PENSIONS POLICY INSTITUTE

PPI

The impact of tax policy on employer sponsored pension provision

This report was commissioned and funded by the Actuarial Profession and benefited from the support of Age UK.

The Actuarial Profession
making financial sense of the future

age UK
Improving later life

PPI commissioned Jackie Wells to undertake this research project. Jackie is a freelance strategy & policy consultant. She has more than 25 years' experience in the pensions market, working for providers, industry bodies, advisers and Government departments.

A Research Report by Jackie Wells, Sean James and Chris Curry

Published by the Pensions Policy Institute

ISBN 978-1-906284-15-2
www.pensionspolicyinstitute.org.uk

Executive Summary

This report has been compiled using both existing published material as well as input from a small number of employers, trade bodies and other industry influencers. A provider, an industry body and employers, pension schemes and consultancies were interviewed for this project. The views expressed by the individuals interviewed cannot be held to be representative of all of the pensions industry but their observations have been incorporated into this report on an anonymous basis, expressed as quotes, to support more general observations about changes in employer provision.

The provision of pensions by employers has undergone a series of significant changes since the Second World War. Whilst membership rose in the early years after the war, later years saw a decline in the membership of occupational schemes, starting in the late 1960s.

The forces for change in pension provision have been well-documented and can be broadly grouped into three domains: economic developments; social change and policy and regulatory change.

- Most notable of the social and medical developments has been the very significant shift in life expectancy. More importantly for pension schemes and members, the improvements in life expectancy at age 65 have extended the period over which pensions have to be paid. The knock-on effects have been felt throughout the pension system, whether through the increased liabilities of Defined Benefit pension schemes or through lower annuity rates for defined contribution scheme members.
- Changes in the provision of and engagement with pension schemes have also been affected by changes in society's attitudes to pensions and retirement. People's attitudes to savings in general and pensions in particular have changed, brought about in part by the pension 'scandals' of Maxwell, pension miss-selling and the collapse of Equitable Life. Attitudes towards borrowing have also changed as credit became more readily available in the 1980s until the economic crisis of 2007/08.
- The past three decades have been characterised by very considerable policy changes and interventions in the pensions market, including: the removal of an employer's ability to make pension scheme membership compulsory in 1986; the introduction of personal pensions and the ability to contract out of the State Earnings Related Pension (SERPs) in 1988; and the requirement, since 2001, for most employers to offer access to a pension plan.

- The Government has also responded to a series of well-publicised problems in the pensions market by enhancing the protection for scheme members and increasing the regulation of occupational pension schemes. Changes included:
  - a series of changes in the 1980s and 1990s which gradually removed the discretionary element of pension benefits and replaced them with higher, and more certain, member benefits;
  - the introduction of the Pension Protection Fund in 2005;
  - the introduction of a new statutory funding formula for Defined Benefit pension schemes introduced through the Pensions Act 2004;
  - changes in accounting regulation have also changed the relationship between employers and their Defined Benefit pension schemes.

  Collectively, these changes have improved protection for scheme members but have also increased the burden and cost of pension provision for employers.

Several employers interviewed for this study were critical of a 'dislocated', 'reactive' and 'short termist' approach to pension regulation. Most had closed their final salary schemes to new entrants and some to future accruals.

The current system of taxation of private pensions in the UK follows the broad principle that pensions are a form of deferred pay and that taxation of that pay should also be deferred until retirement. This can be broadly described as contributions being Exempt from tax, Investment returns Exempt from tax, and withdrawal from pensions being Taxed. This is sometimes called an EET system. In a pure EET system, tax is smoothed over a lifetime and this generally avoids any double taxation of income.

Some of the changes made to pension taxation over the past three decades have adapted, and in some cases, eroded the principle of EET. The different changes have all had different impacts, either directly or indirectly, on employer sponsored pension provision.

- In an effort to reduce the scale of surpluses then estimated to exist in pension schemes and to increase exchequer revenue, the Finance Act 1986 introduced restrictions on the size of surpluses and the way in which they should be dealt with. The immediate impact of this change was generally positive for scheme members of Defined Benefit schemes, employers and government, although in the longer term the effect was largely negative for all. Those interviewed for this project were divided about the impact of the change with some arguing that changes to Defined Benefit schemes would have occurred anyway, whilst others argue that the changes were directly responsible for the weakened state of Defined Benefit schemes. The resulting fall in surpluses, whether or not driven by tax changes, left many Defined Benefit schemes and employers less able to cope with the challenges facing them.

