Tax Relief and Incentives for Pension Saving

A Report by the Pensions Policy Institute for Age Concern England

Age Concern and the Pensions Policy Institute

Age Concern is the UK's largest organisation working for and with older people. We are a federation of over 400 charities working together to promote the well-being of all older people.

Age Concern's work ranges from providing vital local services to influencing public opinion and government. Every day we are in touch with thousands of older people from all kinds of backgrounds – enabling them to make more of life.

The Pensions Policy Institute (PPI) is an educational charity promoting the study of retirement provision through research, analysis, discussion and publication. The PPI takes an independent view across the entire pensions system. The PPI is funded by donations, grants and benefits-in-kind from a range of organisations, as well as being commissioned for research projects.

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A Research Paper by Chris Curry and Alison O'Connell, Pensions Policy Institute

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Foreword

Our voluntary private pension system depends on individuals choosing to save in ways which are appropriate for their needs. At present, the evidence suggests that millions of people are not saving enough, either because they cannot afford to do so or because they are choosing not to do so. If we are to avoid considerable further numbers experiencing poverty in retirement, we need to encourage or compel people to save more. But before we decide to compel additional saving, either through state or private systems, we should consider whether we can encourage people to do more for themselves.

State, employers and individuals each have a part to play in building our retirement income in our mixed pension system. At one stage, it was envisaged that the state pension would replace a reasonably high proportion of people's final working salary but that dream proved short-lived and for most of us today that task falls to private and occupational pension schemes.

Each year the state pension slips further behind rising living standards and top-up benefits like Pension Credit are required to lift pensioners out of poverty. Because fewer people had private or occupational pensions in the past, only one pensioner in two today has an income that Age Concern would judge adequate for their needs.

The future will be a little brighter as the number of people with occupational pensions grew through much of the 1970s before hitting a plateau in the 1980s from which it has yet to recover, leaving considerable inequalities in provision. Whether you have a private or occupational pension depends on who you are, where you live and what you do for a living. People do badly who work in shops, factories or small and medium sized enterprises, which make up the bulk of employers. People in Scotland and the North of England do worse than people who live in the South-East. Gender inequalities in the labour market feed gender inequalities in pension provision, carers and those from minority ethnic groups, fare badly and those in more than one disadvantaged group do even worse.

Overall, Government estimates that three million people are not saving enough for their retirement, and up to 10 million people should consider saving more. Considerable attention is now being given to those who we believe are not saving enough. Do they have access to suitable schemes, and the information to make sensible decisions? Can they afford to save more, and if so what savings vehicles would best suit their needs? Can they be persuaded to prioritise saving against other competing needs and be encouraged to do more to help themselves? What would encourage them to do so, or is further compulsion to save now an unfortunate necessity?

UK government spending on pensions and top-up benefits for pensioners amounts to 5.9 per cent of GDP – and this figure is projected to increase to 6.3 per cent over the next half century. In addition, as this report indicates the Government also spends another 1.8 per cent of GDP on tax relief which is designed to encourage people to save. Incidentally, this still puts us considerably behind the levels of state spending seen in other EU countries, and demonstrates that there is no crisis of sustainability in our system.

These tax reliefs represent a considerable state investment towards retirement saving and should in theory reward and reinforce the kinds of actual saving behaviour we wish to encourage. But are they doing the job that is needed? Three questions must now be asked.

Firstly, do these tax reliefs actually work as incentives? Is there evidence that they encourage people to begin to save, or to save more? Or would the people who receive them have chosen to save in any case?

Secondly, do these reliefs incentivise the right people into the right forms of saving? Do they have any positive effect on those people who are currently under-saving for their retirement? And do they encourage people to save into vehicles which are appropriate for their needs?

And finally, is the distribution of these incentives fair? To what degree should wealthier individuals benefit from incentives compared with others on low and average incomes? How far, if at all, should we be concerned that 55 per cent of tax relief goes to the 2.5 million higher rate taxpayers who make up only around 10 per cent of taxpayers?

Many working people share an anxiety about the income they will enjoy in retirement and it is politically significant that this anxiety extends across the workforce and across generations. This anxiety could create paralysis, stopping people saving into schemes they no longer trust.

Age Concern believes the time has come for our politicians to forge a new and lasting pension settlement which removes once and for all the threat of poverty and gives us all a fair chance to build an adequate income for retirement. If we are to have a voluntary private system, as at present, it is important that we understand the role of incentives in achieving fairness and adequacy for all. This Pensions Policy Institute report will help improve that understanding and promote much needed debate around incentives.

Neil Churchill, Age Concern England

1. Background

The UK has a history of private pension provision, supported by a system of tax relief and incentives.

But is the current system working? Despite significant annual expenditure on incentives, and apparent success in building up a large stock of pension fund assets, there is still said to be a 'savings gap'.

This brief paper is intended as a starting point for further debate on savings incentives in the UK, and to raise questions that could be considered in further research.

Chapter 1 looks at the rationale for savings incentives, how they impact on the decision to save, and on the decision of how to save.

Chapter 2 looks in detail at the current system of tax relief on pension contributions, how much it costs, and who benefits most.

Chapter 3 considers some alternative proposals for incentives for individual saving, highlighting advantages and disadvantages of each approach and quantifying the potential impact on a range of individuals with different income and savings levels.

Tax incentives are part of a wide system of state support for pensions, and should not be considered in isolation. Reform should be considered alongside wider policy issues including reform of the state pension system.

Summary of conclusions

Tax incentives are often used to encourage people to save more, but their effectiveness is unproven:

- There is no evidence that tax incentives increase the overall level of saving. They are complex, do not appeal to their target group, and do not solve the basic problem for most low income people; that they do not have the money to save.
- Tax incentives can encourage pension rather than other types of saving.
- But tax incentives appear not to have been effective in generating enough pension saving for future pensioners.

