

## **PPI Response to HMT consultation: strengthening the incentive to save**

### **Executive summary**

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system.

### **The current system**

2. The two main reasons why tax relief is given on pensions are to encourage people to save for their retirement, and to make the tax system for pension saving neutral by ensuring that people do not pay tax twice on the same income.
3. The UK pension tax system is based on an EET system; the principle of contributions being Exempt from tax, Investment returns being Exempt from tax, and withdrawals from pension being Taxed.
4. However in practice the tax treatment of pensions in the UK is better than that of other savings, including ISAs (which are sometimes described as tax neutral). Pension saving in the UK is therefore tax advantaged.
5. The current distribution of tax relief benefits higher rate taxpayers more than basic rate taxpayers. An important tax advantage accrues from the fact that it is possible to withdraw a tax-free lump sum of up to 25% of the pension value.
6. Many people are likely to experience lower tax rates in retirement than during their working lives, meaning that they gain a further tax advantage.
7. The net cost of tax relief, after allowing for tax paid on pensions in payment, was estimated to be £21.2 billion in the 2013/14 tax year.
8. While basic rate taxpayers make 50% of the total pension contributions, they benefit from 30% of pension tax relief. In contrast, 50% pension tax relief goes to higher rate taxpayers and 20% goes to additional rate taxpayers, these groups make 40% and 10% of the total contributions respectively.

### **Radical reforms**

9. This response considers a range of alternative radical reforms. Key findings include:
  - An EET system (retaining the tax free lump sum) with a single rate between 20% and 40% has a redistributive effect, improving the outcomes for basic rate taxpayers but worsening outcomes for higher and additional rate taxpayers.
  - Even though outcomes for higher and additional rate taxpayers are lower in a single rate system than the current system, outcomes are still better than in a purely tax neutral system, such as a pure TEE system.

- A pure TEE system without matching contributions is likely to reduce pension outcomes, because, with tax being paid up front, none of the pension is received tax free, and the tax paid is at the individual's marginal rate in work, rather than an average rate after retirement.
- Giving a matching contribution on a TEE system is similar to a single rate EET system in the accumulation phase.
- A TEE system with significant matching contributions could improve the outcomes for individuals.
- A single rate EET system of 30% relief would mean double taxation for individuals who were Additional Rate taxpayers both when contributing and in retirement.
- A single rate EET system of 25% or 20% would lead to individuals who were Higher rate or Additional rate taxpayers in retirement facing double taxation.
- No individuals who pay Basic rate tax in retirement would face double taxation if the single rate in an EET tax system is at least equal to the basic rate of income tax.
- An EET system with a single rate of slightly over 30% might be implemented for around the same initial cost of tax relief as the current system. A lower single rate would lead to lower costs to the exchequer.
- A pure TEE system will lead to an initial reduction in cost as the tax relief on contributions falls to zero, however there will be a longer term cost when the resulting pensions are paid out with no tax payable.
- A TEE system with matching contributions introduces up-front costs to the exchequer in addition to the loss of future tax revenue on pension payments.
- The distribution of tax relief would be equal to the distribution of contributions under any system with a matching or single rate element. This gives a more even distribution of relief than the current marginal rate system

### Savings incentives

10. The evidence surrounding the potential behavioural changes in response to changes in tax relief is limited, and where there is evidence of changes in behaviour in response to changes in rates of return, responses are usually relatively small.
11. As highlighted by the lack of impact on pension saving of the current system, providing a large fiscal incentive is not necessarily enough in itself to change behaviour. If the incentive is not clear, well defined, or easily understood, individuals cannot respond to it. Even if it is clear, individuals will not necessarily respond in the way that might be expected.
12. There is some evidence to suggest that such matching contributions do affect behaviour, in the context of US pension saving and in other savings policy areas in the UK. This might be easier with a single rate of matching than, for example, in the current system where the match depends on the tax band of the individual. Presenting the current system as a match could

also lead to questions as to why higher earners receive a higher match, and the technical explanations might be hard to get across to individuals.

### **The role of employers**

13. The relative value of pension contributions to employers and employees is likely to be an important determinant of behaviour. In the current system, there is a clear financial benefit to both the employer and employee of an employer making an employer pension contribution, in part due to the tax relief and tax-free lump sum, and in part due to the NIC relief on pension contributions. If there was no longer a clear financial benefit, employers and employees might prefer other methods of remuneration after meeting the statutory minimum requirements of automatic enrolment.

### **Government contribution to saving**

14. Even if individuals have only limited responses to incentives, tax relief can still be seen within the automatic enrolment framework as a Government contribution to pension saving. Moving to a single rate of tax relief presented as a matched contribution would, depending on the rate used, change the distribution of the Government contribution to pension saving compared to the current system, leading to increased contributions and therefore larger pension funds for basic rate taxpayers, and lower contributions and therefore smaller pension funds for higher rate and additional rate taxpayers. If matching contributions encourage higher levels of participation in workplace pension saving, there may also be a reduction in opting-out.

### **Coherence with other policies**

15. It is important not to view tax relief in isolation from other parts of the UK pension saving system, including recent reforms which will also have an impact on levels of pension saving. These include:
  - The introduction of the new State Pension for individuals reaching state pension age from April 2016 onwards.
  - The introduction of automatic enrolment, which is still only partially rolled out and with very low contribution levels.
  - Freedom and choice for DC pension saving.

### **Potential longer term and intergenerational consequences**

16. A shift to TEE would bring forward tax collection, but lead to lower tax receipts from pensions in payment in the future.
17. Demographic projections highlight that the proportion of the population aged above state pension age is likely to increase significantly in the future. If the majority of their income is tax free, at a time that age-related Government expenditure will be under increasing pressure, a TEE system suggests an increased tax burden on a relatively smaller working age population.

## Introduction

The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

1. This response will look in detail at the outcomes from the current system of tax relief in the UK, to illustrate the counterfactual against which any future reform should be considered. The response then covers detailed analysis of the outcomes from radical reform alternatives, and considers relevant other issues such as incentives, transparency and savings behaviour, as well as briefly highlighting potential long term and intergenerational impacts.
2. Although raising some of the relevant issues, this response does not cover in detail any potential implementation issues where others will have better evidence and experience of operating and administering systems.

## The rationale for pension tax relief

3. There are two main reasons why tax relief is given on pension saving:
  - Tax incentives are used to support retirement saving by encouraging individuals to save for their retirement and employers to contribute to pension schemes. The ultimate objective is to ensure that people have enough money to live on once they have retired, limiting the extent to which they rely on the state in retirement. In this way, tax relief looks to compensate people for the fact that they cannot access their money before a particular date and, when they are able to access this money, it must be accessed in a particular way (for instance, they must take it as an annuity or via a Capped Drawdown arrangement).
  - Tax relief is also designed to help people defer consumption by ensuring that people do not pay tax twice on the same income if they save it to spend in the future; e.g. at the point where they earn the income and when they receive the income in retirement. This centres on the avoidance of double taxation. This is sometimes called a “tax neutral” system, as it is neutral between spending and saving.
4. These two reasons are not mutually exclusive and are, in some cases, complementary – avoiding double taxation may also incentivise pension saving over other forms of saving. However, the relative importance given to each of these reasons can lead to different conclusions about the best structure for tax relief. An emphasis on avoiding double taxation means that high earning individuals with high marginal tax rates can receive large amounts of tax relief. However, an emphasis on incentivising pension saving to ensure adequacy of retirement income might suggest that limiting relief to high earners (who are more likely to

save in the absence of incentives) and targeting incentives on low income individuals could be the most beneficial approach in the long run.

