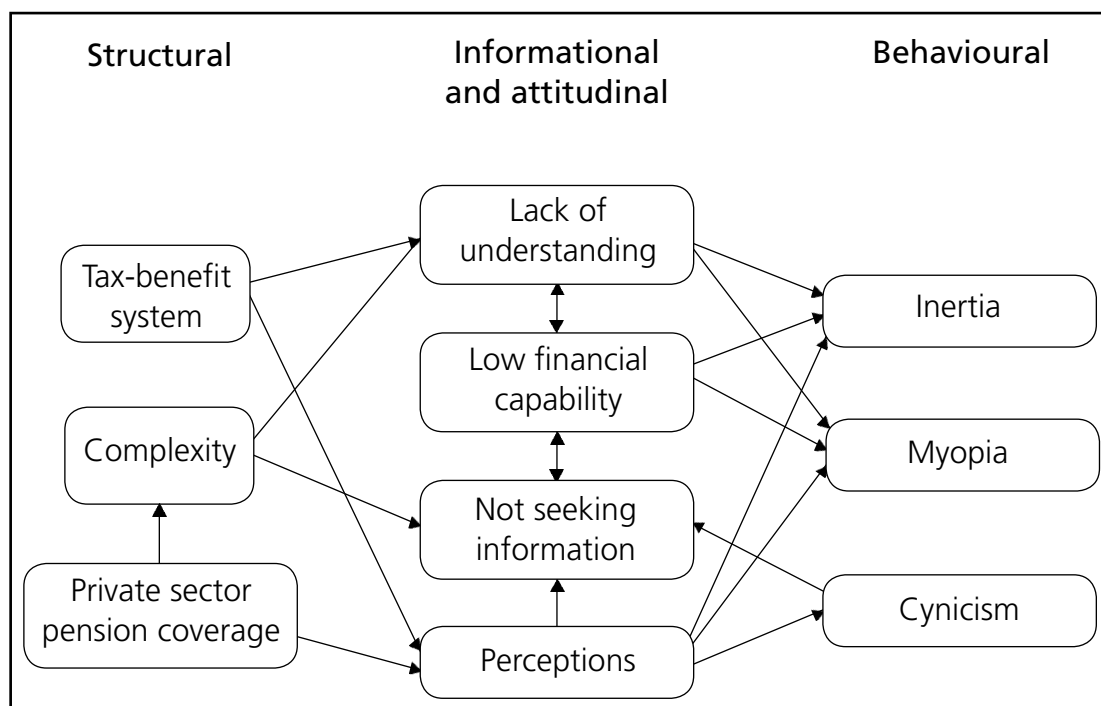
Behavioural barriers to saving include myopia, cynicism and inertia. Even in a hypothetical circumstance, where someone is in a high earning period of their life, they have all the information necessary to 'smooth' income into retirement and the structures in place allow them to gain more than they save, behavioural barriers may still inhibit saving. In this way, behavioural economics, and its application to the study of savings, helps explain why financial incentives do not always work in practice for even the most informed individuals.

3.1 Introduction

Having seen in Chapter 2 that the existence of the income smoothing and price motives are not in themselves perfect predictors of savings behaviour, it is appropriate to examine, in more detail, the barriers to the sort of 'rationally motivated' behaviour that theory assumes.

These fall within three categories: informational/attitudinal, structural, and behavioural; and as will be revealed, they are closely inter-related. As a reference for the ensuing discussion the following diagram may be helpful.

Figure 3.1 Links between different barriers to saving²²



²² DWP, 2008.

3.2 Informational and attitudinal barriers to saving

Like other standard economic theories, the *life cycle* model assumes that economic agents have perfect information when making decisions. Further, since they are also assumed to be perfectly rational, the model takes for granted that they will seek out information they are missing.

Unsurprisingly, this is often not the case. In practice, informational and attitudinal barriers can take the form of:

- limited level of understanding and financial capability;
- not seeking information through inaction, or because of inaccessibility or poor quality of sources; and
- negative perceptions about saving and decision processes that inhibit saving.

3.2.1 Level of understanding and financial capability

Understanding resources and needs over time

The assumption of perfect information includes the idea that people can quantify future needs and make long-term decisions about how to meet those needs, financially. However, individuals may have difficulty assessing their own future needs because of unpredictability of future financial and personal circumstances.²³

Sometimes people do respond when their ability to support future needs changes. Analysis of data from the British Household Panel Survey (BHPS) from 1991 to 1996²⁴, shows that savings tended to increase where a decline in an individual's financial situation was anticipated. For example, the literature suggests that a divorce can have an adverse effect on a family's financial security, which may be felt particularly by women and especially in terms of their retirement income.²⁵ There is also evidence that divorce is a trigger for many women beginning to save independently for retirement.²⁶ This suggests a rational response to distinct events but in general it is difficult to predict one's health²⁷ and ability to work and therefore, the number of years that will be spent in retirement.

Given that longevity is growing and the retirement age has become more flexible²⁸ it is possible that many individuals may not realise the number of years over which their pension funds will be required to support them. A pension fund that looks impressive compared to current annual income looks less impressive if divided into 25 annual instalments that may be taxed and whose value can be reduced by cost-

²³ Pensions Commission, *op.cit.*

²⁴ ILR Working Paper No. 026,1998.

²⁵ ABI, 2004.

²⁶ *Ibid*, pp.7-8.

²⁷ ILR Working Paper No. 026, *op cit*, p.15.

²⁸ Van de Ven, J.,2006.

of-living inflation. This misunderstanding may be the result of lump sum bias, an issue recognised in the behavioural economics literature, where people view lump sums more preferably to an income stream.

Understanding risk

Risk can be measured in terms of variability in the performance, or growth, of investment funds. In one study,²⁹ only a small percentage of those surveyed were concerned about risks associated with poor investment returns: four per cent of current savers and six per cent of non-savers viewed performance risk as a disincentive to greater saving.³⁰ This finding appears to suggest that some were either unaware or unconcerned about the risks involved, although there would probably have been others who were unconcerned because they were confident of their investment decisions.

The role of perceived risk is ambiguous in the literature, perhaps because it takes many different forms. Reasonably accurate predictions of a lengthy retirement can prompt more adequate saving for retirement. Anticipation of 'event risks' such as redundancy or ill health can prompt precautionary saving. Feeling confused about pensions, however, can heighten the sense of being at risk of making poor decisions and deter people from acting. Attitudinal research undertaken for the Pensions Commission³¹ records:

'Private pensions were considered to be both risky and confusing, and this combination led, in some cases...to inaction. Participants [71 people aged 25-55 in 10 focus groups] considered private pensions to be unacceptably risky for a number of reasons that can be summarised under five headings: market risk, lack of liquidity, modest annuity values, the collapse of some schemes, and charges of mis-selling. The majority claimed they lacked confidence in their ability to make decisions about pensions. The confusion that participants felt added to their sense that private pensions were unreliable.'

In terms of the performance risks associated with investment, there remains a perception of risk that impedes saving, although there is some evidence to the contrary, which suggests that performance risk may be generally underestimated. Accordingly, there is little appreciation of the asset allocation risks involved in selecting funds in which to invest in defined contribution (DC) schemes. Though not always confirmed in the literature,³² the difficulty of choosing among funds,

²⁹ ABI, 2002.

³⁰ Please note the limitations to the robustness of this data discussed in Section 3.2.2.

³¹ Pensions Commission, 2005, pp. 103-104.

³² DWP Research Report No. 550, December 2008. The research was conducted on behalf of DWP by Caroline Webb, Julia Pye, Rea Robey, David Jeans and Patten Smith from Ipsos MORI.

about which most know little, may encourage many to select the default fund, whether or not it meets their needs.³³

One survey looked at measuring people's risk aversion by asking respondents how they would invest a sum of money if they had an equal chance of doubling their money, or losing a third of what was invested. Based on this, the study concluded that the respondents were generally fairly risk averse. Interestingly, those who said they would opt out of a hypothetical pension scheme (modelled on personal accounts and other qualifying schemes) were relatively risk averse.³⁴

Understanding how pension provision works and financial capability

One of the most prominent and consistent themes running through the literature on pensions – well documented in many contexts – is individuals' lack of understanding of pensions.

