

Why inflation matters

Inflation, a word barely heard over the past 10 years, is once again rearing its ugly head. Official figures put inflation at an annual rate of 3.3% and it is expected to rise to 4% by the end of 2008. The official target which the Bank of England is charged to maintain is just 2%.

But former Prime Minister, John Major, put the cat among the pigeons recently by suggesting that the real rate of inflation is nearer 10%. Major warned that the consumer price index, the government's official measure of inflation, could not be trusted as it doesn't include housing costs, such as mortgage repayments and rent, and council tax in inflation calculations.

Anyone who goes regularly to the supermarket cannot avoid the reality of higher food prices, while household bills for heating and lighting have been going through the roof – not least because of rising oil prices.

The very real danger is that inflation erodes the value of people's savings, reduces the buying power of their earnings or income and leads to higher wage claims which in turn push up prices. It is all too easy to get into a vicious upward spiral if inflation is not contained.

Inflation and retirement planning

So what does all this mean for those saving for retirement today? NHS employees are fortunate to enjoy inflation-proofed pensions, generally linked to final salary at retirement age, and increased each year in retirement by the level of increase in the retail price index. It is worth emphasizing just how valuable this is.

If you were saving for retirement through a personal pension, you would need a significant amount to provide sufficient pension to take care of inflationary rises in prices after retirement. For example, a man aged 65 years, retiring today with £100 000 in a pension fund, could buy a non-increasing annuity income of around

£7900 a year for the rest of his life, while a woman aged 60 years would receive £6800 a year. But if they want to inflation proof this and receive a pension linked to the retail price index, the same £100 000 would provide a pension of just £4750 for the man or £3690 a year for a woman.

Those who work in the public sector, such as the NHS, are fortunate to benefit from index-linked pensions, which are 'protected' from inflation. It is possible that within a decade they may be the only employees to enjoy this inflation-proofed retirement income as the cost of provision drives employers in the private sector to discontinue these schemes.

But even those working in the public sector may not get a full pension because employees typically have to be a member of the scheme for 40 years to qualify for the maximum two-thirds final salary.

The key issue to consider is whether your NHS pension will be sufficient to provide the standard of living you want when you retire. If it won't, then it makes sense to top up your NHS pension or supplement it, with either a personal pension or an individual savings account (ISA).

Pension plan or ISA

Whether you choose to invest in a pension plan or ISA really depends on your circumstances. For younger employees, who may need their savings long before they reach retirement age – to buy a home, move house or educate children – an ISA is a more flexible option because money saved can be withdrawn at any time.

Both ISAs and pension savings benefit from capital gains tax-free growth on investments. Pension contributions attract income tax relief at your highest rate paid, whereas ISA contributions do not. On the other hand pension income in retirement will be taxed at up to 40% but income from gilts and bond funds held within an ISA is tax-free. There is also the advantage that income from ISAs is not taken into account when calculating any claw-back of higher personal allowances given to those over the age of 65 years.

Pension schemes must be used to provide an income by the age of 75 years, but there is no such requirement with ISA sav-

ings and so any surplus on death can be passed on to children or grandchildren – albeit with a potential inheritance tax charge.

It is worth pointing out for those able to save relatively large amounts and who have used up their ISA allowances, that the new rules on capital gains tax mean gains in excess of £9600 a year are taxed at only 18% compared with income tax of up to 40%. Further, gains up to £9600 are free of capital gains tax so it can pay to invest for growth.

For higher rate taxpayers who expect to be basic rate taxpayers in retirement, the advantage of 40% tax relief on pension contributions now, with only basic rate tax deducted from the income, can be very attractive. Also, the ability to take a tax-free lump sum of up to 25% from a pension fund when you retire can be beneficial. This lump sum can be used to provide a tax-efficient income, only a small part of which is taxed at 40%.

Those who want to keep their options open can save in an ISA, moving the money into a pension scheme at a later date, perhaps in their forties or older. The new rules on tax relief on pensions mean you can contribute up to £235 000 or 100% of earnings (2008–9), less the value of any increase in NHS pension, and qualify for tax relief on contributions. This means that over only a few years, money built up in ISAs could be transferred to a personal pension and the full amount would qualify for tax relief of up to 40% provided it does not exceed 100% of earnings for that tax year.

The NHS pension scheme itself offers the opportunity to purchase extra retirement income and it is important to assess the costs of the options available here as compared to the alternatives discussed earlier.

However you choose to save it would be wise to seek advice from a specialist financial adviser who has a detailed understanding of the NHS pension scheme and can help you plan for the retirement you've worked for. **BJHM**

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