All taxpayers pay for the tax incentive system, but it benefits higher earners most:

- Tax relief is often described as tax deferral, but there is also an element of tax advantage.
- Most tax relief is paid to higher (male) earners.
- Almost £20 billion a year of tax revenue is foregone each year due to tax relief on pension contributions. After taking account of other pension tax advantages and the tax paid on private pensions in payment, the net annual cost to the taxpayer is more than £19 billion (1.8% of GDP). This is significant, being 25% of the cost of state pensions and retirement benefits.
- The proposed tax simplification is likely to increase the cost of tax relief on private pensions.

A number of alternative proposals have been suggested for reform of tax incentives:

- Matching contribution and single tax-rate options give the highest net retirement income for the same size contribution to non-taxpayers, and the lowest to people paying higher rate tax in retirement. These options distribute tax relief more evenly than the current system. However, there could be difficulties in integrating these options with existing occupational pension schemes.
- An ISA regime allows for more flexible pension arrangements, and would cost less than the current regime. It would give everyone the same pension income for the same contribution,

but would give most tax relief to people paying higher rate tax in retirement.

- The current system pays more tax relief to higher rate taxpayers than to basic rate taxpayers, but is simple to operate.

1. Do savings incentives work?

Tax incentives are often used to try and encourage people to save more. Government hopes to increase the amount people save by contributing some financial incentive which increases the return on saving.

Tax incentives are used in 2 ways in the UK:

- To encourage saving generally (such as in Individual Savings Accounts (ISAs) and their predecessors Personal Equity Plans (PEPs) and Tax Exempt Special Savings Accounts (TESSAs))
- To encourage saving for retirement in a private pension (occupational or personal pension). Pension incentives are described in more detail in the next chapter.

But the effectiveness of tax incentives is unproven. There is no evidence that tax incentives increase the overall level of saving. Incentives may change the way in which people save, diverting savings into pension funds. But tax incentives have not been effective in generating enough pension saving for future pensioners.

There is no evidence that tax incentives increase total saving
Saving is generally seen as 'a good thing' and policies are often proposed or implemented to increase the amount that people save[1]. These policies are often targeted at groups who do not have large savings, and in particular lower income groups. This could be to encourage people to be more secure financially, or to spread their income more evenly over a lifetime. Saving is also encouraged as a way of reducing state expenditure[2].

However, there is no evidence to suggest that tax incentives increase the overall level of saving [3]. Explanations put forward for this generally fall into one of three areas:

- Tax incentives are complex, making them difficult to understand.
- Tax incentives often do not appeal to their target group. Low to middle income groups (who are traditionally low savers) pay

[1] *See, for example, the recent Conservative proposals for a Lifetime Savings Account (Norman and Clark 2004)*
[2] *For example, the government's target of changing the ratio of state to private income in retirement from 60% state and 40% private today to 40% state and 60% private in future (DWP 2004 DR)*
[3] *See for example Littlewood (1998), Sandler (2002), NZT (2001) and Gale et al (2004)*

lower rates of tax, and so gain less from reduced tax liabilities.

- The amount that people want to save is determined by a range of factors not linked to tax relief or rates of return, such as income and affordability.

Tax incentives are complex

Current tax incentives are predominantly based around the marginal rate of income tax[4], and the different tax rules, limits and even language makes it difficult for people to understand the value of tax relief in their own specific circumstances. Many low- and middle-income savers do not know if they pay tax on their savings, or what the value of relief would be to them[5].

The Government has recognised the complexity of tax incentives, and are considering different ways of presenting tax relief (or re-branding it[6]) to increase people's understanding of the value of tax incentives.

People have said that they prefer other, simpler, forms of saving incentive. For example, more people say they would be highly likely to increase their saving if a matching contribution, or an increased employer contribution were available compared to higher tax relief[7].

Tax incentives have also been reported to increase indirectly the costs of saving in general, by increasing the need for advice and regulation[8].

Tax incentives do not match their target group

While low to middle income individuals in the UK often do save (either for a 'rainy day' or longer term), they are not strongly influenced by the availability of tax relief, and most do not use ISAs[9]. Because they pay little tax, tax relief seems less relevant to their circumstances. One survey reported that less well-informed individuals have negative associations with anything to do with 'tax', even tax relief[10].

Other factors are more important in the savings decision

Research also suggests that people do not save for retirement for a number of reasons. Many of these are linked to difficulty imagining the future, or aversion to long term planning rather than concerns about the effective rate of return on saving. People with low or

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[4] *Since 2001 tax relief at the basic rate of income tax has been available to non-taxpayers on private pension contributions of up to £3,600 a year*

[5] *Whyley and Kempson (2000 b)*

[6] *DWP (2002 GP)*

[7] *Vidler (2002)*

[8] *Sandler (2002)*

[9] *Whyley and Kempson (2000)*

[10] *Altmann (2002)*

insecure incomes, or supporting a family, often find they do not have enough money to save in a pension[11].

Even in strict economic terms, tax incentives may encourage low income people who do already save to save less than they would have otherwise. Tax relief increases total net income[12]. People with low incomes may choose to spend more and save less of their 'own' money if their saving is then topped up to a higher level by the Government. In effect the tax relief replaces their own saving.

The impact of tax incentives is complicated by the Pension Credit (PC), comprising the Guarantee Credit (GC) and the Savings Credit (SC)[13]:

- For people who are over 65, SC gives more state benefit to those who have private pension savings. This is on top of the incentive they received through tax relief.
- People of working age face the uncertainty that as their private pension income increases, their future claims on GC and SC could be reduced. This means that a large proportion of saving potentially just replaces state benefits, and so the extra pension income generated by tax relief on pension contributions may be offset by the means-testing trap[14].