The report, *Attitudes to pensions: The 2006 survey*, found that just five per cent of respondents felt that they had a 'good' knowledge of pension issues.³⁵

There is also much documentation of people admitting that they are confused about pensions:

*'Sixty-seven per cent of people agreed that "I find all pensions confusing".'*³⁶

Uncertainty or confusion can heighten individuals' sense of being at risk in the pensions arena. The many who feel they do not understand pensions may think that this puts them at risk of making poor decisions, based on misunderstanding what is to their advantage and how to achieve it. For example, making pension contributions for many years with little understanding of annuities, e.g. how their value is determined and how they are purchased, is likely to make saving into a pension feel risky. A circular pattern can emerge in which individuals possessing limited knowledge feel uncertain about their choices and actions and are therefore deterred from seeking to understand more.

³³ Cronqvist, H. and Thaler, R.H., 2004.

³⁴ DWP Research Report No. 550, *op.cit.*

³⁵ DWP Research Report No. 434, 2006. The survey, based on a random probability sample of 1,950 adults between 18 and 69 taking part in face-to-face interviews, can be considered robust.

³⁶ Retirement Planning Monitor, 2005, cited in DWP Research Report No. 403, *op cit*, p.17.

The Retirement Planning Monitor (RPM), co-sponsored by DWP, is based on 1,000 face-to-face interviews every year, with quota sampling, set on age, sex, social grade and working status. Some caution should be exercised due to the commercial focus of the report, quota sampling method and by the fact that interviewers spoke to the 'financial decision maker' in the household, presenting a possible skew towards higher earners.

In *Attitudes to pensions*, individuals' knowledge of how the pensions system works was tested by asking respondents a series of questions. The questions, covering State and private pensions, were designed 'to evaluate their knowledge objectively, as opposed to their self-perceived knowledge'.³⁷ Although this is a valuable contribution to the literature on pensions knowledge, the authors acknowledge that it was possible for respondents to guess correct answers. Hence, the incidence of 'correct answers' is unlikely to give an accurate reading of the overall knowledge base.

Despite this caveat, it is interesting to note that respondents scored an average³⁸ of 7.7 correct answers to the 14 questions asked.³⁹ The majority appeared to know about the state pension age, and to have some knowledge of how the contributory National Insurance system works.⁴⁰ The authors concluded that in some cases the understanding they measured was not a matter of generally accurate information but more sophisticated levels of comprehension. For example, 'High proportions of respondents knew that State Pension and private pensions were taken into account within income tax calculations'.⁴¹ In contrast, issues surrounding the State Second Pension, including Home Responsibilities Protection,⁴² and questions about the relationship between pensions and taxation showed lower levels of understanding, to which between one in five and one in four answered 'don't know'.⁴³

There is also misunderstanding over compound interest and the associated benefits of saving for longer periods of time:

*'...most people have little intuitive grasp of interest and compound interest mechanisms and believe it is possible to compensate for the low contributions made during the first half of their working life by saving twice as much during the second half, which it is not.'*⁴⁴

Looking at differences between genders reveals that women feel that they understand financial issues less clearly than men:

*'34 per cent felt they had a clear idea what to do when making important financial decisions. Men and older respondents were more likely to state this.'*⁴⁵

³⁷ DWP Research Report No. 434, *op cit*, p.57.

³⁸ The number of correct answers to a knowledge test of 14 questions was summed to give a 'score' for each respondent.

³⁹ DWP Research Report No. 434, *op cit*, pp.59-60.

⁴⁰ *Ibid*, p.58.

⁴¹ *Ibid*.

⁴² The authors acknowledge, however, that it was too soon to accurately test people's knowledge of Home Responsibilities Protection.

⁴³ DWP Research Report No. 434, 2006, *op cit*, p.59.

⁴⁴ MEA Discussion paper series No. 4052, 2004, p.3.

⁴⁵ DWP Research Report No. 434, *op cit*, p.101.

Variation with respect to educational attainment shows that 62 per cent of those who had a degree as opposed to 80 per cent of those who had no qualifications stated pensions can be too complicated.⁴⁶ The *Attitudes to pensions* report found that those with higher levels of qualifications were more skilled at navigating the complicated information and demanding forms often found in pensions material.⁴⁷

Understanding forecasts

A poor understanding of financial systems and complex pension products, uncertainty over compound interest and the level of payback and some confusion over the impact of savings on the level of benefit entitlement, can result in inaccurate forecasting of retirement savings.

*'...it is important that people can plan with a reasonable degree of clarity over what they can expect their income from the state to be in retirement. In the past, the complexity of the state pensions system has made this difficult.'*⁴⁸

The price motive, coupled with optimism over returns and, possibly, misunderstanding about the accessibility of pension saving, may result in individuals inaccurately forecasting their income in retirement:

*'...individuals might be making inappropriate retirement saving decisions because they are misestimating the retirement income that a given amount of saving is likely to provide.'*⁴⁹

This finding has been replicated elsewhere:

*'Overestimating future income and employment prospects leads to inadequate precautionary saving and too little pension provision.'*⁵⁰

In considering reactions to pension forecasts, a lack of background knowledge about pensions and annuities has been widely reported. Many respondents in recent DWP research demonstrated a poor understanding of how pensions worked, which limited their ability to understand and interpret their forecast:

*'The system (State and private) is complex and unfamiliar to many and although our sample included some respondents with a reasonable degree of pensions "know how", most had only a relatively superficial grasp of how things work – and a small number appeared to have scarcely any understanding at all.'*⁵¹

⁴⁶ *Ibid*, p.122.

⁴⁷ *Ibid*.

⁴⁸ DWP Research Report No. 403, *op cit*, p.5.

⁴⁹ Blundell, R., Emmerson, C., Wakefield, M., *op cit*, p.9.

⁵⁰ FSA, *op cit*, p.49-50.

⁵¹ DWP Research Report No. 492, 2008, p.2.

The scope for inaccurate forecasting will remain large if people operate on the basis of poorly informed assumptions, having failed to obtain accurate predictions that they can interpret correctly. The frequency with which people mis-estimate the value of the State Pension provides one indication of the scope for inaccurate forecasting. In a survey done in 2005,⁵² only around one in ten employees who were surveyed could give an accurate estimate of the value of the basic State Pension for individuals. Of the mis-estimates, more were too low rather than too high, by a ratio of about three to one.

There is some evidence in qualitative research⁵³ that inaccuracy in forecasting the value of annuities from DC schemes runs in the opposite direction, being more prone to overestimation than underestimation by those approaching annuitisation. In one or two of the cases reported, the shock of discovering how modest annuity income would actually be caused saving into a pension to cease on the grounds that the reward was not worth the sacrifice.

The State Pension Forecast (SPF), which is sent automatically to people approaching retirement by the DWP and shows an individual's estimated weekly State Pension at retirement, is generally regarded as trustworthy and accurate in contrast to doubts some have about non-State Pension forecasts. Therefore, it may encourage people to look more closely at their pensions and consider the retirement income they can expect to receive. Recent research found that, of those respondents who remembered having received an SPF, 66 per cent understood all or most of it and 76 per cent found the information useful. Only a minority of 16 per cent, however, undertook any action after having received a SPF.⁵⁴ This has been echoed elsewhere in the literature⁵⁵ – indeed, understanding doesn't necessarily lead to action.

Requesting an SPF may indicate that serious consideration is being given to the income that will be available in retirement, if a State Pension is expected to make a useful contribution to income in retirement. Even when pre-addressed forms were provided as part of information and advice about pensions offered to employees in their workplaces, few employees submitted a request for a forecast to DWP:

⁵² DWP Research Report No. 294, 2005, p.72.

⁵³ DWP Research Report No. 515, 2008.

⁵⁴ DWP Research Report No. 434, *op cit*, p.83.

⁵⁵ DWP Research Report No. 212, 2004.

*'Amongst the employees surveyed 'before and after' [being offered information and advice in the workplace], nine per cent claimed to have requested a [State Pension] forecast. A clear pattern emerged by age, with 22 per cent of all surveyed employees aged 50 and over saying they made a request compared with only four per cent of all those under 35. Findings from the survey matched reasonably well with the total number of requests logged by the Department for Work and Pensions from all employees of the...companies [participating in the study]. In total...271 applications were recorded, representing six per cent of all employees at the 100 [participating] firms.'*⁵⁶

A more encouraging response, however, was found in recipients of a combined State and occupational/personal pension forecast.⁵⁷ Those recalling this Combined Pension Forecast (CPF) were significantly more likely to have taken retirement planning action in the last 18 months. Of these, 40 per cent (15 per cent of all respondents) reported that they were unlikely to have acted without a CPF. Thus, the provision of a forecast, in a clear manner and with reliable information, may be beneficial in improving understanding of savings and encouraging some to take action.