### **How does pension tax relief currently work in the UK?**

5. The regime for tax relief for private pensions has evolved over recent years, but the main principles of tax relief have remained the same.
6. There are three stages of pension scheme saving where tax could be payable or relieved. These are:
  1. Contributions to the pension scheme
  2. Investment returns on the subsequent pension fund
  3. Payments out of the pension scheme
7. The UK has broadly adopted what is known as an EET system; the principle of contributions being Exempt from tax, investment returns being Exempt from tax, and withdrawal from pensions being Taxed. If a pure EET approach were in place in the UK, this would allow for the following:

#### *Stage 1- Contributions*

Contributions made by the individual to be paid from gross pay and not subject to income tax. Contributions paid by the employer would also be free of income tax.

#### *Stage 2 - Investment*

Growth and income within the pension fund to be free of capital gains tax (CGT) and income tax.

#### *Stage 3 - Payment*

Benefits to those taking retirement income from a private pension to be taxed at the individual's marginal rate of income tax.

8. In practice, in the current UK system of pension tax relief there are some variations to the application of the EET approach as follows:
9. In the investment stage, where the investment returns on the fund are equity dividends, tax at the Corporation Tax rate has been paid on these and cannot be reclaimed by the pension fund.
10. In the payment stage, up to 25% of the pension fund can be taken in the form of a lump sum which is exempt from tax.
11. For these reasons, today's system is better referred to as **Eet**, with the second two letters in lower case to reflect the taxation of some investment returns at the second stage and the opportunity to access tax-free benefits at the third stage.

12. Tax relief is generally at the individual's marginal tax rate; however, even where someone does not have income high enough to pay tax they can benefit from basic rate tax relief on payments up to £2,880 a year.

### **Tax relief is limited in the UK**

13. There are limits in place to tax relief on pensions. These restrict the amount of relieved pension that can be built up every year and the total value of the pension at retirement. These are known as the Annual Allowance and the Lifetime Allowance respectively. Both of these have been reduced significantly in recent years.

#### *Annual Allowance*

14. If the individual's and employer's contributions (for Defined Contribution pension schemes), or the real increase in the value of the pension rights (for Defined Benefit pension schemes), exceed the Annual Allowance, then the excess is subject to a tax charge at the individual's marginal tax rate. The Annual Allowance is set at £40,000 for the 2015/16 tax year. Unused Annual Allowance from the three previous tax years can be carried forward and added to the Annual Allowance.
15. From 2016 the annual allowance will be reduced for those earning over £150,000. Individuals with incomes between £150,000 and £210,000 would have their Annual Allowance gradually reduced from £40,000 down to £10,000, and individuals with incomes over £210,000 would have an Annual Allowance of £10,000.

#### *The Lifetime Allowance*

16. The Lifetime Allowance limits the amount of pension saving that can be built up over the course of an individual's life for tax relief purposes. This is usually assessed when a pension comes into payment. If the value of the pension benefit at retirement is over the Lifetime Allowance tax is payable at the 25% rate on the excess if it is taken as an annuity (on which income tax is then payable at the individual's marginal rate) and at the 55% rate if it is taken as a lump sum (which is then payable tax-free). The current life time allowance is £1.25 million from 2014-15 onwards.<sup>1</sup> Both the Annual and Lifetime Allowances have been reduced incrementally over time.
17. While, in theory, the UK pension tax relief system allows taxation to be smoothed over a lifetime, there are some irregularities in the pension system. These arise mainly from timing issues and fiscal policy. Over their lifetime individuals are likely to experience changes to levels of their own personal income and government changes to allowances and tax rates. However, many people are likely to experience lower incomes and tax rates in retirement than in their working lives. For example, some

<sup>1</sup> Protection exists to allow individuals who would have built up pension saving in excess of the Lifetime Allowance at the time it was introduced to avoid tax charges. More information is available at [www.hmrc.gov.uk/pensionschemes/pension-savings-la.htm#1](http://www.hmrc.gov.uk/pensionschemes/pension-savings-la.htm#1)

individuals will move from being higher rate taxpayers at some point during their working lives to basic rate taxpayers in retirement.

#### **Tax relief is currently delivered through two different systems**

18. The actual amount of tax relief on pension contributions varies depending on whether contributions are paid from income before income tax is deducted, or after.
19. Contributions taken from salary before the deduction of income tax reduce the taxable income of an employee. They therefore implicitly attract tax relief at the employee's marginal rate. Pension schemes that receive employer contributions, including all Defined Benefit schemes, can be set up in this way. This is sometimes called a *net pay arrangement*. If an individual does not pay income tax, they receive no tax relief in a net pay arrangement.
20. Pension schemes that receive contributions from post-tax pay, such as personal pensions, are also eligible for tax relief but it is through a more explicit process. The pension fund will claim tax relief on all contributions at the basic rate from the government. Further tax relief for higher and additional rate taxpayers must be reclaimed by the individual in a tax return. This is known as *Relief at Source*.

#### **How much does pension tax relief cost?**

21. Tax relief has a cost and there are different ways to estimate this cost. One way of calculating the cost is the 'present value' approach. This calculates the cost over the lifetime of individuals, taking into account the amount paid out in relief on contributions, relief on investment income and tax paid on pensions in payment over individuals' lifetimes. However, this cost can be hard to measure or project, as it depends on individual decisions as well as changing tax rates and systems.
22. HM Revenue and Customs (HMRC) uses a cash flow approach to estimate the annual amount of tax revenue foregone because of pension tax relief on private pension contributions by employers, employees, and the self-employed.
23. In 2013/14 the cost of tax relief amounted to £27.0 billion (table 1). In addition, relief given on investment returns is estimated to cost another £7.3 billion, bringing the total gross cost of pension tax relief to £35 billion.
24. Offset against this amount is the amount of tax collected on private pensions in payment, £13.1 billion, to reach an estimate of the net tax relief cost. HMRC estimated this cost to be around £21.2 billion.<sup>2</sup>

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<sup>2</sup> HMRC PEN6 (2015)

25. However, if the Government phased out tax relief on pension contributions this would not necessarily result in extra revenue of the full cost of tax relief as, for instance, some pension savings would be diverted to other tax-advantaged savings account or spent.<sup>3</sup>

**Table 1: Estimated costs of tax relief on private pensions (2013/14)<sup>4</sup>**

<b>Tax relief on:</b>	<b>£ millions</b>
<i>Relief paid on contributions into schemes:</i>	
Employees' contributions to occupational pension schemes	£4,300
Employers' contributions to occupational pension schemes	£17,100
Employees' contributions to personal pension schemes	£1,900
Employers' contributions to personal pension schemes	£3,100
Contributions to personal pensions by the self-employed	£600
<b>Total tax relief on contributions</b>	<b>£27,000</b>
<i>Relief paid on investment returns:</i>	
Investment income of funds	£7,300
<b>Total tax relief on private pensions</b>	<b>£34,300</b>
<i>Less tax liable on:</i>	
Pension payments	£13,100
<b>Total tax received</b>	<b>£13,100</b>
<b>NET TAX RELIEF COST</b>	<b>£21,200</b>

26. There is also a cost of relief from National Insurance contributions on employers' pension contributions worth £14.0 billion in 2013/14.
27. Some employers offer what are known as 'salary sacrifice' schemes to take further advantage of this relief. Under these arrangements, an employee will agree a reduction in salary, while the same amount is then paid as an employer pension contribution. This can increase the overall level of remuneration, due to a reduction in the level of NI paid by both the employer and employee.
28. There is no comprehensive, robust evidence as to how many employers offer this scheme, how many employees take advantage of it or how much is foregone in NI relief.
29. The cost of pension tax relief has been increasing in recent years. The gross cost before taking into account tax paid on pensions in payment increased from £29.4 billion in 2008/9 to £34.3 billion in 2013/14, despite reductions in both annual and lifetime allowances.<sup>5</sup>
30. More recent developments are likely to affect the cost of tax relief in different ways. Further reductions to the Annual and Lifetime Allowances, and the proposed changes to the Annual Allowance for high earners from 2016 will reduce the cost of tax relief. In contrast, the