- The budget of 1989 introduced an earnings cap to limit the levels of earnings on which pension provision could be made to new entrants to pension schemes. Some of the employers interviewed, typically those with few higher earners, had been largely unaffected by the earnings cap. Other employers felt that the earnings cap was the first step in senior decision makers disengaging from pensions.
- The initial reduction in advance corporation tax (ACT) by the Conservative Government in 1993 and the subsequent abolition of ACT by the Labour Government in 1997 and the ability of pension funds to reclaim this in full led to a short term fall in income for both Defined Benefit and Defined Contribution schemes as well as workplace and individual personal pensions. Individuals interviewed expressed mixed views about ACT removal but in general did not link any changes in provision to the tax changes.
- On A-day 2006, eight different tax regimes for pensions were replaced by a single new regime to be applied to all private pensions, whether occupational schemes or personal pensions and whether Defined Benefit or Defined Contribution. Among employers interviewed for this project, attitudes towards simplification were again mixed but often tinged with disappointment at an opportunity lost. Several commented that simplification did not live up to its promise and that the changes led to increased complexity. However, by far the most common criticism was that the lifetime allowance led to senior management starting to detach from pensions and added complexity to the benefit structure for higher earners through the need to establish unapproved schemes.
- In the 2009 Budget Statement, the then Chancellor announced a fundamental change to the way in which pension contributions attract tax relief for higher earners. The employers, advisers, provider and representative body interviewed for this project criticised the costs and complexity of the proposals, particularly for Defined Benefit schemes, and again raised concerns that most senior people affected would have chosen to leave the pension scheme altogether with further consequences for employer engagement.
- Following the change in UK Government in 2010, the new coalition Government announced changes to the Labour Government proposals in its first budget. The Government proposed to achieve a reduction in the cost of pension tax relief by reducing the AA (annual allowance) from its current level of £255,000 to £50,000 whilst retaining tax relief at an individual's marginal rate of tax. The revised proposals were seen as preferable to the proposals made in 2009 by those interviewed, although a number felt that more employees in their own schemes would be affected by the new change, which could cause them a different set of problems to the 2009 proposals.

- The Coalition Government proposals are targeted on high earners, and will only directly affect a very small minority of pension scheme members (most likely those in the top 1% of UK earners). Even an individual earning enough to put them just in the top 10% of earners in the UK would be highly unlikely to ever have pension contributions in excess of the £50,000 annual allowance.
- The impact of the Coalition Government proposals may increase over time. With the new annual allowances being frozen until 2016 and then potentially indexed at a lower rate than earnings, significantly more individuals could face the prospect of a tax charge on their pension contributions in future, particularly those in public or private sector Defined Benefit schemes. An individual contributing less than £40,000 in 2011 who increases their contributions in line with average earnings growth each year could breach the annual allowance by 2016.
- PPI analysis of hypothetical high earning individuals suggests that:
  - Additional tax charges could lead to high marginal tax rates for very high earners
  - If lower allowances lead to lower contributions, income in retirement will fall
  - The lifetime allowance can still be exceeded even with a lower annual allowance
  - Younger individuals with very high lifetime earnings and prolonged pension scheme membership may see a greater impact over their lifetime than similar older individuals

  As a result very high earning individuals may change their behaviour in order to avoid additional taxation.
- Employers with Defined Benefit schemes face a number of operational and strategic issues, most notably how to deal with the small number of employees who are caught by the rules. Some employers may choose to deal with members on a case by case basis. Others may decide on more radical solutions such as moving to a Defined Contribution arrangement.

It is evident that changes in pension provision have taken place against a backdrop of economic, social and regulatory change. Within this environment, changes to pension taxation have added costs to the operation and funding of pension schemes and have removed some of the benefits of pensions for very high earners and, as with recent proposals, have created a sense of uncertainty. Changes to pension provision cannot be laid at the door of tax changes alone, but the findings from the interviews carried out for this research suggest that it is probable that some of the changes may have accelerated change, or at least failed to stem the tide of employers reducing their commitment to pensions.