Over the next 10 years the number of pensioners entitled to receive Pension Credit (and so not receive the full value of their saving) is projected to increase from 4.7 million to 6.4 million[15].

Tax incentives may encourage saving in private pensions

Tax incentives may affect the *way* that people save. For example, countries that offer tax relief on pension often have large numbers of people making individual private pension provision:

- 8 million people between ages 25 and 64 (50%) make contributions to Registered Retirement Savings Plans (RRSPs) in Canada[16]
- More than 40 million households (40%) make contributions to Individual Retirement Accounts (IRAs) in the US[17]
- Over 4 million employees and self-employed people (15%) report making contributions to a personal pension in the UK[18]

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[11] Rowlingson (2002)
[12] This is known as the income effect. A fuller explanation is given in NZT (2001).
[13] See PPI (2004 TPP) for a description of the Pension Credit
[14] PPI (2004 BN9)
[15] DWP estimates, rounded to the nearest 0.1 million
[16] PPI calculation based on data from Statistics Canada
[17] Munnell (2003)
[18] PPI analysis of the Family Resources Survey 2002/3

Research suggests that most of this pension saving comes at the expense of other forms of saving[19].

However, tax incentives are not the only driver for increased individual private pension saving. In New Zealand the number of people with individual private pensions almost doubled between 1990 and 2001, despite New Zealand not having any tax incentives for private pension saving[20]. 24% of the New Zealand labour force now has individual private pensions.

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[19] *Sandler (2002), OECD (1994), Whitehouse (2003)*
[20] *PRG (2003)*

Tax incentives have not closed the 'savings gap'
Despite the tax incentives used in the UK, there has been much discussion about the 'savings gap' – the difference between the amount people need to save each year to achieve a reasonable retirement income, and the amount they are actually saving. Although the existence of a 'savings gap is generally accepted, there is no consensus on how big it is. The Government estimates that between 3 million and 13 million people may be 'undersaving'[21].

Conversely, a similar calculation suggests, tentatively, that there is no 'savings gap' in New Zealand, despite having no tax relief for pension saving[22].

In fact the 'savings gap 'may be better defined as a 'retirement income gap', as saving is not the only way to increase income in retirement. For example, people could choose to work longer and retire later, or state pensions could be increased or become payable at a higher age. Alternatively, people may alter their expectations, and prefer a lower standard of living in retirement to that experienced by pensioners today.

Policies to alter state pension provision, increase retirement ages or increase work at older ages could all be used to tackle the 'savings gap' as alternatives to additional tax relief.

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[21] *DWP (2002 GP)*
[22] *Grant Scobie and Le Thi Van Trinh (2004)*

2. Who benefits from the current system?

All taxpayers pay for the tax incentive system, but it benefits higher earners most:

- Tax relief is often described as tax deferral, but there is also an element of tax advantage.
- Most tax relief is paid to higher (male) earners.
- Almost £20 billion a year of tax revenue is foregone each year due to tax relief on pension contributions. After taking account of other pension tax advantages and the tax paid on private pensions in payment, the net annual cost to the taxpayer is more than £19 billion (1.8% of GDP). This is significant, being 25% of the cost of state pensions and retirement benefits.
- The proposed tax simplification is likely to increase the cost of tax relief on private pensions.

Tax incentives in the UK
The current tax regime for private pension saving in the UK is generally thought of as EET: pension contributions attract tax relief at the individual's then marginal rate (**E**xempt); investment returns roll up tax-free (**E**xempt); and the pension income is **T**axed when received at the individual's then marginal rate[23].

As a tax-free lump sum can be taken instead of some of the pension income, the final 'T' is only partial.

The roll-up is also not fully 'E'. The extent of taxation on the roll-up depends on the mix on investments within the pension fund, and the marginal tax rate paid by the individual.

- The roll up of funds invested directly in bonds, property or cash is completely tax-free. However, since 1997, dividend income from equities has been taxed at a Corporation Tax rate, although capital gains remain tax-free. The amount of tax paid therefore depends on the proportion of the fund that is held in equities, and the proportion of the equity return that is derived from dividends. The larger the proportion of the fund held in equities, the larger the proportion of the investment

[23] *For further information see O'Connell (2004 CPNZ)*

return that is liable to taxation. At the end of 2003, 67% of the average pension fund was invested in equities[24].
- Dividend income from equities is taxed at the Corporation Tax rate – currently 30%. This is above the marginal income tax rate for basic rate taxpayers, but below the marginal rate for higher rate taxpayers.

The UK tax regime for private pension has been described as[25] E T^{plus} $T^{partial}$, for a basic rate taxpayer with a high equity allocation. This is an overstatement of the middle 'T' for higher rate taxpayers and where there is less equity investment in the pension fund. For brevity, the UK regime is referred to as EtT.

Tax relief is also available for Individual Savings Accounts (ISAs). In an ISA, contributions are made from taxed income (**T**), the investment returns are rolled up 'tax-free' in the same way as in a private pension (**t**), and any income withdrawn from an ISA is exempt from tax (**E**). This results in a TtE regime. The rest of this chapter concentrates on tax relief on private pensions, but the ISA regime can be compared to the private pension regime to measure the tax advantages accruing to pension contributions relative to other tax advantaged savings.

Private pensions are tax advantaged

In theory, the system of tax relief on pension contributions can be said not to be designed to provide a subsidy for pension saving, but to remove pension saving from the tax system. This avoids taxing pensions twice, and fits in with the notion that pensions are deferred pay[26]. However, there are also two specific tax advantages within the current system, that can be seen as direct incentives to encourage pension saving:

- The tax free lump sum
- Receiving tax relief at a higher rate than is paid on the pension received in retirement

The tax free lump sum has a clear tax advantage. It can increase the value of a pension contribution by 7% for a basic rate tax payer, and 17% for a higher rate taxpayer[27], compared to a 'tax neutral' regime.