<sup>3</sup> PPI (2004)

<sup>4</sup> HMRC PEN6 (2015)

<sup>5</sup> HMRC PEN6 (2015)



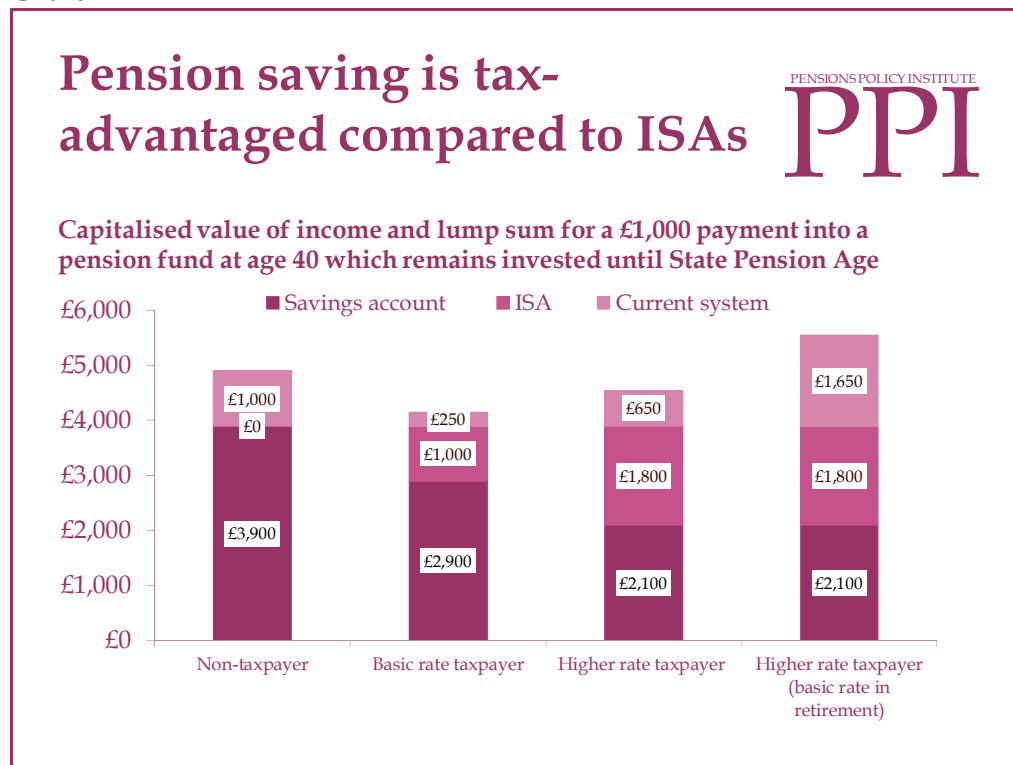
introduction of auto-enrolment is likely to result in more people paying into pensions. Under automatic enrolment, the total amount paid in, and the corresponding tax relief, is likely to increase all other things being equal.

**The impact of the UK pension tax system varies between individuals**

31. The pension tax system enables individuals to benefit from the smoothing of taxation over their lifetime. While their contributions and returns on their investment are largely tax-free, the state reclaims the tax foregone through the taxation of part of private pension income (after allowing for the 25% tax-free lump sum), though this is sometimes at a lower rate of taxation. This regime means that, relative to other types of saving such as ISAs, high levels of financial benefit can accrue to the individual through tax relief on pension contributions.
32. The following analysis shows the impact of the current tax relief system on the amount of pension tax relief received by four different types of taxpayer:
  - A non-taxpayer
  - A basic rate taxpayer
  - An individual who pays higher rate tax both during their working life and in retirement
  - An individual who pays higher rate tax during their working life and basic rate tax in retirement
33. Calculations are based on a payment of £1,000 into a pension by an individual aged 40 which remains invested until state pension age, assumed to be 67 in line with current legislation.
34. These calculations compare the amount that would be received if the same contribution were paid into a pension, into an ISA and into a normal savings account. Where someone pays into an ISA, their contributions are made out of taxed income and subsequently any growth in the fund and income withdrawn from the fund is exempt from tax. In theory this is known as a TEE regime, although in the UK as in the pension tax relief system, the investment stage is not completely exempt from taxation and is best described as TeE. In contrast, it is assumed in these calculations that any growth or income in a normal savings account is fully taxed – this is known as a TTE regime.
35. To isolate the impact of tax relief, it is assumed that both the ISA and the savings account would achieve the same investment return before tax as the pension fund. For simplicity the middle 'e' in both the ISA and the pension has been treated as 'E'; investment returns are assumed to be free of tax. This does not affect the relative difference between the different types of saving.

36. A TEE regime, such as an ISA, is often used to describe a tax-neutral system, in that it avoids double taxation.<sup>6</sup> Therefore, where the UK pension tax relief system provides a better outcome than an ISA, this is tax beneficial rather than tax neutral.
37. Chart 1 shows what each type of taxpayer would receive, net of tax, under different regimes.

Chart 1<sup>7</sup>



### Normal savings account

38. If the £1,000 payment is paid into a savings account, of all of the groups of individuals, non-taxpayers and basic rate taxpayers would receive the largest capitalised value. This is because non-taxpayers do not pay tax on any interest from a normal savings account and a basic rate taxpayer pays tax at 20%. While non-taxpayers would receive £3,900, basic rate taxpayers would receive £2,900 and higher rate taxpayers would receive £2,100 irrespective of their tax rate in retirement.

<sup>6</sup> IFS (2011) Mirrlees Review

<sup>7</sup> Based on a one-off payment of £1,000, a nominal rate of return of 6% per annum and an Annual Management Charge of 0.77%. Further information is available from PPI (2013) *Tax relief for pension saving in the UK*.

*ISA*

39. In contrast, all individuals would achieve the same capitalised value of £3,900 under the tax neutral ISA regime. This is because interest on an ISA is tax-free for all types of taxpayers.

*Pensions*

40. Both taxpayers, regardless of their marginal tax rate, and non-taxpayers benefit from the current system relative to ISAs and savings accounts. Non-taxpayers benefit from the current system because they can receive basic rate tax relief on contributions of up to £2,880 per year. The capitalised value of the pension to the non-taxpayer is £4,900, which is £1,000 (34%) higher than the ISA. For taxpayers, the main tax advantage of a pension compared to an ISA comes from the tax-free lump sum. This is higher for higher rate taxpayers than for basic rate taxpayers, as they would have had to pay tax at the higher rate if the lump sum were taxable. The capitalised value of the pension to the basic rate taxpayer is £4,150, which is £250 (6%) higher than the ISA. The capitalised value of the pension to the higher rate taxpayer is £4,550, which is £650 (17%) higher than the ISA.
41. A further advantage exists for the individual who pays higher rate tax when working, but is a basic rate taxpayer in retirement. This is because they receive relief on contributions at the higher rate of tax, but only pay tax at the basic rate. The capitalised value of the pension to this taxpayer is £5,550, £1,650 (42%) higher than the ISA.
42. As such, the current distribution of tax relief benefits higher rate taxpayers more than basic rate taxpayers, particularly those people who pay higher rate tax during at least part of their working lives, benefitting from higher rate tax relief, and go on to pay basic rate tax in retirement.
43. An important tax advantage accrues from the fact that it is possible to withdraw a tax-free lump sum of up to 25% of the pension value. While there are no specific figures regarding the uptake of this option and use of lump sums, research suggests that around 80% of those drawing a company or private pension in 2011 took a lump sum from their fund at retirement<sup>8</sup>. Of these people, over half of those who took a lump sum put some of the money in a savings account, while just over a quarter invested in stocks, shares or investment trusts.<sup>9</sup> Other reported uses of tax-free lump sums include paying off mortgages or other debts.<sup>10</sup>