When considering responses to, and understanding of, pension forecasts, age appeared to be one of the most significant factors, as interest in and concern about pensions increases as retirement approaches.⁵⁸ Gender variations are also evident in relation to SPFs. Recent research⁵⁹ illustrates that there were occasions when female respondents had concerns about pensions due to interruptions to work patterns, which 'might be' addressed in forecasts.⁶⁰ This suggests an awareness of the requirement for sustained pension contributions and a need for information about this.

3.2.2 Seeking information, guidance and advice

Does lack of understanding motivate people to seek information about pensions or to take advice? There is evidence that people are not necessarily motivated to seek information about pensions and financial services, particularly amongst lower income groups.⁶¹

⁵⁶ DWP Research Report No. 294, *op cit*, p.49.

⁵⁷ DWP Research Report No. 293, 2006.

⁵⁸ DWP Research Report No. 492, 2008, p.62.

⁵⁹ *Ibid.*

⁶⁰ *Ibid*, p.5.

⁶¹ DWP Research Report No. 550, 2008. The research was conducted on behalf of DWP by Caroline Webb, Julia Pye, Rea Robey, David Jeans and Patten Smith from Ipsos MORI.

Literature about the communications and decision-making processes that involve pensions reflect a preference for two-way, face-to-face communication,⁶² particularly as a way to receive advice. In *Attitudes to pensions*, 60 per cent stated this preference.⁶³ This was also indicated in an earlier Association of British Insurers (ABI) report⁶⁴ although this preference was reported from a relatively small sample.

It should be noted that advice about pensions that can be given by regulated financial advisers who are independent of product providers (IFAs) is distinct from information supplied by providers. There is evidence that some information, including material from pension providers, can be difficult to understand and access when it is wanted (see pension providers section).

Preferred sources: IFAs

Views⁶⁵ on the best source for information and advice on planning for retirement were mixed and were probably associated with a person's own experiences of pensions and exposure to different sources. Just under a quarter of respondents (23 per cent) said their first choice source of information and advice would be an IFA. Employers and pension providers were also relatively popular sources for information with 14 and 11 per cent respectively choosing them as their first choice for information in the future. Around one in ten (nine per cent) said the DWP would be their first choice. In addition to the above sources, some people would prefer to access information about financial services from newspapers and the internet.⁶⁶

It should be noted, however, that there may be differences between sources people say they would prefer to use and those they actually use. For example, the study that found IFAs to be the most popular choice as a source for future information and advice also found that in practice, employers were most likely to have been contacted for this purpose.⁶⁷ There may be an accessibility and affordability issue when it comes to seeking advice about financial services. Findings show that higher earners were more likely to use IFAs than lower earners (32 per cent compared to 14 per cent).⁶⁸ In terms of pensions, a possible explanation comes

⁶² Byrne, A., Harrison, D. and Blake, D., 2007.

⁶³ DWP Research Report No. 434, *op cit*, p.83.

⁶⁴ ABI, *op cit*.

⁶⁵ DWP Research Report No. 434, *op cit*, p.86.

⁶⁶ DWP Research Report No. 550, December 2008. The research was conducted on behalf of DWP by Caroline Webb, Julia Pye, Rea Robey, David Jeans and Patten Smith from Ipsos MORI.

⁶⁷ DWP Research Report No. 434 (2006), *Attitudes to pensions: The 2006 survey*, <http://www.dwp.gov.uk/pensionsreform/pdfs/rrep434-1.pdf>, p.85.

⁶⁸ DWP Research Report No. 550, *op cit*.

from a considerably smaller qualitative study⁶⁹ that found some were deterred from consulting an IFA for advice about annuitising a pension because they believed IFAs charged substantial fees, although advice from an IFA is generally priced into the costs of buying an annuity.

Although three-quarters of those interviewed in this small study had not taken advice from an IFA about annuitisation, those who did found that IFAs helped them overcome some powerful barriers to understanding and to acting in their own best interests. These barriers had to do with:

- the confusing terminology used in generic communications;
- the ease of adopting default solutions rather than considering options that might be better suited to an individual's circumstances;
- the need to understand the wider financial implications of specific decisions, e.g. the tax implications of annuitising a pension before stopping work and how to achieve their own medium- and longer-term goals;
- doubts about the impartiality of information and advice that is available, e.g. from providers;
- the time and procedural difficulties perceived to be involved in implementing important financial decisions once they are made, e.g. annuitising a pension.⁷⁰

Pension providers

Pension providers are a potential source of information for those seeking to make informed decisions about pensions, but trust in them is not high. For example, fewer than one-third of those questioned in one study said they trusted financial institutions to run their pensions.⁷¹

Decisions about annuitising a pension may be particularly problematic in terms of understanding and information provision because once made, these decisions cannot be changed. Thus, it may be unfair to generalise to the information provided about other pension-related matters. Nevertheless, reactions to generic information from pension providers about annuitisation were more critical than positive. In-depth qualitative research⁷² among 60 people who faced an imminent decision or had recently decided to annuitise revealed five perceived causes of difficulties with material from providers:

- documents were laden with financial terminology and did not use plain English;
- there was a confusing mass of paperwork and forms; the sheer quantity of information made it difficult for the less financially knowledgeable to pinpoint information that they considered relevant to their own circumstances.

⁶⁹ DWP Research Report No. *op cit*, 2008.

⁷⁰ *Ibid*, pp.49-50.

⁷¹ DWP Research Report No. 492, *op cit*.

⁷² DWP Research Report No. 515, *op cit*, pp.45-46.

- practical guidance was lacking or under-played, especially regarding how to access independent financial advice;
- in some cases, the material provided seemed, to the recipients, to assume that they would annuitise with the pension provider who had sent the information, i.e., it was self-interested;
- written communications had come too close to the date when a decision was required, leaving insufficient time for people to shop around and consider their options.

Generic financial advice or money guidance

Research conducted for the Thoresen Review⁷³ suggested that individuals would use a generic '*information and guidance service for personal finance issues*' (e.g. money management topics, such as saving, planning for retirement and budgeting) but not for problem or crisis resolution.⁷⁴ While the results were weighted where necessary to ensure that they were demographically representative, it was '*acknowledged that the online method would be likely to under-represent certain demographic, behavioural and attitudinal groups and could overstate the preference for online interaction*'.⁷⁵ The Thoresen Review proposed a new generic financial advice service (which it called Money Guidance) to provide free and impartial information and guidance on a whole range of financial topics. A large-scale pilot (or pathfinder) of a Money Guidance service is due to launch early in 2009 in the North East and North West of England. The pathfinder will investigate the effectiveness of such a service.

Making information and advice available may not always result in it being taken up. The Thoresen Review recommended that engagement, through marketing campaigns, trusted intermediaries and social networks, should be a key part of a money guidance service. It suggests providing a service that seeks to explain the information available and guide people through the available options. By making the information and help provided through Money Guidance personalised and tailored to individuals' needs and circumstances, there may be a far greater chance of motivating people into taking action.

Information provision at the workplace

Evidence⁷⁶ from surveys taken before and after pension information was offered in the workplace showed little impact on pensions behaviour. The objective was to increase membership and contributions to DC occupational schemes to which the employer made little, if any, contribution. The view that the barriers to saving were too great to overcome was commonly found among the surveyed employees. The

⁷³ HMT, 2008.

⁷⁴ *Ibid*, p.41.

⁷⁵ *Ibid*, p.4.

⁷⁶ DWP Research Report No. 294, *op cit*, ch.4.

unwillingness to read a pensions information pack that was provided or to attend group meetings that were held during work time and to sign up for one-to-one meetings designed to provide information or to give advice also helped to explain the absence of a measurable effect in this large and rigorous study.

3.2.3 Other perceptions, misperceptions and decision processes that can act as barriers

Perceived availability or accessibility of information

Half of surveyed employees from 100 workplaces 'agreed' or 'agreed strongly' that they 'did not know where to get information about planning for retirement.'⁷⁷ This may relate to the various behavioural barriers to saving identified in Section 3.4 and to the perception that consulting an IFA is costly.

Lack of trust in sources of information

Having noted the value that two-way, individually tailored, professionally provided information and advice can have, it is important to understand that more people appear to distrust financial institutions than to trust them. Which? survey results showed that fewer than one-third of those questioned trusted financial institutions to run their pensions.⁷⁸ Other studies found that lack of trust in providers is influenced by negative coverage of financial issues in the media,⁷⁹ presumably including coverage of the mis-selling of pensions and doubts about the objectivity of advice given by IFAs paid on commission by providers.

The Thoresen Review aimed to overcome the issue of trust by suggesting that the money guidance service is not commercial or sales-driven. One of the principles of the service is that it will not seek to recommend a single product and/or provider. It suggests that by providing guidance which is not driven by sales, people will trust the guidance received and therefore, feel motivated to address their own financial situation.