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[24] *UBS Global Asset Management (2004)*
[25] *Booth and Cooper (2002), (2003)*
[26] *Booth and Cooper (2003)*
[27] *Cook and Johnson (2000)*

Receiving tax relief at the higher rate (currently 40%) and paying tax on a private pension in retirement at the basic rate (22%) can increase the value of a pension contribution by up to 40% compared to a 'tax neutral' regime[28].

A further advantage accrues to an employee if his or her employer makes a pension contribution. Any contribution made to a tax-approved private pension by an employer also attracts tax relief, so has a higher monetary value to the employee than simply paying the money directly in pay. Over half of tax relief paid on pension contributions is in respect of contributions from employers[29].

Making pension contributions on behalf of employees also has direct tax advantages for the employer, as employers' pension contributions are not eligible for National Insurance contributions. This subsidy is now included in government estimates of the cost of tax relief[30]. Tax relief is particularly important to pension schemes and pension providers. One-fifth of all contributions to private pensions (occupational and personal pensions) come from tax relief[31].

Most private pension tax relief is paid to higher earners, and men

Tax relief on private pension contributions is regressive, in that higher earners receive a higher rate of tax relief, and so receive more state support for a given level of private pension contribution. Higher earners are also more likely to belong to private pension schemes[32], and so be making contributions that attract tax relief.

This results in most tax relief being received by high earners. 55% of tax relief on individual and employee pension contributions is received by 2.5 million higher rate tax payers. These higher-rate taxpayers gain even more if they pay tax on the pension benefits in retirement at a lower rate.

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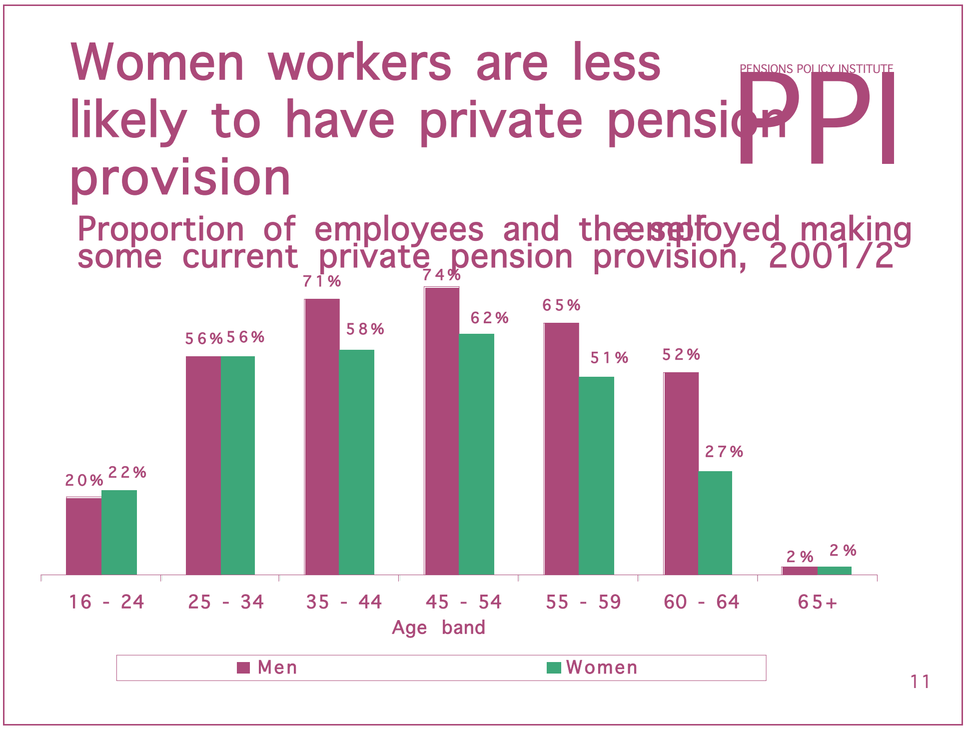
[28] Cook and Johnson (2000)
[29] PPI calculation based on Inland Revenue data
[30] Inland Revenue table 7.9 and Table 1 below
[31] PPI calculation based on IR and ONS data
[32] Curry and O'Connell (2003)

The remaining 45% of tax relief on pension contributions goes to 13 million basic rate or non-taxpayers[33]. Nine million taxpayers are estimated to receive no tax relief, as they are not saving in pensions.

It is not possible to distinguish directly how much tax relief is paid to men and how much to women. But it is clear that most tax relief will be paid to men rather than women. Only 20% of higher rate taxpayers are women[34]. Women are also less likely than men to be accruing a private pension (Chart 1).

[33] *PQ Steve Webb 11 February 2004 House of Commons Hansard Column 1490W*
[34] *Inland Revenue estimate for 2004/5*

Chart 1[35]



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[35] Curry (2003 TUP W)

Tax relief on pensions has a cost

There are many different estimates of the 'cost' of tax relief on private pensions, often based on different definitions of cost.

One important consideration in any cost estimate is to what should the current tax regime be compared? In the absence of tax relief, the money in private pension contributions could be saved in other tax efficient vehicles (such as ISAs, or offshore), saved in savings vehicles with no special tax treatment (such as building society accounts), or spent.

One definition of cost is the 'present value' approach, which considers the amount paid out in relief on contributions, relief on investment income and tax paid on pensions in payment over the lifetime of individuals. Using this methodology, the annual 'cost' of the tax relief system in place in 1993 was estimated to be around £1 billion compared to investing in PEPs[36], and £4 billion compared to investing in building society accounts. Later estimates based on a similar theory suggested a present value cost of £4.5 billion compared to saving in ISAs, or £9.3 billion compared to saving in a building society in the mid-1990's[37].