<sup>8</sup> [www.pru.co.uk/pdf/presscenter/ret\\_inc\\_worries\\_lump\\_sum\\_regrets.pdf](http://www.pru.co.uk/pdf/presscenter/ret_inc_worries_lump_sum_regrets.pdf)

<sup>9</sup> [www.pru.co.uk/pdf/presscenter/ret\\_inc\\_worries\\_lump\\_sum\\_regrets.pdf](http://www.pru.co.uk/pdf/presscenter/ret_inc_worries_lump_sum_regrets.pdf)

<sup>10</sup> [www.scottishwidows.co.uk/documents/generic/2008\\_grandparents\\_travel\\_delayed\\_debt.pdf](http://www.scottishwidows.co.uk/documents/generic/2008_grandparents_travel_delayed_debt.pdf)

**Avoidance of double taxation**

44. The current pension tax relief system aims to ensure that pension saving is at least tax neutral (people do not pay tax twice on the same income). The 25% tax-free lump sum means that the pension tax relief system is actually tax advantaged. In this respect, all individuals with pension saving receive a tax advantage. In addition, the system works so that some people gain a further tax advantage from pension saving:
- Where people receive tax relief on contributions at the higher rate and pay tax on a private pension in retirement at the basic rate, they gain a greater tax advantage.
  - Similarly, people who receive tax relief on contributions at the basic rate and do not pay tax in retirement receive a tax advantage.
45. It is difficult to know how many people benefit in either of these ways. Table 2 shows the number of people in 2012/13 who paid basic, higher and additional rate tax.<sup>11</sup> In 2010/11, higher rate tax was paid by around 2 million (10%) taxpayers whose largest source of income was from employment and by around 200,000 (4%) of taxpayers whose large source of income was from a pension. The percentage of people paying higher rate tax has been increasing, and in future more individuals are likely to pay higher rate tax, both while working and in retirement as the income at which higher rate tax is payable has been falling relative to average earnings. Previous PPI calculations suggest that the proportion of pensioners paying higher rate tax could increase to around 9% of pensioners by 2026, assuming that thresholds are increased broadly in line with prices.<sup>12</sup>

**Table 2: Numbers of taxpayers by tax rate and main source of income, 2012/13<sup>13</sup>**

	<b>Main source of income from employment (thousands)</b>	<b>Main source of income from pension (thousands)</b>
<b>Basic rate taxpayers</b>	18,000	5,210
<b>Higher rate taxpayers</b>	2,760	293
<b>Additional rate Taxpayers</b>	185	9

<sup>11</sup> HMRC table 3.4

<sup>12</sup> Assuming that the Personal Allowance increase in line with CPI, following the increase to £10,000 in 2014/15 and that the basic rate band increases in line with RPI from 2016/17 following planned increases of higher rate threshold in 2014/15 and 2015/16. See HMRC, *Income tax higher rate threshold for 2014-15* and HMRC *Income tax personal allowance for those born after 5 April 1948 and basic rate limit for 2014-15*

<sup>13</sup> HMRC, table 3.4

46. Fiscal drag, whereby an increasing number of people are pulled into paying higher rate tax, means that higher numbers of people will pay higher rate tax during retirement and also during their working lives. However, it is likely that there will remain a group of people who pay higher rate tax at some point during their working lives and basic rate tax in retirement. If this pattern persists, this suggests that a large proportion of those people currently paying higher rate tax on their earnings, and benefitting from higher rate tax relief, may not pay higher rate tax on their pension income.

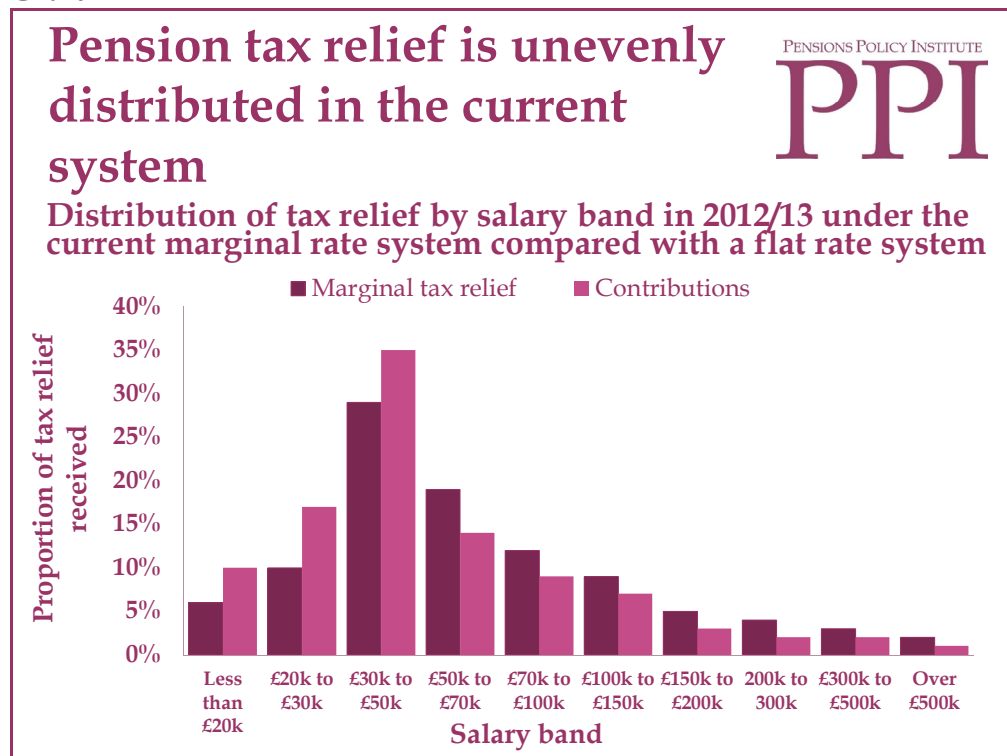
**Does current tax relief encourage pension saving?**

47. Evidence around the effectiveness of tax incentives in encouraging pension saving is limited. However the literature enables some understanding around the effectiveness of tax relief as well as reasons why tax relief is not effective. There are some issues which relate directly to the tax relief system:
- Lack of understanding around tax relief.
  - People redirect money from savings into a pension, rather than increase their savings overall.
  - Higher earners, who may be more likely to save, are more likely to respond to incentives.
  - Tax relief has not led to enough saving to close the 'Savings Gap'.
48. There are some more general barriers to pension saving, which an effective incentive system would need to overcome:
- People have insufficient income to make pension savings.
  - Lack of understanding around pensions.
  - Issues related to the current design and delivery of pensions.
  - Inertia.
49. The current system of tax relief is very good at avoiding double taxation, and in fact provides a very tax favourable system for many. However, despite the significant fiscal incentives offered by the system, it has not been effective at increasing pension savings except at higher earnings levels. The evidence also suggests that where pension saving has been increased it has at least in part been due to redirected savings rather than new saving. Much of the cost of the current system may therefore be as a Government contribution towards pension saving rather than as a savings incentive.
50. This is not necessarily a bad feature in a system, and is broadly consistent with the principles of the Government making a contribution to automatic enrolment. However, if tax relief is directed towards individuals who would already be saving rather than being used to encourage new saving, the distribution of tax relief becomes a relevant consideration.

### How is pension tax relief distributed?

51. Tax relief benefits higher earners disproportionately, with higher earning employees receiving the majority of the tax relief from the government. However, this partly reflects the fact that higher and additional rate taxpayers pay a larger proportion of tax revenues (Chart 2).