Expectation of provision

Some research⁸⁰ has found that one of the reasons given for lack of interest in retirement planning was a feeling that the State should provide for people in retirement. Not all research agrees, however.⁸¹ The former view may be related to the post-war 'cradle to grave' Welfare State and an accepted reliance on the support provided. Nevertheless, it seems fair to observe that, in the lifetime of someone born in 1943 and retiring in 2008 at age 65, three shifts have taken

⁷⁷ *Ibid*, p.66.

⁷⁸ Which?, 2005.

⁷⁹ DWP Research Report No. 438, 2007.

⁸⁰ DWP Research Report No. 294, *op cit*, p.10.

⁸¹ DWP Research Report No. 551, 2008. The research was conducted on behalf of DWP by Emily Gray, Paul Harvey and Joe Lancaster from Ipsos MORI.

place in the locus of responsibility for pensions: from individuals looking out for themselves to the advent of state pensions, then to employer-led occupational pensions, and finally back toward individuals in DC schemes. Perhaps it is not surprising that attitudes have not kept pace uniformly.

In contrast, an acceptance of self-reliance is also recorded in the literature:

*'Few participants [71 people aged 25-55 in ten focus groups] expected the state pension to provide an adequate retirement income, and some expected nothing at all from the state....The decline of the state pension, or uncertainty about its value, and the closure of generous occupational pensions led most participants to the uncomfortable conclusion that there was increasingly a need for people to look after themselves. Most people felt resigned to having to be more self-reliant in planning for retirement but only a few higher earning participants had plans in place and thought they knew how to achieve financial security in retirement.'*⁸²

It appears, therefore, that the literature reports some expecting or hoping to rely on the state for provision and acceptance among others of need for greater self-reliance.

Perceived safety and pay-out

Research in 2006⁸³ about attitudes to retirement saving, including views on the safest way to save for retirement and the best way to achieve high returns, show that property investments were highest on both lists, although pensions do feature high on the list of safest investments.

Table 3.1 Perceptions of different savings and investments⁸⁴

Options for retirement saving. The safest way to save for retirement (in order of safest first)	The way you make most of your money (in order of most return first)
Investing in property	Investing in property
Paying into an employer pension scheme	Saving into an ISA (or other tax-free savings account)
Paying into a personal pension scheme	Saving into a high rate savings account
Saving into an ISA (or other tax-free savings account)	Paying into an employer pension scheme
Saving into a high rate savings account	Investing in the stock market by buying stock and shares
Buying premium bonds	Paying into a personal pension scheme
Don't know	Don't know
Other	Buying premium bonds
	Other

⁸² Pensions Commission, 2005, *op cit*, pp.103-104.

⁸³ Pensions Commission, 2005, *op cit*, pp.103-104.

⁸⁴ *Ibid*, p.134.

The attractiveness of investing in property has been confirmed by other studies. In an evaluation of the impact of providing information and advice about pensions in the workplace, one reason cited by employees for not wanting to participate in a study about pensions was a preference for alternative methods of retirement funding that was felt to be more reliable than pensions. The alternatives included:

*'...investing in property, or other options considered to be under an individual's direct control, as likely to produce better returns and remove reliance on a mistrusted financial services industry.'*⁸⁵

Data for these studies, however, were collected in 2005 and 2006, and the preference for property as an investment for retirement may have changed in the context of the recessionary economic situation that took hold in 2008 and the slowdown in the housing market.

There is evidence of a recent decline in the preference for investing in property. The March 2008 National Association of Pension Funds (NAPF) Workplace Pensions Survey showed that 25 per cent of employees viewed property as the best method of saving for retirement.⁸⁶ The October 2008 survey, however, showed that 18 per cent of employees viewed property as the best method of saving for retirement.⁸⁷

Parental template

It is common for individuals to base choices on those made by their parents.⁸⁸ For example, if an individual's parents were keen savers and bought luxury items only when they could afford them, and never on credit, there is evidence to suggest that the individual will be likely to follow these cautious habits and save adequately.

Others, also referenced in the same report, stress the influence of information over parental modelling. Without information being easily available, however, individuals tend to follow the pattern set by their parents. Indeed, parents can be a source of informal information.⁸⁹ This could conceivably reinforce inclinations to save too little, if levels of State support are decreasing relative to expectations and people are living longer than their parents.

There is also evidence of individuals intentionally breaking away from the parental model. When some young people, aged 16-29, were surveyed about savings, retirement planning and pensions, they noted that their families' financial difficulties had influenced their savings behaviour as young adults. Some had experienced financial hardship while growing up due to their parents' poor

⁸⁵ DWP Research Report No. 294, *op cit*, p.33.

⁸⁶ NAPF, March 2008, Table 6.

⁸⁷ NAPF, October 2008, Table 3.

⁸⁸ Blundell, R., Emmerson, C., Wakefield, M., *op cit*, p.8.

⁸⁹ DWP Research Report No. 551, *op cit*.

financial planning. Now, they saved to avoid experiencing this themselves.⁹⁰ There is some possibility, therefore, based on logic rather than research evidence to date, that greater numbers from the upcoming generation of parents auto-enrolled into personal accounts or qualifying schemes will be models for their children to save, setting up a virtuous circle. It would make sense for future research to focus on this proposition.

Mental accounting

Many people use mental accounting as a means of organising their finances: they have different 'pots' of money reserved for things such as fuel, food and retirement.⁹¹ This can create difficulties if the 'pots' become too rigid, as in the case of someone continuing to save into the 'pension pot' at a set level despite a growth in income, or taking out a loan when they have money saved in a different 'mental account'. This might be seen as irrational or unwise behaviour. The opposite danger arises if the 'pots' are not protected from 'raids' and the individual no longer fears moving money from one 'pot' to another. Mental accounting can support self-control and may result in a greater likelihood of saving into a 'retirement account', provided 'creative bookkeeping' is not used to justify additional spending and contributions to the pots are reviewed and possibly revised from time to time.⁹²

Processing information

There may be different, overlapping ways in which people decide about saving. A study looking at how people decided whether or not to opt out of an automatic enrolment pension scheme identified four such processes: People might take time to weigh up information and evaluate the costs and benefits, consider current costs and affordability only, decide by way of valuing the principle of saving for retirement by linking their decision to a wider ideological standpoint, or a combination of these four ways of thinking.⁹³

Demographic variations in perception

In general terms, the literature suggests that a number of demographic factors influence perceptions and understanding of financial incentives and that there are certain groups for whom savings may be of lesser or greater concern:

*'Levels of worry about retirement income were significantly higher among the economically inactive, older age groups, women, those with fewer financial resources and those without pension provision.'*⁹⁴

⁹⁰ DWP Research Report No. 438, *op cit*, p.25.

⁹¹ FSA, *op cit*.

⁹² Cheema and Soman, 2007, cited in FSA, *op cit*, p.57.

⁹³ DWP Research Report No. 551, *op cit*.

⁹⁴ DWP Research Report No. 434, *op cit*, p.115.

3.3 Structural barriers to saving

This section discusses three structural factors that act as barriers to saving. These relate to complexity, the tax/benefit system and the pensions coverage by the private sector.

3.3.1 Complexity of the pension system

Changes in the last 30 years to the legal framework of pensions have increased the complexity of the system and made it more difficult to understand old and new provisions, rules and products. This was summed up in the first report of the Pensions Commission:

*'This complexity reflects the impact of multiple decisions made over the last several decades, each of which appeared to make sense at the time, but the cumulative effect of which has been to create confusion and mistrust.'*⁹⁵

In addition, there is reason to doubt that the financial literacy required to fully understand pensions and how they work is present in most of the population. Compound interest⁹⁶ and the level of payback are key areas of confusion. There is also some confusion over the impact of savings on the level of benefit entitlement in both working age and in retirement.⁹⁷ Further, co-ordinating multiple pensions and optimising decisions that partners make about pensions can also be complex to achieve.

Following the work of the Pensions Commission, new legislation aims at simplifying the rules governing private pensions and the State Pension system by giving people a better understanding of the State Pension they are accruing and to support people in deciding whether to save. It is not currently clear if this will address the detail of all of these issues.

3.3.2 Role of the tax/benefit system

Targeted support for the poorest groups in society can have inevitable consequences such as reducing the incentive to save and look for work.