[36] *The equity-based predecessor of ISAs*
[37] *Agulnik and Le Grand (1998)*

An alternative approach is to look at a cash-flow estimate of cost. The Inland Revenue estimates the annual amount 'paid' in tax relief on private pensions by comparing the private pension tax regime against the regime for unapproved pension schemes – these are not tax advantaged in any way. This method estimates the annual cost of tax relief, that is, tax revenue foregone because of relief on private pension contributions, investment returns and lump sums. For 2003/4 this cost was almost £20 billion, or 1.8% of GDP (Table 1).

Additional costs are also estimated for the relief from National Insurance Contributions on employers' pension contributions, and the tax foregone due to higher income tax personal allowances for people aged 65 or older[38]. Set against this is the amount of tax collected on private pensions in payment.

Including all of these estimates gives the 'net' cost of tax relief in a year – the tax not collected in relief on pension contributions (and other tax and NI advantages) *less* the tax paid on pensions in payment. The latest estimates for 2002/3 suggest a net cost of over £19 billion, or 1.8% of GDP (Table 1).

This is significant, representing around 25% of the cost of all state pensions and retirement benefits[39].

Because this is a snapshot, costs estimated in this way are likely to change over time as demographic trends and levels of private pension provision change. For example, relief on contributions and investment income is currently more than double the tax collected on pensions in payment. As the number of pensioners increases, and if private pension contributions fall, it could be that more tax is collected than relief is given, resulting in a net saving. However, no projections of this cost are made by government, or by other organisations.

In the absence of tax relief, many pension contributions would be redirected to other tax efficient vehicles such as ISAs[40], or spent. This suggests that were all tax relief to be abolished, tax revenues would not increase by the full 1.8% of GDP. The extent of this overestimation is unclear as there are much stricter limits on

[38] See www.inlandrevenue.gov.uk/rates/it.htm for further details of the higher personal allowances for people age 65 or older
[39] Including the Basic State Pension, SERPS/S2P, Pension Credit, and Winter Fuel Payments
[40] Dilnot and Johnson (1993), Hughes and Sinfield (2003)

contributions to ISAs, and many people with pension contributions may already use some or part of their ISA allowance. However, money could also be invested tax-free offshore, where there are no limits[41].

[41] The Inland Revenue is continuing to work towards common tax treatment for offshore and UK investment vehicles, including changes in the 2004 Budget (IR (2004 BN)).

Table 1: Estimated costs of tax relief on private pensions, 2003/4[42]

Tax relief on:	Cost, £ million
Employees' contributions to occupational pension schemes	£3,500
Employers' contributions to occupational pension schemes	£9,800
Employees' contributions to personal pension schemes	£1,100
Employers' contributions to personal pension schemes	£850
Employees' contributions to Free Standing Additional Voluntary Contribution schemes	£130
Contributions to personal pensions by the self-employed	£950
National insurance rebates	£236
Investment income of funds	£2,600
Lump sum payments from unfunded schemes	£300
Total tax relief on private pension contributions	**£19,466 (1.8% of GDP)**
National Insurance relief on employer contributions	£5,800
Higher tax allowances for pensioners	£2,000
Including additional relief (1)	**£27,266 (2.5% of GDP)**
Less tax liable on:	
Pension payments	£8,000
Refunds by funds to employers	£39
Total tax received (2)	**£8,039 (0.7% of**

[42] *Inland Revenue statistics, Table 7.9* www.inlandrevenue.gov.uk/stats/pensions/table7_9.pdf

	GDP)
NET TAX RELIEF COST (1-2)	**£19,227 (1.8% of GDP)**

On the other hand, some argue that these estimates underestimate the true cost. They do not include, for example, the fact that capital gains on pension funds are not taxed, or the true costs of all pension lump sums[43].

This estimate is still indicative of the impact of the tax relief system on government finances in any one year, and as such is consistent with other components of state pension spending. For example estimates of spending on the Basic State Pension are of the amount paid out to pensioners in any one year, rather than the value of the liabilities accrued to those with a qualifying year. The cost of tax relief is not counted in government estimates of state pension spending[44], but does represent a reduction in the resources that government has available to spend. The current annual cost, and projections of future costs, should be included as part of published estimates of overall government spending on pensions.

Simplification will increase the costs of tax relief

Under current government proposals, new limits will be used to determine the tax relief payable on pension contributions from April 2006. Contributions of up to £215,000 a year will be eligible for tax relief, subject to a total lifetime fund limit of £1.5 million. Under the current system, contributions are limited to a proportion of annual earnings (subject to an earnings cap of £102,000) or £3,600, whichever is the higher, with a maximum pension level of two-thirds of final salary.

These proposals should allow the vast majority of individuals to make more private pension provision eligible for tax relief[45]. However, the Government estimates that there will be only a small impact on the overall cost of tax relief – an increase of £165 million by 2008/9[46]. It is assumed that the only people likely to change their savings behaviour as a result of the proposals are the few currently constrained by the current limits.

[43] Sinfield (2000)
[44] See for example DWP (2002 GP). PPI Briefing Notes Number 3 and Number 14 examine these issues in more detail.
[45] IR (2002) para 4.31
[46] IR (2004)

There is some debate as to whether the proposed changes will make the distribution of tax relief more progressive and remove the current gender inequality, or will make these problems worse[47]. If high earners are more likely to be constrained under the current system than low earners, or if the constrained high earners are more likely to change behaviour than the constrained low earners, the system will become more regressive. But if the low estimated additional cost is correct, there will be little change overall.

[47] Sinfield (2003)

3. Is there a better alternative?

A number of alternative proposals have been suggested for reform of tax incentives. Each of these has advantages and disadvantages, and would impact on different individuals in different ways.