Chart 2 <sup>14</sup>



52. In the current system, basic rate taxpayers currently make 49% of the contributions, but receive 29% of tax relief. Higher rate taxpayers make 42% of contributions but receive 56% of tax relief. Additional rate taxpayers make 9% of contributions but receive 15% of tax relief.

### Radical reforms

53. The Consultation mentions two potential radical reforms – a move to a flat rate of tax relief and a move to a TEE system (as is used for ISA's) - as well as more minor changes to the current system. In the next part of this response analysis is presented to consider the potential impacts of the radical reforms on individuals, on costs, and on savings incentives.
54. This response does not cover analysis of minor reforms to the current system. Many of the issues arising from the current system, such as complexity and lack of understanding undermining the value of tax relief as an incentive to save in a pension, would not be addressed by minor reforms to the annual and lifetime allowances. There is also a lack of data

<sup>14</sup> PPI (2015) *Comparison of pension outcomes under EET and TEE tax treatment*

in the public domain that could be used to inform the potential impact of changes in the annual, and in particular, the lifetime allowance.

55. The PPI has produced a number of different reports and analysis which consider the impact of alternative radical reforms of pensions tax relief in the UK.<sup>19</sup> To help inform this consultation, the PPI has undertaken analysis on behalf of the ABI, and the main findings of that analysis is included in this response.<sup>20</sup>
56. The reforms considered include:
  - Maintain the status quo (i.e. a EET system with tax paid in retirement at the individuals marginal rate, but with access to 25% of the fund tax free);
  - A reformed system similar to the current system but without the option to take any cash as tax free
  - A single rate of tax relief at 20%, 25%, 30% and 33%;
  - A TEE system with no matching payment;
  - A TEE system with matching payments between 10 and 50 percent.
57. The analysis compares:
  - The outcomes for individuals under the alternative options to the outcomes under the current system
  - The outcomes for individuals to a tax neutral system
  - The initial first year costs of alternative systems, based on the current pattern of pension contributions
  - The distribution of tax relief compared to the current system
58. The analysis initially considers the value of a £1,000 pension contribution made at age 25 under alternative systems of tax relief, for individuals paying different rates of tax when the contribution is made and when the pension comes into payment. The main findings of the analysis are that (Table 3):
  - An EET system (retaining the tax free lump sum) with a single rate between 20% and 40% has a redistributive effect, improving the outcomes for basic rate taxpayers but worsening outcomes for higher and additional rate taxpayers.
  - Even though outcomes for higher and additional rate taxpayers are lower in a single rate system than the current system, outcomes are still better than in a purely tax neutral system, such as a pure TEE system.
  - A pure TEE system without matching contributions is likely to reduce pension outcomes, because, with tax being paid up front, none of the pension is received tax free, and the tax paid is at the individual's marginal rate in work, rather than an average rate after retirement.
  - Giving a matching contribution on a TEE system is similar to a flat rate EET system in the accumulation phase.

<sup>19</sup> For example PPI (2013) *Tax relief for pension saving in the UK*

<sup>20</sup> PPI (2015) *Comparison of pension outcomes under EET and TEE tax treatment*

- A TEE system with significant matching contributions could improve the outcomes for individuals.
59. If a pure TEE system is taken to represent a “tax neutral” system which avoids double taxation, there are some systems for some tax payers that would result in some double taxation:
- A single rate EET tax system of 30% relief would mean double taxation for individuals who were Additional Rate taxpayers both when contributing and in retirement.
  - A single rate EET tax system of 25% or 20% would lead to individuals who were Higher rate or Additional rate taxpayers in retirement facing double taxation.
  - No individuals who pay Basic rate tax in retirement would face double taxation under any of the single rate EET tax system options considered.
60. Of course individuals are likely to be in different tax positions at different points of their life. Further analysis considers individuals at different ages and earnings levels (20 year olds earning £15,000 and 40 year olds earning £40,000) with different future career paths. A similar pattern of results to those seen for a single contribution is seen for continuous contributions, which is likely to be more representative of the real life impact on individuals. Analysis that considers different patterns of work and earnings, highlights that (Tables 4 and 5):
- Individuals who are basic rate taxpayers through their working life tend to do better under a single rate EET system which offers tax relief at greater than 20%.
  - Those who have significant periods as higher rate taxpayers, including those who may have started as basic rate taxpayers, do less well under TEE systems or the single rate EET system than in the current system, requiring a high matching contribution or rate of tax-relief rate to maintain the value under the current system.



**Table 3: Taxed Fund value of 25 year olds under an EET and TEE system as a result of a £1,000 contribution<sup>21</sup>**

Tax Position (pre/post)	Current EET system	TEE system	Flat rate 20% relief	Flat rate 25% relief	Flat rate 30% relief	Flat rate 33% relief	TEE 10% match	TEE 20% match	TEE 30% match	TEE 40% match	TEE 50% match
Non/Non	£1,680	£1,344	£1,680	£1,792	£1,920	£2,006	£1,479	£1,613	£1,748	£1,882	£2,016
Basic/Non	£1,680	£1,344	£1,680	£1,792	£1,920	£2,006	£1,479	£1,613	£1,748	£1,882	£2,016
Basic/Basic	£1,428	£1,344	£1,428	£1,523	£1,632	£1,705	£1,479	£1,613	£1,748	£1,882	£2,016
Higher/Basic	£1,904	£1,344	£1,428	£1,523	£1,632	£1,705	£1,479	£1,613	£1,748	£1,882	£2,016
Higher/Higher	£1,568	£1,344	£1,176	£1,255	£1,344	£1,404	£1,479	£1,613	£1,748	£1,882	£2,016
Additional/Higher	£1,711	£1,344	£1,176	£1,255	£1,344	£1,404	£1,479	£1,613	£1,748	£1,882	£2,016
Additional/Additional	£1,619	£1,344	£1,113	£1,187	£1,272	£1,329	£1,479	£1,613	£1,748	£1,882	£2,016
Key			< 95% of current		Between 95% and 105% of current				> 105% of current		

<sup>21</sup> PPI calculations, key to colours in the table. The taxed fund value is the amount of the contribution plus tax relief, after investment returns up to retirement, less tax payable at the individuals post-retirement marginal rate allowing for 25% being tax free (when taken as a lump sum). This is presented in earnings terms.

**Table 4: Taxed pension value for 20 year olds earning £15,000 in 2015 who work throughout their future working life under an EET and TEE system<sup>22</sup>**

	Current EET system	TEE system	Flat rate 20% relief	Flat rate 25% relief	Flat rate 30% relief	Flat rate 33% relief	TEE 10% match	TEE 20% match	TEE 30% match	TEE 40% match	TEE 50% match
Full working life	£46,200	£37,872	£46,200	£48,987	£52,172	£54,311	£41,659	£45,446	£49,233	£53,020	£56,808
Career break for kids	£36,873	£29,669	£36,873	£39,177	£41,764	£43,477	£32,635	£35,602	£38,569	£41,536	£44,503
Career break to care	£38,081	£30,701	£38,081	£40,443	£43,096	£44,855	£33,771	£36,841	£39,911	£42,981	£46,051
Key			< 95% of current		Between 95% and 105% of current				> 105% of current		