*'At the heart of the [pension] reform is a trade-off between the economic efficiency of targeting pension benefits and the potential for targeting to reduce the payback that people might see from their private saving.'*⁹⁸

If the level of benefits available does not encourage saving, this can be considered a disincentive to save for retirement. For example, if the level of State Pension is comparable to working-age income, which is the case for very few people, then there may be no incentive to smooth one's income by saving privately in

⁹⁵ Pensions Commission (2004), *op cit*, p.xiii.

⁹⁶ MEA Discussion paper series No. 4052, *op cit*, p.2.

⁹⁷ DWP Research Report No.438, *op cit*, p.28.

⁹⁸ DWP Research Report No. 403, *op cit*, pp.15.

addition. Similarly, if means testing of benefits results in those in a certain income band seeing their saving affecting their benefit entitlement, individuals may feel that the money saved should have been spent, as they would then have received benefits providing an income similar to that gained from saving. There may also be the possibility of saving and being no better off, for a small minority:

*'...one disadvantage of means-tested benefits is that they can be disincentives to save. This is because, if an individual makes private saving, the extra income received in retirement can mean lower entitlements to means-tested benefits. In extreme situations, individuals may be no better off from having saved.'*⁹⁹

Papers such as Van de Ven,¹⁰⁰ Blundell *et al.*¹⁰¹ and the forthcoming report of the Government-led savings incentives programme, *Saving for Retirement: Implications of Pensions Reforms on Financial Incentives to Save for Retirement*, seek to model the exact levels of these financial incentives within the current and future tax/benefit system, so we shall not go into detail here. The trade-offs between targeted benefits and private saving are issues that pensions reforms are seeking to address. For example, as a result of State Pension reform, many people, particularly women, will need to rely less on income-related benefits.

There is evidence of a belief among some that those saving for retirement will ultimately be penalised by the State system, such as in research undertaken for DWP on young people:

*'There was a perception across all groups, but most strongly in the non-savers groups, that having savings or investments reduces your entitlement to benefits and other forms of support from the state.'*¹⁰²

A lack of knowledge may amplify the actual financial disincentives created by the benefit system. A majority surveyed did not realise that you can receive Pension Credit even if you have savings.¹⁰³

In addition to the structural issues with income-related benefits, the tax advantages and disadvantages associated with pensions can act as a barrier by complicating the calculation of expected returns, especially if understanding is low. Tax relief is a particular example, which could act as a financial incentive to save if people knew about it (see Chapter 4). A 2005 DWP research report finds that, of those surveyed, knowledge of pensions issues was limited, with only approximately one-quarter confident of their eligibility for tax relief on pension contributions.¹⁰⁴ Results of

⁹⁹ PPI (2007), *Increasing the value of saving in Personal Accounts: taking small pension pots.*

¹⁰⁰ Van de Ven, J., 2006.

¹⁰¹ Blundell, R., Emmerson, C., Wakefield, M., *op cit.*

¹⁰² DWP Research Report No. 438, *op cit*, p.28.

¹⁰³ DWP Research Report No. 434, *op cit*, p.59.

¹⁰⁴ DWP Research Report No. 294, *op cit*, p.39.

a knowledge test, however, illustrate that there is a slightly higher knowledge of how the tax system treats pensions, when compared to that of other pension issues.¹⁰⁵ Just over half (53 per cent) knew that private pensions qualify for tax relief, with higher earners being more likely to be aware of it.

3.3.3 Private sector pension coverage

An additional structural issue can be that the market fails to provide adequately for certain groups of people who would otherwise want to save for retirement. For example, providers find it difficult, profitably, to serve low to moderate earners within the existing charging regime, due to the low level of their contributions, administrative costs and lack of persistence in their savings. There is evidence that providers are reluctant to seek out their custom, given the difficulty in keeping products profitable within the existing charging structure.¹⁰⁶

3.4 Behavioural barriers to saving

There are several behavioural factors critical to understanding the interplay between savings theory and practice. These can be grouped under three inter-related headings: myopia; cynicism; and inertia.

3.4.1 Myopia

Myopia, also referred to as the 'spend now focus', is said to occur when people strongly discount the future and do not act within their long-term self-interest. This relates to something known as 'hyperbolic discounting', where people do not discount the future at a constant rate, so preferences for smaller pay-offs now over greater pay-offs later may be regretted.

Some people may find saving genuinely unaffordable¹⁰⁷ such as those on low incomes who have children and/or mortgages. Immediate financial demands have been found to cause some to decide against joining workplace schemes or to opt out if automatically enrolled because they think that the contributions required from employees are unaffordable.

The concept of myopia relates to those who perceive they can't afford saving because of a greater desire to spend their income now. A quantitative survey carried out with 754 individuals found that after explaining what their contribution might mean in monthly/weekly terms based on their salary, only 16 per cent of respondents who said they would opt out from the proposed workplace pension reforms said this was because they couldn't afford to save.

¹⁰⁵ DWP Research Report No. 434, *op cit*, p.59.

¹⁰⁶ Pensions Commission, *op cit*, p.70.

¹⁰⁷ ILR, Working Paper No. 026 *op cit*, p.14.

People may choose to save but for goals that are within a shorter timeframe than retirement. For example, in one survey, about 45 per cent of the regular savers claimed that they save for special events such as holidays, or for no special reason – so called precautionary saving.¹⁰⁸

Savers often tended to talk in terms of key stages in their lives or shifts of their lifestyles, for example, moving out of home or in with a partner, getting a mortgage or having children.¹⁰⁹ This way of understanding motivations and why they change is broadly consistent with life cycle theories about incentives to save. It suggests that such events make people less myopic about the future.

Two life events often halt saving into a pension: the onset of disability and redundancy, especially if they occur after the age of 50.¹¹⁰ Rather than myopia, this could be a rational response if such people are suddenly earning less and are no longer in a period of life from which income can be transferred.

Marketing messages from the finance industry seek to encourage many to spend or take out credit. People commonly felt that *'credit was too easy to obtain and that it was vigorously promoted by banks and other financial institutions'*.¹¹¹

The Pensions Commission identified the contradiction whereby most people felt that saving for the future was becoming increasingly important and simultaneously more difficult:

*'Most contrasted the fixed demands of today with the uncertainties of the future. The combination of uncertainty about the future and concern about meeting current financial commitments led half to agree that they would prioritise having a good standard of living today rather than saving for retirement. Only a minority, those closest to retirement, were trying to address their uncertainties about [how to make] adequate preparation for retirement...'*¹¹²

Moreover, many people do not enjoy looking ahead or do not want to think about the future or old age:

*'...many people are myopic and only begin to make provision for their old age when it is too late.'*¹¹³

Perceptions are subject to subtle changes as people move up the age range, however:

¹⁰⁸ *Ibid*, p.14.

¹⁰⁹ DWP Research Report No. 438, *op cit*, p.22.

¹¹⁰ DWP Research Report No. 515, *op cit*, pp.33-34.

¹¹¹ DWP Research Report No. 438, *op cit*, p.29

¹¹² Pensions Commission (2005), *op cit*, pp.102-103.

¹¹³ MEA Discussion paper series, *op cit*, p.3.

*'Younger age groups were more likely to think it is not worth saving for retirement as it is so far off. Thirty-eight per cent aged 18-24, 15 per cent aged 25-34 and three per cent aged 55-64 expressed this attitude. Those who were older would logically be less likely to perceive retirement as far off. What is interesting though is that, as with perceptions of ability to afford to save, there was a major shift in attitudes between those aged 18-24 and those aged 25-34 [away from agreeing that saving is not worth worrying about as it is so far off], after which agreement declined more gradually.'*¹¹⁴

There is evidence that young employees do not consider pensions in detail, as the long-term does not seem particularly relevant and retirement seems to be too far into the future to warrant current concern.¹¹⁵ A common viewpoint is of 'living for the moment,'¹¹⁶ and it tends to be later in life when individuals concern themselves more with retirement planning. Typically, pension planning becomes a greater priority when people reach their mid-40s, with BHPS research showing that the proportion of people saving specifically for their old age rises steeply around this age.¹¹⁷

Additional, if limited, research¹¹⁸ finds that the mean age at which respondents felt it was sensible to start saving was 29.¹¹⁹ This is significantly higher than the proposed age for automatic enrolment into personal accounts and other qualifying schemes (22), but other research found support for the age of 22, with some suggesting as young as 18 and others as soon as an individual starts work, which may be as young as 16.¹²⁰

3.4.2 Cynicism

Some individuals are cynical about the pension system and the returns they can expect, particularly those who have had previous bad experiences. DWP surveys

¹¹⁴ DWP Research Report No. 434, *op cit*, p.120.

¹¹⁵ E.g., DWP Research Report No. 294, *op cit*.

¹¹⁶ DWP Research Report No. 438, *op cit*.