- **Matching contribution and single tax-rate options** give the highest net retirement income for the same size contribution to non-taxpayers, and the lowest to people paying higher rate tax in retirement. These options distribute tax relief more evenly than the current system. However, there could be difficulties in integrating these options with existing occupational pension schemes.
- **An ISA regime** allows for more flexible pension arrangements, and would cost less than the current regime. It would give everyone the same pension income for the same contribution, but would give most tax relief to people paying higher rate tax in retirement.
- **The current system** pays more tax relief to higher rate taxpayers than to basic rate taxpayers, but is simple to operate.

The reforms examined in this chapter concentrate on tax relief on pension contributions. They do not, for example, cover the incentives for employers to make pension contributions discussed in the previous chapter. Proposals for additional employer incentives have also been made – for example for a pension contribution tax credit[48] – but they are beyond the scope of this paper.

Matching contributions would be more progressive than the current system

A number of different proposals have been put forward to use a system of 'matching contributions' to incentivise private pension saving, or private saving more generally. Some of these[49] aim to replace the existing system of tax relief, but others[50] suggest additional incentives on top of the current system. In the US, a matching contribution for low income households was introduced

[48] ABI (2002)
[49] Such as Agulnik and Le Grand (1998) and Altmann (2002)
[50] Such as Legal and General (2002), Norman and Clark (2004)

in the form of the Saver's Credit in 2001[51], on top of existing tax reliefs.

A matching contribution system works by giving every individual the same saving incentive for the same level of contribution. This is achieved by government paying a fixed monetary amount for each personal contribution, rather than using a marginal tax rate. For example, a £1 government contribution for each £1 of personal contribution.

The actual match could be reduced progressively as the total contribution increases – for example matching contributions £-for-£ for the first band of savings, then £1 government contribution for every £2 of personal contribution for the next band.

The system could be designed to 'cost' the same as the current system by changing matching rates and the size of contributions they apply to.

There are a number of advantages of such an approach:
- Lower earners receive a large incentive to save, so incentives would be better targeted on those who currently do not save.
- The incentive is much clearer, and presented in a way that is easier to understand.
- The system could be more progressive than the current system, if matching levels are high over a relatively small band of income.

Some disadvantages of this approach are:
- Matched contributions do not fit with the economic rationale behind tax relief – avoiding double taxation[52]. A portion of the pension contributions of higher rate taxpayers could be taxed twice.
- It is difficult to fit matched contributions with employer pensions, and employer pension contributions would have to be treated as taxable benefits. There is a particular issue in defined benefit schemes where employer contributions are assigned to a central fund rather than to individual employees[53]. This means that matched contributions would

[51] Gale et al (2004)
[52] Booth and Cooper (2003)
[53] Booth and Cooper (2003)

not change the pension received from a defined benefit scheme.
- Larger incentives may lead to low earners who already save deciding to put aside less of their own money, leaving their total savings unchanged[54].
- In a cost neutral scheme, higher earners would receive lower tax incentives, and so may switch saving away from pensions.
- Higher earners are still likely to receive most of the tax relief, as they would still make larger contributions.

A single rate of tax relief also aims to benefit low earners
To avoid the problem of lower earners receiving a lower incentive to save because their marginal tax rate is lower, the rate of tax relief could be set at a single limit for all pension contributions. This could be restricted to the basic rate (costing less than the current system), increased to the higher rate (increasing the cost of the system)[55], or set at a separate rate between the higher and basic rates. A single rate of 30 per cent would cost the same as the current system[56].

The advantages of this approach include:
- Everyone receives the same incentive, irrespective of earnings.
- The system would be more progressive than the current system.
- If the rate is set above the basic rate, lower earners have a larger incentive to save.

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[54] The income effect, see page 9
[55] Lord Oakeshott of Seagrove Bay proposed tax relief should be given at the higher tax rate for pension contributions made by standard rate tax payers (15 May 2002, House of Lords Hansard column 358)
[56] Parliamentary Question Lord Oakeshott of Seagrove Bay, 28 January 2004, House of Lords Hansard column WA46

Some disadvantages of this approach are:
- The system would still be opaque – arguably even more so as there would be less of a link between the individual and the rate of tax relief.
- If tax relief were restricted below the higher rate, a portion of the pension contributions of higher rate taxpayers could be taxed twice.
- An 'arbitrary' rate would be more difficult to administrate for employer contributions to pensions, using a different rate to that used for pay.
- In a cost neutral scheme, higher earners would receive lower tax incentives, and so may switch saving away from pensions.

Switching to an ISA regime would allow flexible pension arrangements
Rather than having different systems of tax relief for pensions and for ISAs, tax incentives for pensions could be provided in the same way as for ISAs. Pension contributions would be paid out of taxed income, but the investment returns would be tax advantaged and all withdrawals made free of tax. This could be combined with reform of the state pension to provide a coherent interaction between the state and private pension systems[57].

The advantages to this system are:
- It changes the flow of tax expenditures and receipts, leading to a lower cost to be funded by the state (i.e., all taxpayers) or even a net saving in the short term. This could offset pressures on other areas of pension spending[58].
- It levels the playing field between saving for retirement and other forms of saving, removing distortions.
- The ISA tax regime should allow totally flexible private pension arrangements. With a TtE system, removing the distinction between pension and ISA saving, there need be no regulation on how the private pension money is taken. This could extend to removing the requirement to purchase an annuity. This point is strengthened if an ISA tax regime were combined with reform of the state pension system that removed means-testing (such as a Citizen's Pension), so that the way in which money is paid from a pension would not affect state pension benefits.