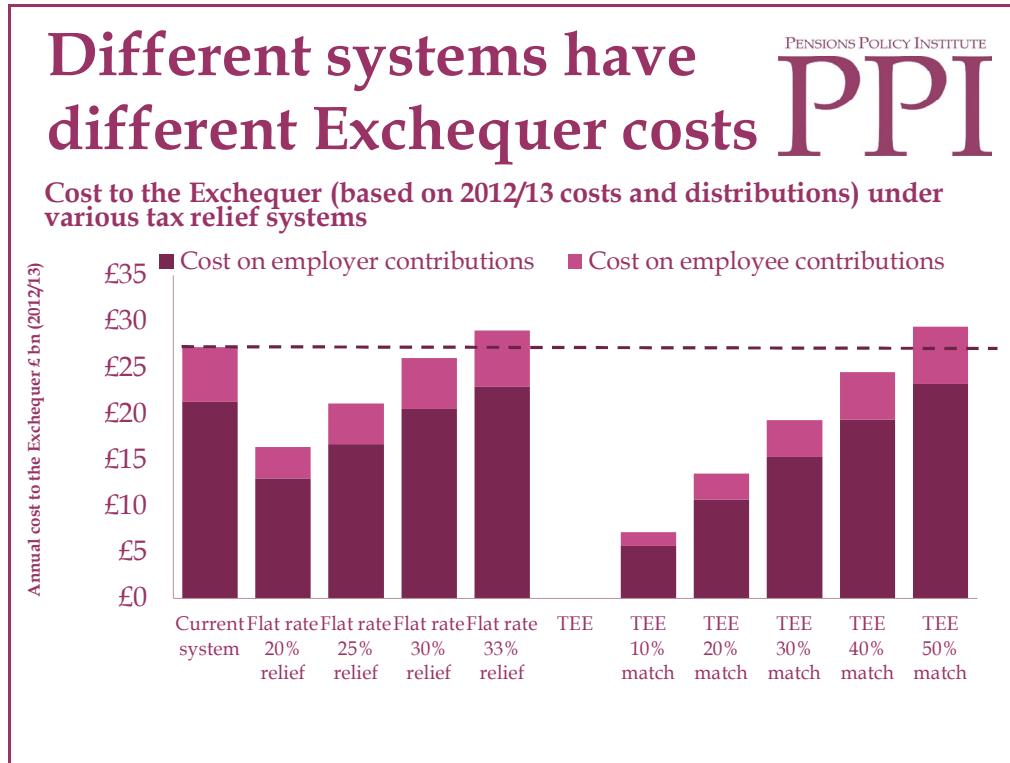
**Table 5: Taxed pension value for 40 year olds earning £40,000 in 2015 who work throughout their future working life under an EET and TEE system and annuitise in retirement**

	Current system	TEE	Flat rate 20% relief	Flat rate 25% relief	Flat rate 30% relief	Flat rate 33% relief	TEE 10% match	TEE 20% match	TEE 30% match	TEE 40% match	TEE 50% match
Full working life	£78,923	£73,358	£78,923	£83,773	£89,316	£93,038	£73,905	£80,623	£87,342	£94,061	£100,779
Career break to care	£53,059	£49,466	£53,059	£56,256	£59,859	£62,262	£47,721	£52,059	£56,397	£60,736	£65,074
Higher salary growth	£93,135	£85,488	£76,408	£81,090	£86,442	£90,036	£71,350	£77,836	£84,323	£90,809	£97,296
Key			< 95% of current		Between 95% and 105% of current				> 105% of current		

<sup>22</sup> See PPI (2015) *Comparison of pension outcomes under EET and TEE tax treatment* for further details of the individuals modelled here (Career break for kids is a career break between age 30 and 40, career break to care is a career break between ages 50 and 60, higher salary growth is an additional 1% of earnings growth on top of the standard earnings growth assumption, and other modelled examples including 40 year olds earning £60,000)

61. The different tax relief systems would have different impacts on the cost to the exchequer of tax relief. In terms of the current 1 year cost of tax relief (Chart 3):
- An EET system with a single rate of slightly over 30% might be implemented for around the same initial cost of tax relief as the current system. A lower single rate would lead to lower costs to the exchequer.
  - A pure TEE system will lead to an initial reduction in cost as the tax relief on contributions falls to zero, however there will be a longer term cost when the resulting pensions are paid out with no tax payable.
  - A TEE system with matching contributions introduces up-front costs to the exchequer in addition to the loss of future tax revenue on pension payments.
  - For those who would be eligible for means tested benefits, those benefits may be able to offset some of the loss in a switch from the current system to a pure TEE with no matching contributions. However that would increase the cost on the government of providing means tested benefits.
62. The longer term costs of a radical reform to the system are highly uncertain, and would depend to a large extent as to how individuals and employers changed behaviour in response to changes in relative incentives.
63. Although a TEE system would have an initial positive impact on the Exchequer by increasing the amount of tax collected, some of this could be offset by funding the matching contributions that provide the incentive to save. In future years, however, the Exchequer would collect less revenue than under the current system as pensions that have been accumulated with taxed contributions come into payment tax free. The future impact will therefore depend on the balance of contributions in to payments out.

Chart 3 <sup>25</sup>

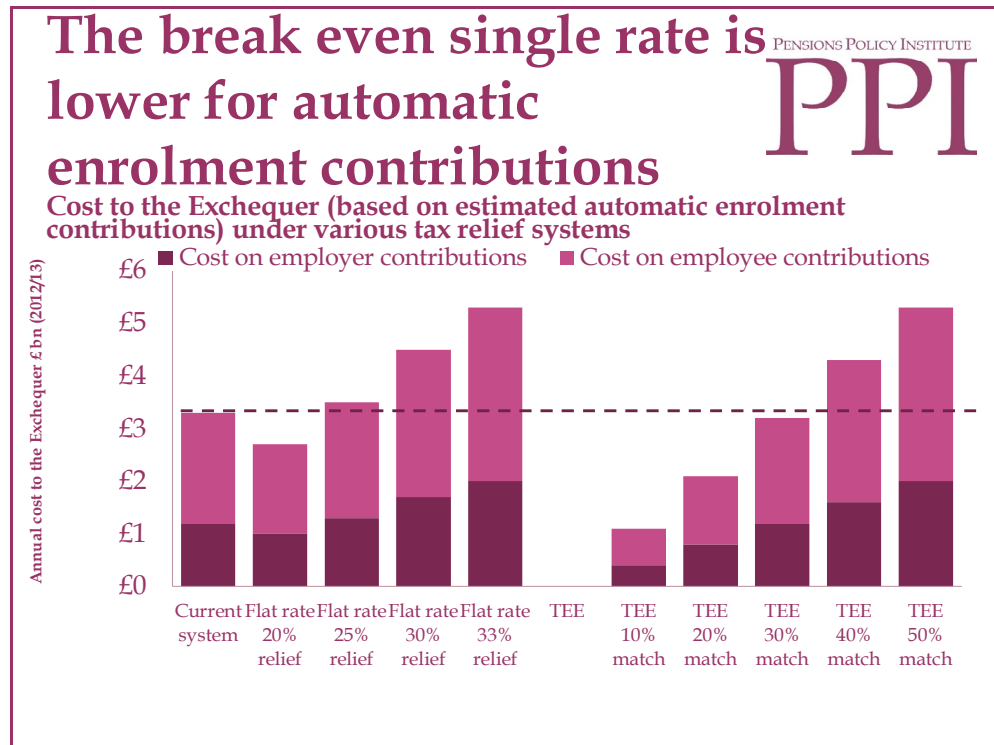


### The impact of automatic enrolment

64. The estimates of costs to the Exchequer in this response are based on the latest available data from HMT, which is for 2012/13. This will only cover the first few months of automatic enrolment, which will significantly increase the number of individuals making pension contributions, and over time increase the cost of pension tax relief (all other things being equal).
65. Automatic enrolment will also change the distribution of pensions tax relief, as the majority of people being automatically enrolled are likely to have lower rather than higher earnings. This means that, over time, the “break even” level of a single rate of tax relief will reduce. A broad initial analysis of the potential tax relief paid out as a result of the additional pension contributions arising from automatic enrolment suggests that the breakeven level on these contributions could be just below 25% (Chart 4).