¹¹⁷ ONS, 2005.

¹¹⁸ Scottish Widows, 2007. The survey was undertaken by YouGov which only interviews people with online access. There are a number of problems with such an approach. Samples are drawn from a group of people who not only have access to the internet, but are active users of it, have sufficient interest in the types of issues that are polled upon to access this site in the first place and are willing to take the time to participate in surveys. Also, the sample is more likely to be employed in professional or managerial occupations, to have above average levels of income and to have an occupational or personal pension. This and other issues (including the use of an incentive system for completion) render the results insufficiently robust.

¹¹⁹ *Ibid*, p.3.

¹²⁰ DWP Research Report No. 438, *op cit*.

have produced a number of findings that document suspicion and negative views of the pensions industry or some of its members. In addition, there were those who believed that pension returns were so poor that those on low to modest incomes who saved into pensions would probably end up with no more in retirement than those who had made no provision.¹²¹ This would seem to be related to perceptions of the benefits system, discussed previously. Another set of perceptions, presented earlier as an informational barrier may impact cynicism and, therefore, act as a behavioural barrier. That is, people are also influenced by negative coverage of financial issues in the media and some claim not to 'believe' what they are told.¹²² This is likely to be exacerbated in an economic downturn. Reported falls in pension funds are likely to feed cynicism even among younger people who may benefit in the longer run.

Past experience was also relevant in a few cases. Several had lost money either through collapse of a previous pension scheme or due to poor investment performance.¹²³

3.4.3 Inertia

This can be considered one of the greatest barriers to be overcome in pension provision, and in the literature it is linked to feelings of apathy, hopelessness, demotivation, procrastination and disinterest.¹²⁴ A feeling that planning for retirement was a task that should be done but was rather unpleasant, makes it easier to put off.

Such apathy figured strongly in recent research on employees¹²⁵ to assess the impact of providing information and advice on pensions in the workplace. One of its central objectives was to examine its impact on employees' behaviour and attitudes to saving. The findings were striking:

*'The dominant attitude to emerge among employees was of considerable, often substantial, apathy and indifference with respect to pensions and retirement income as an issue.'*¹²⁶

Inertia and apathy are manifested in a range of ways. Employees in one study failed to opt in to the evaluation and often cited total disinterest in pensions as a reason, which was confirmed indirectly by employers, providers and IFAs who claimed employees would not engage with initiatives, such as presentations about pensions offered during work time.¹²⁷

¹²¹ DWP Research Report No. 294, *op cit*, p.33.

¹²² DWP Research Report No. 438, *op cit*, pp.26.

¹²³ DWP Research Report No. 294, *op cit*, p.33.

¹²⁴ *Ibid.*

¹²⁵ DWP Research Report No. 294, *op cit*.

¹²⁶ DWP Research Report No. 294, *op cit*, p.9.

¹²⁷ *Ibid*, p.30.

There is evidence that confusion about the pensions system can lead to inertia and affect behaviour:

'In exceptional cases participants were so bewildered by the choices with which they were faced that they decided to delay making decisions at all...'

'I switch off as soon as I read or hear anything about pensions, because I don't understand...I suppose that's one of the reasons why I don't want to retire: the money will be useful, but I don't want to have to make the decision either. ...I feel quite inadequate in making the decision.'

(Female; prospective annuitant; >£15k – <£40k fund value)¹²⁸

This lack of action appears to be related to the effort required and the understanding deemed necessary to opt into a pension scheme and make decisions required from members: *'for many it was easier to let time drift by than tackle the issue'*.¹²⁹

There is also evidence that some people find retirement planning overwhelming and feel helpless, believing that the task they would face in trying to make adequate provision would be impossible.¹³⁰ This relates to a number of points covered in previous sections and may be particularly relevant to those with lower income, due to lower-paid jobs, part-time work, time off for caring responsibilities and being self-employed. It also relates to expectations about the effort, frustration and fear of failure that some see as being the 'cost' of trying to become better informed about retirement planning and pensions. Finally, a sense of futility may also be age-related among those who know they have not prepared adequately for retirement. Some of these will simply give up, thinking that what they could contribute while still in work would be too little to make any difference to their later financial security.

Not only can too little information cause inertia; too much can also overwhelm people into inaction, as observed in the United States.

¹²⁸ DWP Research Report No. 515, *op cit*, p.36.

¹²⁹ DWP Research Report No. 294, *op cit*, p.9.

¹³⁰ *Ibid.*

Evidence on information overload from the United States

Too much choice may not be beneficial in terms of encouraging savings. A large dataset, of approximately 800,000 employees in 69 industries, is used to show the impact of choice of funds in 401(k) plans. Findings show that those plans with a greater number of funds had significantly lower participation rates.¹³¹ Further, the greater the number of funds, the greater the proportion opting for money market and bond funds, which Iyengar and Kamenica (2008) argue is due more to seeking simplicity within a large choice than risk avoidance.¹³²

¹³¹ Iyengar *et al.*, *op cit.*

¹³² *Ibid.*

4 Overcoming barriers to saving

Chapter summary

Provision of information, advice and guidance may increase understanding. In contrast, too much information may be counter-productive, while the evidence that financial education initiatives have a positive impact upon financial decisions and actions taken subsequently is still limited.

The two most powerful financial incentives for saving into a pension are tax relief and employer contributions. These can enhance the price motive since they make savings cheaper. Some individuals cite tax relief as a key motive for their decision to save, whilst others say they are unaware of the benefits. Employers' contributions to a workplace-based pension scheme have a measurable influence on uptake and employee contribution levels.

As from 2012, automatic enrolment is intended and expected to increase participation in workplace-based pension schemes and recast the savings landscape by:

- reducing structural and behavioural barriers of opting into an occupational pension scheme and having to select investment funds before joining a DC scheme;
- increasing the financial incentive to remain in a scheme, once enrolled, by matching the level of contributions required of employees with contributions from the employer and Government.

4.1 Introduction

This review has summarised the theory behind financial incentives to save, considered how well people understand pensions and discussed the barriers to saving for retirement. After this discussion, it is worth noting that many people do save into pensions, the majority of retirees are not deeply impoverished, and

an industry thrives on pensions. This chapter brings together some concepts and findings from earlier sections and talks about ways in which the barriers to saving can or are being overcome. Focus is given to financial education and information and guidance, financial incentives and automatic enrolment.

4.2 Financial education, information and guidance

As has been suggested previously, efforts to provide information to individuals so that they can evaluate incentives to save wisely, need to be carefully managed, given individual circumstances. It has been shown that people are not fully informed and that there is a desire for information and advice regarding pension planning (see Section 3.2.2). As people are assisted in calculating their pension requirements and understanding how to build their pension funds, their confidence can increase. One study cites the importance of advertising and provision of information in raising awareness and understanding of the individual pension savings accounts in the USA, known as Individual Retirement Accounts (IRAs) and 401(k) plans¹³³, combined with regulations that limited uncertainty for investors:

*'The great success of individual retirement accounts...and employer-sponsored retirement saving plans...also seems to be due to information and advertising, and a consistent capital market regulation that reduced the uncertainty of investors.'*¹³⁴

Of course, while structured provision of information and advice or levels of education and financial advice can improve understanding, it is not a simple solution since behavioural barriers can still inhibit action¹³⁵. Further, as noted earlier when discussing inertia, there is a risk that too much information may lead to information overload and decision fatigue.

The impact of financial education is not easy to measure over a short timeframe; as yet, there is limited UK evidence that financial literacy has a large beneficial effect on financial decision-making and financial actions taken subsequently¹³⁶. Some modest positive results of financial education are available from the US (see box).

¹³³ IRAs allow individuals to obtain tax-deferred or tax-free investment growth; 401(k) plans are similar but allow for employer contributions.

¹³⁴ MEA Discussion paper series No. 4052, *op cit*, p.16.

¹³⁵ FSA, *op cit*.

¹³⁶ *Ibid*, p.10.

Evidence on financial education from the United States

Modest positive results of financial education: Previous studies on the effects of financial education reveal positive, but modest, results. For example, when considering data from various states in the USA, some of which included compulsory consumer and financial education, it was found that a small, but statistically significant, increase in savings rates of 1.5 per cent resulted from those who had been educated in states which had compulsory financial education, compared with those who did not. Further, there is some indication that the length of time in which such education has been enforced has an influence, perhaps related to the development of the programme.¹³⁷

Difficulty of measuring the influence of education: Reviewing previous studies of knowledge provision, the FSA (2008) note some impacts of knowledge accumulation from attendance at seminars or fairs, but that this is limited in terms of significance and accuracy. There are issues such as the **self-selection** when using data related to influence of completion of a university finance course, for example¹³⁸. There is a need for more research into financial education as an influence on savings behaviour.