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[57] O'Connell (2004 CPNZ)
[58] For example, the transition to a Citizen's Pension (O'Connell (2004 CPNZ)) or the switch to a fully funded state pension system (Lilley (2003) annex B)

Disadvantages include:

- An ISA system still retains the regressive nature of tax relief, with higher earners likely to receive more relief.
- The political risk that future governments may decide to tax withdrawals would need to be seen to be prevented.
- There would be a need to run two tax regimes (pre-and post change pensions) for decades, or otherwise absorb a one-off cost of making existing pensions tax free on withdrawal. A one-off tax on pension funds may be possible as part of the switch in systems, but this would remove a large sum from savings overnight and could have macro-economic consequences.
- There would be less emphasis on 'locking-in' benefits, which may result in less private saving being used for retirement income.

Retain the current system is the default option

The default option is to retain the current system, which[59]:

- Is difficult for people to understand
- Has not closed the 'savings gap'
- Is regressive as it pays most relief to higher (male) earners

However, additional arguments that have been used in the UK for retaining the current system (EtT) are[60]:

- Giving tax relief on contributions at the marginal tax rate is relatively simple to operate, as it works with the grain of the existing income tax system[61].
- Compared to the ISA regime, it sends a strong signal about the benefits of saving, and rewards the locking-in of benefits until they can be accessed at retirement[62]. This implies that it is the role of Government to incentivise people to save, and to save one way rather than other available ways.

People paying less tax benefit most from alternatives

The proposed options for tax incentives would give different individuals different pension incomes for a given level of pension contribution (Table 2). The pension incomes can be compared to

[59] See Chapters 1 and 2
[60] O'Connell (2004 CPNZ)
[61] Booth and Cooper (2003)
[62] NAPF (2002); Periodic Report Group (1997)

the amount that would be received if the same contribution were paid into a normal savings account, where contributions and investment returns are taxed in full, and money can be withdrawn from the account free of tax (a **TTE** regime). To highlight the impact of tax relief, it is assumed that the savings account would achieve the same investment return before tax as the pension fund, and that on retirement 75% of the fund in the savings account is used to buy an annuity at the same rate as in the pension system, but is paid tax-free.

The options also give different amounts of tax relief to different individuals (Table 3). The tax advantage of each element of each different option has been estimated by comparing the amounts received against what would have been received under the TTE system at each stage.

Note that the matched contribution option cannot be compared on a like-for-life basis directly against the others, because it is more generous and would cost more.

The overall impact of each option depends on how many people are in each particular situation illustrated in Tables 2 and 3. There are 13 million people receiving tax relief who are basic rate and non-taxpayers, and 2.5 million people who are higher rate taxpayers when working. It is not known how many of the 13 million are basic rate rather than non-taxpayers; nor is it known how many of the 2.5 million higher rate taxpayers will still be higher rate taxpayers in retirement. It is likely that most of the latter group will pay basic rate tax in retirement. Only 2% of pensioners currently pay higher rate tax[63].

[63] *PQ Mr Steve Webb, House of Commons Hansard 11 February 2004: Column 1489W*

Table 2: Net annual retirement income and tax-free lump sum received from a one-off pension contribution of £1,000[64]

		Current system (EtT)	Single tax rate (30%)	Matched contributions (£-for-£)	ISA system (TtE)	Savings account (TTE)
Non-taxpayer	Income	£147	£164	£230	£115	£115
	Lump sum	*£986*	*£1,098*	*£1,538*	*£769*	*£769*
Basic rate taxpayer	Income	£115	£128	£179	£115	£87
	Lump sum	*£986*	*£1,098*	*£1,538*	*£769*	*£583*
Higher rate taxpayer paying basic rate tax when retired	Income	£149	£128	£179	£115	£66
	Lump Sum	*£1,281*	*£1,098*	*£1,538*	*£769*	*£440*
Higher rate taxpayer	Income	£115	£99	£138	£115	£66
	Lump sum	*£1,281*	*£1,098*	*£1,538*	*£769*	*£440*

[64] *PPI calculation based on an individual aged 35 today retiring at age 65. See Appendix for further details.*

Table 3: Tax relief, compared to the savings account regime (TTE), received on each element after a one-off pension contribution of £1,000[65]

	Current system EtT	Single tax rate (30%)	Matched contributions (£-for-£)	ISA system TtE
		Non-taxpayer		
Contribution	£282	£429	£1,000	£0
Investment fund	£867	£1,318	£3,075	£0
Tax-free lump sum	£0	£0	£0	£0
Pension payment	£0	£0	£0	£0
Total tax relief	**£1,149**	**£1,747**	**£4,075**	**£0**
		Basic rate taxpayer		
Contribution	£282	£429	£1,000	(-£282)
Investment fund	£1,613	£2,063	£3,821	£745
Tax-free lump sum	£217	£242	£338	£169
Pension payment	(-£651)	(-£725)	(-1,015)	£507
Total tax relief	**£1,525**	**£2,073**	**£4,208**	**£1,204**
		Higher rate taxpayer when contributing, basic rate taxpayer in retirement		
Contribution	£667	£429	£1,000	(-£667)
Investment fund	£3,365	£2,633	£4,390	£1,315
Tax-free lump sum	£282	£242	£338	£169
Pension payment	(-£846)	(-£725)	(-1,015)	£507
Total tax relief	**£3,468**	**£2,578**	**£4,714**	**£1,325**
		Higher rate taxpayer when contributing and in retirement		
Contribution	£667	£429	£1,000	(-£667)
Investment fund	£3,365	£2,633	£4,390	£1,315
Tax-free lump sum	£513	£439	£615	£308
Pension payment	(-£1,538)	(-£1,318)	(-1,845)	£923
Total tax relief	**£3,007**	**£2,183**	**£4,160**	**£1,878**

[65] PPI calculation based on an individual aged 35 today retiring at age 65. A negative figure is tax paid, rather than relief received. See Appendix for further details.

The conclusions apparent from this analysis are:

- Most tax relief appears to be gained on the roll-up of the investment fund. Under all options part of the investment return attracts relief at the marginal rate of tax.

- The least valuable tax relief is the tax-free lump sum. The lump sum gives most relief to individuals paying higher rate tax in retirement.