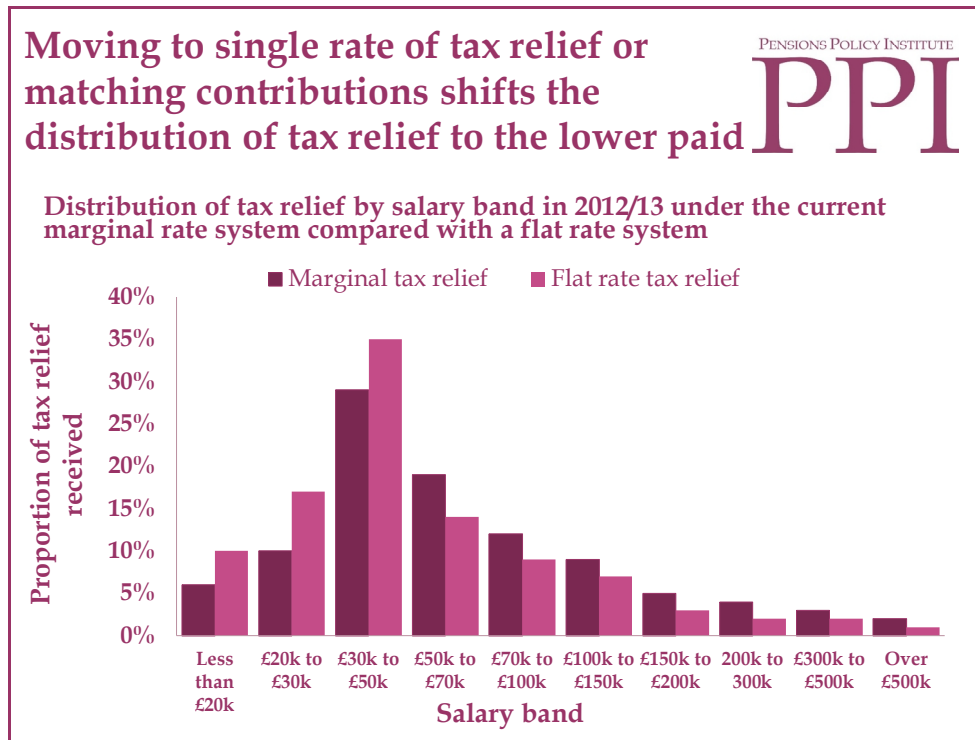
<sup>25</sup> PPI (2015) *Comparison of pension outcomes under EET and TEE tax treatment*

Chart 4<sup>26</sup>



66. The distribution of tax relief would be equal to the distribution of contributions under any system with a matching or single rate element. This gives a more even distribution of relief than the current marginal rate system (Chart 5).

<sup>26</sup> PPI (2015) *Comparison of pension outcomes under EET and TEE tax treatment*

Chart 5 <sup>27</sup>

67. This analysis is based on the current distribution of pension contributions. But one of the main aims of the pensions tax relief system is to change behaviour. If behaviour changes, this would change the distribution and cost of tax reliefs. However, it is not clear how behaviour might change in response to such radical changes in the tax relief system.

### Incentives

68. If the system of pensions tax relief changes we might expect behaviour to change in a number of ways:
- As the Government contribution to pensions changes, the rate of return on individuals' own pension contributions will change. This could lead to individuals changing their behaviour.
  - It may affect perceptions and ease of use of the pension tax relief system. This may affect individual's interaction with the system (for instance, if they are required to pay extra tax at the end of the year).
  - It may affect employers through administrative complexity and cost, and indirectly through their employees' perception of value of pensions.
69. The value of a contribution increases if an individual is offered more tax relief, leading to a larger pension fund at retirement. If less tax relief is offered, the pension fund at retirement is smaller. Consequently, pension saving will, in theory, become more or less attractive to different income

<sup>27</sup> PPI (2015) *Comparison of pension outcomes under EET and TEE tax treatment*

groups, potentially leading to an increase or decrease in the amount of contributions made.

70. Restriction of tax relief below marginal rates may lead those people who currently receive higher rate tax relief to divert their savings from pensions. A single rate of tax relief above a marginal rate may incentivise lower and middle earners to make more pension saving.
71. However, the evidence surrounding the potential behavioural changes in response to changes in tax relief is limited, and where there is evidence of changes in behaviour in response to changes in rates of return, responses are usually relatively small.<sup>28</sup>
72. In considering how individuals might respond, it is also important to consider the right counterfactual for individual comparisons and incentives. So even if some reforms – such as a single rate of tax relief lower than an individual’s marginal tax rate – is less generous than the current system, it may still offer more generous tax treatment than is available through other forms of savings.

### Transparency

73. As highlighted by the lack of impact on pension saving of the current system, providing a large fiscal incentive is not necessarily enough in itself to change behaviour. If the incentive is not clear, well defined, or easily understood, individuals cannot respond to it. Even if it is clear, individuals will not necessarily respond in the way that might be expected.
74. One presentation option put forward that would work with the current system or the radical alternatives, is to use the idea of a matching contribution. For example, a presentation of “Contribute X and receive a contribution of Y from the Government” might be clearer and therefore more likely to affect behaviour than “Receive tax relief at X per cent / the Basic Rate”.
75. This has been used in the presentation of automatic enrolment, although the message has been diluted in net pay arrangements, where a 5% contribution is taken from gross pay and the 1% Government contribution manifests as lower income tax and higher take home pay, which is not necessarily clear to employees. A match is more likely to be effective where it is obvious and makes a positive impact on the amount saved rather than reducing the amount of income tax paid where an individual is not aware of how much less income tax is being paid (if they are aware of the reduction at all).

<sup>28</sup> For example see Annex 6 in PPI (2013) *Tax relief for pension saving in the UK*

76. There is some evidence to suggest that such matching contributions do affect behaviour, in the context of US pension saving and in other savings policy areas in the UK. For example:

- In the early 2000s the UK Government ran extensive pilot schemes for a Savings Gateway – a short term saving scheme that offered differing levels of matched contributions from the Government (ranging from 20p for every £1 saved to £1 for every £1 saved). Evidence suggests that the matching led to increased participation in the plan. However, there was little evidence to suggest that this was new saving, as there was little impact on overall saving or lower spending.<sup>29</sup>
- In the US many employers offer matching contributions into 401(k) plans. A number of research studies have found evidence that matching contributions can increase participation in 401(k) plans, but that a larger match does not necessarily lead to higher contributions (and if the match is too large it could lead to lower individual contributions).<sup>30</sup>

77. However, this might be easier with a single rate of matching than, for example, in the current system where the match depends on the tax band of the individual. Presenting the current system as a match could also lead to questions as to why higher earners receive a higher match, and the technical explanations might be hard to get across to individuals.

### **Employer incentives**

78. As well as direct impact of pensions tax relief on individuals there may also be indirect effects, not least through employers. Automatic enrolment has reinforced the workplace as the main delivery channel for pension saving, and so the behaviour of employers will be very important in determining future levels of pension saving.

79. Even after controlling for other characteristics, the presence of an employer pension contribution is the most significant driver in employee pension saving.<sup>31</sup>

80. Concerns have been raised that recent changes to limit tax relief have led to lower levels of engagement with pension saving among senior executives, which in turn has led to lower employer engagement with pensions where the senior executives have less personal interest in the scheme used to provide pensions for the majority of the workforce. This has long been a concern as the relative value of pensions for senior staff has been eroded by successive tax reforms, and although there is anecdotal evidence of senior staff leaving pension schemes and taking other forms of remuneration in response to pensions tax relief changes, there has not

<sup>29</sup> Harvey et al (2007) *Final Evaluation of the Saving Gateway 2 Pilot: Main Report*

<sup>30</sup> See for example Adams, Salisbury and VanDerhei *Matching Contributions in 401(k) Plans in the United States* in Hinz, Holzmann, Tuesta and Takayama (2012) *Matching Contributions for Pensions: A Review of International Experience*

<sup>31</sup> Strategic Society Centre (2012) *Who saves for retirement?*



been any detailed research which provides evidence of the full impact on overall pension provision that this has had.