Spillover effect: There is potential for a spillover effect of those receiving financial education to inform and thus raise the knowledge of their peers:

*'...there is evidence here that even controlling for selection effects, information affects decisions and perhaps that education has spillover effects. It helps not only the direct recipients, but their peers too.'*¹³⁹

4.3 Financial incentives that affect the price of saving

As previously noted, the price motive depends on the value of money saved now compared to the value of money received in the future. The two most powerful financial incentives to save currently in operation on a wide scale are tax breaks and employer contributions. Both improve the price motive because they allow more to be saved for a pension than is being contributed by the individual. After automatic enrolment becomes the rule rather than an exception, all the evidence suggests that it will become a powerful means of encouraging pensions saving, in part because it will open up access to tax relief and employer contributions. If individuals are aware of these, they may respond by foregoing spending in the present in order to save more for retirement. Being aware of these incentives may encourage people to find out more about the specifics of the financial benefits they can achieve and the process of saving for retirement through pensions. These incentives can have a role in encouraging people to save for retirement in the face

¹³⁷ Bernheim, Garret and Maki, 2001. Cited in FSA, *ibid*.

¹³⁸ FSA, *op cit*, p.14.

¹³⁹ *Ibid*, p.14.

of competing financial pressures, particularly those who feel that they are just on the cusp of being able to save into a pension.¹⁴⁰

The literature provides a number of clear examples of financial incentives that appear to work for some groups.

4.3.1 Tax relief

Since tax is calculated on income after pension contributions are deducted, there is a tax advantage to saving in a pension. This is known as tax relief and for a basic-rate tax payer it means having 25p extra savings for every pound saved. In the UK even low earners who don't pay tax can get basic tax relief. There is evidence that tax relief can be an incentive which encourages saving for some groups.

Blundell *et al.* highlight the importance of the tax band that individuals are in, and expect to be in, and the impact of tax payments on the level of personal pensions saving. This report notes that the Pensions Commission described how:

*'...the combined effects of income tax, tax credits and means tested retirement benefits, create incentives to save for retirement that vary substantially with an individual's current and (expected) future circumstances.'*¹⁴¹

The tax system's interaction with the benefits/tax credits system has an impact on the incentive to save. For example, those who are currently basic rate tax payers but expect to become higher rate taxpayers or move onto the taper of the Working Tax Credit (WTC) have an incentive to delay pension contributions until this time, whereas those for whom the reverse is true would be incentivised to bring contributions forward.

Research¹⁴² conducted in 2002¹⁴³ found that half of the basic rate tax payers who were studied said that the tax incentives in place were an important factor in their deciding to save into a pension. Perhaps unsurprisingly, 75 per cent of respondents stated that they would be likely to save more if the Government offered a higher level of tax relief on their contributions.¹⁴⁴ We should also be mindful that what people say they would do may not be what they do in practice: saying 'yes' to hypothetical money is costless when the action to secure it is also hypothetical.

¹⁴⁰ ABI, *op cit.* Please note, however, the qualifications to this research set out in Section 3.2.2.

¹⁴¹ Blundell, R., Emmerson, C., Wakefield, M., *op cit.*, p.39.

¹⁴² ABI, *op cit.* Please note, however, the qualifications to this research set out in Section 3.2.2.

¹⁴³ Although this research was conducted in 2002, it is still relevant in highlighting the potential impact of such policies on savings levels.

¹⁴⁴ DWP points out that it is important to note that tax relief is currently given at a persons highest marginal rate and any increase in this would probably require a system of tax credits.

Evidence on the impact of tax credits from the United States

Saver's Credit

The impact of Government matching schemes can be illustrated by an example from the USA: the Saver's Credit¹⁴⁵. Low and middle income families contributing to certain pension schemes have, since 2002, been able to claim a Saver's Credit. The credit rate is higher at lower income levels, from 50 per cent for married taxpayers earning adjusted gross incomes (AGIs) up to \$30k, 20 per cent for \$30,001-\$32,500, 10 per cent for the band \$32,501-\$50,000, with none above \$50k. Estimates suggest that almost 60 per cent of the benefits have gone to those with an adjusted gross income of \$10-\$30k, i.e. those in the lower income bands. However, as the credit is non-refundable, it is not as effective as it could be for those with lower to middle income levels who have no income tax liability against which to offset it.¹⁴⁶

There is some uncertainty with respect to the degree to which schemes have increased total savings. When considering analyses of studies of American 401(k) and IRA schemes, Blundell *et al.* (2006) note that there is conflict within the literature, with some suggesting that there is minimal additional saving (e.g. if the cost of tax relief is taken into account) and others arguing that a large proportion of contributions to the schemes have been new saving¹⁴⁷. However, there is evidence to suggest that, whilst pension contributions did increase due to the introduction of the Saver's Credit, total savings have not and the increase is small when compared to the level of incentives.¹⁴⁸

Lack of knowledge about eligibility for tax relief can limit the impact of this incentive to encourage saving into a pension. In a fairly small sub-group of employees (64) who were somewhat more knowledgeable about pension matters than average, just 33 per cent agreed that they would be eligible for tax relief on pensions contributions.¹⁴⁹

The evidence presented suggests that tax relief has a positive impact on incentivising pension saving for some people. For others, tax advantages in themselves are not enough to precipitate saving.

4.3.2 Employer contributions

An employer's contributions to a workplace-based pension scheme are seen by people as attractive¹⁵⁰ and have a measurable influence on uptake and employee

¹⁴⁵ PwC, 2006.

¹⁴⁶ *Ibid.*

¹⁴⁷ Blundell, R., Emmerson, C., Wakefield, M., *op cit*, p.29.

¹⁴⁸ Duflo *et al.*, 2005. Cited in: Blundell, R., Emmerson, C., Wakefield, M., *ibid*, p.29.

¹⁴⁹ DWP Research Report No. 294, *op cit*, p.68.

¹⁵⁰ DWP Research Report No. 550, *op cit*.

contribution levels. This was found in a study that included employees and employers in 100 organisations.

*'Among surveyed employees of firms where an employer contribution was not currently offered, 80 per cent said that the introduction of one would encourage them to either start or increase contributions themselves.'*¹⁵¹

Employer contributions can be seen as an addition to base pay and a part of the employees' reward package. Further, employees may feel that contributions they make are worth more because they attract the employer's contributions.

Of the young people (16-29 year olds) interviewed in a 2007 qualitative study,¹⁵² many felt that securing an employer contribution into their pension fund would be the strongest reason for them to start saving for retirement.

In organisations employing five people or more, research has found that the availability of an employer contribution had a significant effect on membership of the pension scheme. Where there was no employer contribution, take-up was 13 per cent, compared to over two-thirds (69 per cent) where the employer contribution was at least five per cent.¹⁵³ This appears¹⁵⁴ to illustrate the considerable impact of the employer contribution as an incentive to saving in an occupational pension scheme. This is further highlighted by the finding that 75 per cent of those participating in this study said that they would be likely to save more if employer contributions started or increased.¹⁵⁵

Some groups, namely the self-employed, may not have access to employer contributions. They are one of the groups at risk of being under-pensioned:

*'Traditionally under-pensioned, the self-employed have access to neither an employer contribution nor additional state pensions...they are by far the least confident about the adequacy of their retirement savings and their confidence has declined most over the past year.'*¹⁵⁶

4.3.3 Automatic enrolment and other reforms

Recent policy reverses the historical pattern of employees being urged to enrol in their employer's occupational pension scheme. Soon they are to be automatically enrolled with a subsequent choice to opt out. This will radically shift the burden of responsibility and the manner in which occupational schemes incentivise saving

¹⁵¹ DWP Research Report No. 294, *op cit*, p.9.

¹⁵² DWP Research Report No. 438, *op cit*.

¹⁵³ ABI, *op cit*, p.3.

¹⁵⁴ Please note, however, the concerns over robustness summarised in Section 3.2.2.

¹⁵⁵ ABI, *op cit*, p.15.

¹⁵⁶ *Ibid*, p.20. Please note, however, the concerns over robustness summarised in Section 3.2.2.

into pensions. Employees will be enrolled into occupational schemes without filling in demanding application forms, going through a qualification process and waiting for acceptance; their choice will be whether to opt out once they have been enrolled.