- The current system gives higher and basic rate taxpayers the same <u>pension income</u> for the same contribution. Pension income is higher for non-taxpayers and for those paying higher rate tax when contributing and basic rate tax in retirement.

- The current system gives more than twice as much <u>tax relief</u> to higher rate taxpayers than to basic rate or non-taxpayers, whatever the rate of tax they pay in retirement.

- Both the single tax rate system and the matching contribution system give the highest <u>pension income</u> to non-taxpayers; a lower income to people paying basic rate tax in retirement; and the lowest to those who continue to pay higher rate tax in retirement.

- With a single rate or matching contributions, higher rate and basic rate taxpayers receive similar amounts of <u>tax relief</u>. Tax relief is highest for a person paying higher rate when contributing and basic rate tax in retirement, and lowest for a non-taxpayer.

- Under an ISA system, the same <u>pension income</u> is received irrespective of the tax rate paid.

- An individual paying higher rate tax in retirement receives more <u>tax relief</u> than an individual paying basic rate tax under the ISA system. Non-taxpayers receive no tax relief.

- The matching contributions option used here appears to pay the most tax relief and give the highest pension income for a given contribution, so is likely to be more expensive than the current system rather than cost neutral.

- The ISA system gives least tax relief and would cost less than the current pension tax relief system, even though it is based on the same tax rates.

- None of the options would benefit people who do not – or cannot afford to – save in a private pension.

Appendix: Assumptions used in tax relief calculations

Estimates are based on a £1000 pension contribution (before tax relief) paid into a private pension fund by a man aged 35, who converts the resulting pension fund to an annuity at age 65. Contributions are made by individuals (rather than employers).

In practice, tax relief on a pension contribution for a higher rate taxpayer would initially be paid at the basic rate (22%), with the additional relief would be paid to the taxpayer (rather than into the fund) at the end of the financial year. For simplicity, it is assumed in higher rate taxpayer examples that tax relief at 40% is paid direct to the fund.

In these examples, the pension fund is assumed to attract real investment returns (relative to prices) of 5% a year, before an annual management charge of 1% a year. The average pension fund return has been 6.3% before charges over the past 10 years, but is expected to be lower in future[66].

The 5% growth is assumed to be net of the tax impact on equity dividend income. Corporation Tax is no longer reclaimable on dividend income from equities in pensions, ISAs and savings accounts, so affects all vehicles equally, if they have the same proportion of funds invested in equities of the same dividend yield.

To calculate the tax relief paid on the roll-up of the pension fund, returns (after allowing for the impact of Corporation Tax on equity dividend income) are assumed to grow free of other taxes. The final fund is then compared to a fund under the TTE system, where returns (again after allowing for Corporation Tax) are subject to the individual's marginal rate of income tax (40% for a higher rate tax payer and 20% for a basic rate taxpayer[67]).

Individuals are assumed to take the full 25% tax-free lump sum at retirement.

[66] FSA (2003)

[67] Savings are taxed at a special rate of 20% for a basic rate taxpayer. However, not all savings are taxed at this rate. Dividend income is taxed at 10% for a basic rate taxpayer and 32.5% for a higher rate taxpayer. The actual overall rate faced will depend on the precise investment mix of the fund. For simplicity, these examples assume that all savings income is taxed at 20% and 40% respectively, which is likely to slightly overestimate the actual tax that would be payable.

At retirement, the fund is converted to an annuity using a projected rate for a single male annuitant (based on PMA92 mortality tables adjusted for current mortality).

Tax on pension payments is calculated at the time of retirement, as a proportion of the fund remaining after the tax-free lump sum has been taken.

Table 3 shows the value of tax relief at each stage of possible relief – contributions, investment returns, the tax-free lump sum and pension payments compared to the TTE system. For example, under the current system:

- A basic rate taxpayer making a pension contribution of £1,000 would receive tax relief at the basic rate (22%), giving relief of £282[68].
- The total £1,282 is then invested and accrues interest at a tax advantaged rate; dividend income from equities is adjusted for Corporation Tax, but all other types of investment within the fund accrue tax free rather than attracting the basic rate of tax payable on other savings (20%). This results in a final fund at retirement of £3,943. If the initial £1,000 had been invested with no tax relief, and if basic rate tax had been paid on all of the interest accrued[69], the final fund at retirement would have been only £2,330. The value of tax relief is therefore £3,943 – £2,330 = £1,613.
- From the final fund of £3,943, the individual can take a tax-free lump sum of up to 25% of the fund value before buying an annuity. This would give a lump sum of £3,943 x 25% = £986, and a reduction in tax paid of £986 x 22% = £217.
- The remaining fund (£3,943 – £986 = £2,957) is then taxable at the basic rate of tax, £2,957 x 22% = £651. The annual income after converting the remaining fund to an annuity (after tax) is £115.
- The net value of the tax relief is therefore: the relief on contributions (£282) + the relief on the investment returns (£1,677) + the relief on tax-free lump sum (£217) *less* the tax paid on the final pension (£651) = £1,525.

[68] *This is calculated as £1,000 x 1/(100%-22%), representing the amount of tax that would have been paid to leave an after-tax amount of £1,000*

[69] *Where the interest accrued is calculated net of the Corporation Tax paid on equity dividend income*

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Contact:

Alison O'Connell, Director
Telephone: 020 7848 3751
Email: alison@pensionspolicyinstitute.org.uk
To learn more about the PPI, see:
www.pensionspolicyinstitute.org.uk

Pensions Policy Institute
King's College
Waterloo Bridge Wing
Franklin-Wilkins Building
Waterloo Road
London
SE1 9NN
www.pensionspolicyinstitute.org.uk

Age Concern England
Astral House
1268 London Road
London
SW16 4ER
www.ageconcern.org.uk