81. It is also not clear whether any behaviour changes among senior managers are as a response to the change in overall value of tax relief (which might still be in tax terms more beneficial than other forms of saving), the complexity of the arrangements that individuals would face, a specific feature of the reforms (such as having a higher immediate personal tax bill) or another factor. Depending on the key driver of behavioural change, alternative systems (and changes to the current system) could lead to different behavioural outcomes for senior staff.
82. The relative value of pension contributions to employers and employees is likely to be an important determinant of behaviour. In the current system, there is a clear financial benefit to both the employer and employee of an employer making an employer pension contribution, in part due to the tax relief and tax-free lump sum, and in part due to the NIC relief on pension contributions. If there was no longer a clear financial benefit, employers and employees might prefer other methods of remuneration after meeting the statutory minimum requirements of automatic enrolment.

### **Government contribution to saving**

83. Even if individuals have only limited responses to incentives, tax relief can still be seen within the automatic enrolment framework as a Government contribution to pension saving. Moving to a single rate of tax relief presented as a matched contribution would, depending on the rate used, change the distribution of the Government contribution to pension saving compared to the current system.
84. Redistributing the Government contribution to automatic enrolment pension saving would lead to increased contributions and therefore larger pension funds for basic rate taxpayers, and lower contributions and therefore smaller pension funds for higher rate and additional rate taxpayers.
85. Even if a single rate did not increase individual contribution levels, this redistribution would still lead to higher pension funds at lower income levels. If higher matching contributions do encourage higher levels of participation in workplace pension saving, there may also be a reduction in opting-out.
86. It is also possible that individuals saving more than the minimum might reduce their own individual pension contribution in response to the increased contribution from the Government, as they would still be able to achieve the same combined contribution. However, even in this case these individuals would have higher disposable income.

**Implementation issues**

87. Others with more experience of administering payroll and pension schemes will have a clearer idea about the implementation challenges of moving to a more radical system of tax relief that does not use the marginal rate of taxation. However, that there will be some challenges is clear.
88. TEE systems (with or without a matched contribution) and single rate systems would be easier to implement in a relief at source system rather than a net pay arrangement. In a relief at source system any matched contribution is likely to have a more visible impact and therefore more chance of having an impact on savings decisions.
89. Moving to a TEE system would potentially require the running of parallel systems, with contributions made before the introduction of the new system remaining within the current tax framework, and new contributions within the TEE framework. It may be possible to allow individuals to switch to the new system by paying tax on existing funds, which would increase tax revenue in the short term at the expense of collecting less tax in the future. It would also be possible to convert all existing funds to be part of the TEE system by making a one-off tax charge. This would raise significant tax revenue, but potentially have much wider economic and political impacts.
90. TEE and single rate systems would be much harder to implement for DB than DC schemes. Most DB schemes operate net pay arrangements, and in many cases (unless the AA is breached) tax relief is not directly linked to the annual increase in benefits. Some employer contributions are deficit reduction payments rather than linked to individuals. It is likely that any system other than marginal relief for DB scheme contributions that tried to accurately apportion tax relief at the individual level would be complex and potentially opaque to administer.
91. Alternatively, it may be possible to simplify the way in which relief is given (for example operating at a scheme level rather than an individual level) but this more broad brush approach may lead to cross subsidies and perceived (and / or actual) inequalities in treatment.
92. The consultation specifically asks if different systems should be considered for DB and DC provision. This would of course be possible, and DC and DB schemes were treated differently before A-day in 2005. However, any difference in treatment might raise challenges including:
  - The potential for arbitrage between different systems if one is seen to be more advantageous than the other (as happened, for example, with different DB and DC systems for contracting-out).
  - As the majority of active DB provision is now in the public sector, perceived inequality between the public and private sector.

93. There are concerns that the current system, although in theory the same for DB and DC, treats DB pension provision more generously than DC provision through the use of generous conversion factors when calculating the lifetime allowance. At the same time, however, DB members are currently more likely to be affected by the annual allowance, and are not able to arrange contributions or remuneration packages as flexibly as DC scheme members to fit within allowances.

#### **Integration with other parts of the system**

94. It is important not to view tax relief in isolation from other parts of the UK pension saving system, including recent reforms which will also have an impact on levels of pension saving. These include:
- The introduction of the new State Pension for individuals reaching state pension age from April 2016 onwards. This is expected to reduce (though not eliminate) means-testing for retirement income, and will also lead to the ending of contracting-out for DB schemes. It is likely that many DB schemes will change as a result of this.
  - The introduction of automatic enrolment, which is still only partially rolled out and with very low contribution levels. So far automatic enrolment has significantly increased the numbers of people saving for retirement, but there is little evidence that individuals are putting in more than the minimum level of contributions. Previous PPI research<sup>33</sup> has highlighted the low likelihood that individuals will achieve an adequate retirement income solely through making minimum contributions, even over a full working life and when they have reached the phased in minimum of 8% of band earnings.
  - Freedom and choice for DC pension saving. The recent changes introduced earlier this year are likely to lead to a much greater use of lump sums as opposed to incomes in retirement, as well as increased guidance and / or financial advice.
95. While more work needs to be done to examine how all of these policies interact with one another and how the landscape will look when they have been fully implemented, it is likely that if individuals wish to provide for retirement needs solely through pension saving they will need to contribute more than the minimum level of contributions.
96. There are a number of other potential ways in which greater savings could be encouraged.
97. The Government could encourage or enable the provision of information and advice to individuals. Individuals that have access to advice are more likely to know how much they need to save and when they can expect to retire.<sup>34</sup> Given that individuals are likely to be automatically enrolled in a DC pension where the final pension outcome will depend on a number of

<sup>33</sup> PPI (2014) *What level of pension contribution is needed to obtain an adequate retirement income?*

<sup>34</sup> Unbiased.co.uk (2012)

factors such as the investment strategy and the charges paid, individuals could maximise their savings by choosing the type of pension products more convenient for them. Professional advice may play an important role in providing individuals information about what pension products are more adequate for their needs. The recent introduction of the Pension Wise service in response to Freedom and Choice in DC pensions recognises the value of good guidance and information in financial decision making.

98. Automatic enrolment was introduced because the system of incentives to save and advice has not worked well in the past. Therefore the Government could also consider a number of other alternative strategies to maximise individuals' chances of having an adequate retirement income:
  - Initiatives based on inertia could impact on individuals' saving decisions. For example, increasing minimum contribution levels or implementing initiatives such as "save more tomorrow" and "auto-escalation," which commit individuals to increase contribution levels as their salary increases.<sup>35</sup>
  - Promote initiatives that encourage individuals to use other types of wealth (e.g. housing equity) to increase their retirement savings.
  - Promote initiatives for individuals to work longer. The Government has already taken some measures in this respect such as the elimination of the Default Retirement Age (DRA) and the legislated and planned increases in the State Pension Age (SPA).
99. It is unlikely that any one in isolation would be achieve the required change in behaviour. Any reform of the tax system that is designed to influence behaviour should consider how it would operate in the pension savings environment as a whole.

#### **Potential long term and intergenerational impacts**

100. A shift to TEE would bring forward tax collection, but lead to lower tax receipts from pensions in payment in the future.
101. Demographic projections highlight that the proportion of the population aged above state pension age is likely to increase significantly in the future. If the majority of their income is tax free, at a time that age-related Government expenditure will be under increasing pressure, a TEE system suggests an increased tax burden on a relatively smaller working age population. It may be possible to reduce state spending, for example on state pensions and benefits. However, this may not be easy. An EET system would be collecting tax on pensions in payment from individuals who would be benefiting from the age related expenditure at that point in time.

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<sup>35</sup> Thaler and Bernartzi (2004)