Automatic enrolment will apply to every employee over 22 years of age, with a minimum employer contribution required for each employee enrolled.¹⁵⁷ This is intended and expected to increase participation in workplace-based pension schemes by overcoming barriers that have affected opt-in participation, such as complexity, financial pressure not to contribute and most importantly, inertia. The default, therefore, is of saving:

*'Automatic enrolment is a powerful tool which enrolls those who make no active decision into a pension, so the default is to be saving rather than not.'*¹⁵⁸

There is evidence that personal accounts and other qualifying schemes will still face some disincentives to saving as well as incentives. According to a Pensions Policy Institute (PPI) report:

*'Some factors, such as the proposed employer contribution, tax relief and investment returns will tend to increase returns from saving. Others will reduce returns from saving, such as the charges levied for running Personal Accounts, any income tax paid on pension income in retirement and any reduction in eligibility for means-tested benefits.'*¹⁵⁹

Charges, however, are planned to be as low as possible and a possible advantage of the schemes is simplification, which would reduce the structural barriers to pension saving. A recent qualitative study finds that:

*'Participants spoke about the easy-to-understand nature of the reforms and the scheme.'*¹⁶⁰

These reforms also seek to overcome the structural barrier related to private sector under-provision for low to middle earners by setting up a scheme of personal accounts to complement the qualifying schemes that will be provided by the market.

There is evidence that this type of automatic enrolment raises pension membership. The 2005 Employers' Pension Provision Survey findings showed that:

¹⁵⁷ DWP White Paper, *op cit*.

¹⁵⁸ DWP Research Report No. 403, *op cit*, p.18.

¹⁵⁹ PPI (2007), Increasing the value of saving in Personal Accounts: rewarding modest amounts of pension saving, p.6.

¹⁶⁰ DWP Research Report No. 551, *op cit*, p3.

*'Within private firms with 20 or more employees, the proportion of employees who were in a pension averaged 60 per cent where the firm used automatic enrolment. This compared to 41 per cent for traditional opt-in pension schemes.'*¹⁶¹

Other research findings are even more positive about the effect of automatic enrolment:

*'56 per cent of those who were eligible to join pension schemes in workplaces that used opt-in enrolment methods did so, compared to 90% where automatic enrolment was in use.'*¹⁶²

Groups with low participation in workplace schemes are likely to show the greatest change after automatic enrolment is introduced, e.g., those on low pay, and minority ethnic groups and women, as shown by American research into 401(k) schemes.¹⁶³

Evidence on whether automatic enrolment is likely to be successful with younger age groups is mixed, however. Conducted prior to the emergence of full details of the changes, *Live now, save later?* found that most young people were supportive of automatic enrolment and personal accounts.¹⁶⁴ A slight majority of the younger age groups surveyed in *Attitudes to pensions*, however, opposed automatic enrolment.

¹⁶¹ DWP Research Report No. 329, 2006, p.112.

¹⁶² PPI, 2006, p.5; using data from Deloitte (2006), Employer pension contributions and pension reform, ABI Research Paper 2, Association of British Employers.

¹⁶³ DWP White Paper, *op cit*, p.63.

¹⁶⁴ DWP Research Report No. 438, *op cit*, pp.50-54.

Other ways of overcoming inertia: Evidence from the United States

The Save more Tomorrow (SMarT™) scheme has encouraged increases in savings rates in the US, using the theory of behavioural economics. Employees commit to increasing contributions to a workplace-based pension scheme with each pay rise, although they are able to opt out at any time. There is a maximum contribution level. This, thus, addresses the issue of not increasing contributions when it is possible to do so, as well as the tendency toward aversion, as the savings rate is increased as pay increases, thus there is no experience of a decrease in take-home pay. Findings include:

- 78 per cent of those offered SMarT™ in the first case study took it up;
- the majority of those who signed up stayed in the scheme (80 per cent of those in the first case study);
- savings contribution increased until the maximum level was reached, typically within four years;¹⁶⁵
- further, a study by Thaler and Benartzi (2004) shows that, after two years, participants had nearly quadrupled their saving rate.¹⁶⁶

¹⁶⁵ Benartzi, S. and Thaler, R., 2003, *Save more tomorrow: Using behavioural economics to increase employee saving*, Journal of Political Economy. Cited in: DWP White Paper, *op cit*, p.77.

¹⁶⁶ Thaler, R. and Benartzi, S., 2004. Cited in FSA, *op cit*.

5 Conclusions

5.1 Précis of main findings

The research findings reviewed here can be thought of as participating in a dialogue concerning theory and practice or between expectations about how people are likely to think and behave and how they actually think and behave. In theory, the wish to smooth income and consumption over a lifetime (the *income motive*) and to benefit from the growth of savings made into pension schemes (the price motive) would lead most people to provide for financial security in retirement. These theories are compromised, however, by informational/attitudinal, structural and behavioural barriers, chief amongst which are these:

- **Informational/attitudinal barriers:**
 - lack of understanding;
 - not seeking information;
 - low financial capability; and
 - perceptions about saving.
- **Structural barriers:**
 - complexity;
 - tax/benefit system; and
 - private sector pension coverage.
- **Behavioural barriers:**
 - myopia;
 - cynicism; and
 - inertia.

Despite these barriers, tax relief on pensions contributions, employers' contributions to employees' pensions and automatic enrolment have been found effectively to incentivise joining and contributing to pension schemes for some but not all groups.

5.2 Quality of reviewed research

The quality and relevance of the 42 research projects that have been reviewed has generally been high. This is true of both qualitative and quantitative studies. Qualitative studies commissioned by DWP have carefully avoided overreaching the limits of indicative research and the quantitative studies have done a good job of drawing sensible and useful conclusions from the data that was collected.

Where doubts have arisen about the reviewed research, they pertain mainly to:

- small samples, or more often, analysis of small sub-groups;
- the potential difficulties that on-line data collection presents to achieving a representative sample, especially when data collected on-line is used to predict usage of on-line sources of information about pensions and saving for retirement; and
- use of hypothetical questions, of the sort that ask what people would do or how they would react if the Government or others did something that seems to lie outside the range of current possibilities, which may prompt unreliable replies.

It is worth noting, without criticism, that the reviewed research focused largely on occupational pension schemes. Whether the incentives and barriers to saving into personal pension plans are the same as those that apply to occupational schemes is not possible to judge from the literature that was reviewed.

5.3 Conflicting findings and gaps in the reviewed research

Seven sources of conflicting findings and/or gaps seem to exist in the literature:

- How to motivate people to take up and use available information about pensions and saving for retirement is an unresolved puzzle. Improving the clarity, personal relevance and timeliness of the information is part of the answer, given criticisms of information now available.
- Findings about the impact on savings behaviour of financial education or communications programmes intended to increase financial literacy are limited and somewhat contradictory. The emphasis being given to such programmes creates opportunities to evaluate their impact rigorously and in the longer term.

- Pensions decision-making and providing for financial security in retirement are likely to remain a complicated, 'high denial' area for many people. Information and advice will continue to be needed, but if trust remains low in the providers of information and advice, the scope for greater financial literacy may be limited. The Thoresen Review proposed a Government and FSA sponsored Money Guidance service that will provide personalised information and guidance on a number of financial topics. Principles set for Money Guidance by the Thoresen Review included that it should be impartial and sales-free in order to address the tendency for consumers to mistrust information and advice offered by commercial providers. The large scale Pathfinder, an evaluated pilot which will launch next year, will provide evidence as to the effectiveness and impact of such a service and the degree to which consumers trust and act on the guidance given.
- Could research also show those currently providing information and advice, e.g. pension providers and IFAs, how to improve their services and gain greater trust – a matter of some importance to them in a challenging economic climate?
- In the literature it appears that feeling at risk for somewhat different reasons can act as an incentive and a disincentive to save for retirement. Precautionary saving can be encouraged by uncertainty around future events. Myopia and procrastination, as well as failure to take up available information and feelings of fatalism and futility, can be encouraged if people feel that their lack of understanding about pensions puts them at risk of making poor decisions. There is some new research, but a better understanding of how risk functions and more metrics for factoring it into individuals' financial decision-making would be useful.
- The literature is light on the motivating force of self-reliance, or the consequences when the scope for self-reliance is expanded in saving for retirement. As DC scheme membership grows and investment performance risk is shifted from employers operating Defined Benefit (DB) schemes to employees enrolled in DC schemes, for instance, it will be important to know how much understanding people have of what self-reliance means when it comes to selecting or delegating decisions about the funds in which they invest.
- Because it is difficult to measure, persistence in contributing to a pension or pensions through the course of working life does not feature much in the literature. The portability of personal accounts may provide an incentive to look at this, while possibly making it easier to obtain consistent administrative data about contribution histories.

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