PENSIONS POLICY INSTITUTE

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Comparison of pension outcomes under EET and TEE tax treatment

Executive summary

This report has been commissioned by the Association of British Insurers (ABI).

Association of British Insurers

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Executive summary

In the Budget of 8 July 2015, the Chancellor, George Osborne, announced a consultation into the use of tax relief to “strengthen the incentive to save” for retirement. The ABI has asked the PPI to analyse the impact of a number of potential reforms to the tax relief system, ranging from adjustments to the current system, through to more fundamental changes in the way the pension tax relief works.

This report sets out the impact that the potential policy reforms might have on the level of money that people of different ages and in different tax positions could accrue by retirement and their resulting post-tax pension wealth. It also considers the impact of potential reforms on the cost of tax relief to the Exchequer

Chapter one: impact of tax treatment on a single contribution

Chapter one sets out analysis of a £1,000 contribution made by individuals under the ABI’s set of potential reform options. Using a single £1,000 contribution for individuals in different circumstances serves to set a level playing field for comparison. Under this approach the difference between outcomes for people of different marginal tax rates is not obscured by the variations in the amount of contributions that each type of taxpayer could afford to make.

Chapter one: key points

- The current EET system is beneficial to all individuals. Under the current EET system some of the pension may be received with no tax at all being paid on it. This is because of:
  - the tax free lump sum,
  - and the fact that state pension does not use up all of the Personal Allowance in retirement, so some of the private pension income may not be pensionable.
- EET Tax Systems are beneficial to people who are subject to a tax rate in retirement which is lower than the rate on which they got tax relief.
- A flat rate EET system with a flat rate between 20% and 40% has a redistributive effect, improving the outcomes for basic rate taxpayers and worsening outcomes for higher and additional rate taxpayers.
- 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.
- A TEE system with significant matching contributions could increase the outcomes for individuals.

Chapter two: Impact of tax relief on saving through working life

Chapter two considers the whole working life impact of the various tax regimes on individuals and the extent to which their outcomes are affected by working patterns.

The results in chapter two are set out in a measure that is similar to the 'taxed fund value' defined in chapter one. It is a single figure that sets out the value of their pension saving that is available to them after retirement in terms of the total value of the net income they might achieve under the potential policy reforms.

Chapter two: key points

- Individuals who are basic rate taxpayers through their working life tend to do better under a single tier 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 tier EET system, requiring a high matching contribution or rate of tax relief rate to maintain the value under the current system.
- Individuals with salary growth that leads them to move from basic rate to higher rate tax, will experience a combination of the basic rate taxpayer and higher rate taxpayer impact. The particular impact on them will depend on the amount of time and level of contributions made while basic and higher rate taxpayers.
- Higher rate taxpayers derive a lot of value in their pension from the 40% tax relief. An EET system with a reduced level of tax relief will leave them worse off. Even a TEE system with a 50% matched contribution could leave them worse off compared with the current system, if they would likely be a basic rate taxpayer in retirement.
- 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 TEE system. However that would increase the cost on the government of providing means tested benefits.

Chapter three: Cost and distribution of reforms to tax relief

Chapter three sets out the first year static impact on the cost to the Exchequer of a number of alternative reform options. It goes on to consider how the distribution of tax relief by salary level and by age may change under a flat rate pension tax relief system.

Chapter three: key points

- Adjusting the tax relief on contributions changes the cost to the government of the tax relief.
- An EET system with a flat rate of slightly over 30% might be implemented for around the same initial cost of tax relief as the current system.
- 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 upfront costs to the Exchequer in addition to the loss of future tax revenue on pension payments.
- The distribution of tax relief under a flat rate system reflects the net contribution to pension schemes.
- The age distribution of tax relief is relatively unaffected by introducing a flat rate pension, however there is a slight redistribution from middle ages to younger, and to older pension savers.

Chapter four: Lifetime Allowance and Annual Allowance equivalence

Chapter four considers making an adjustment to the system of pension tax free allowances, the Annual Allowance and the Lifetime Allowance. The reform option considered is that DC schemes would be subject to the Annual Allowance but not the Lifetime Allowance, and that DB schemes would be subject to the Lifetime Allowance but not the Annual Allowance. The reasoning behind this is that DB schemes and DC schemes are each subject to a single element of the Allowance system, the one that is more suitable for that type of scheme. It would be desirable for the DB and DC elements of the system to be consistent.

Chapter four: key points

- It may be possible to consider Allowances in terms of equivalence and thereby apply different types of allowances to different forms of pension savings.
- Changes to allowances which are designed to hit high earners can have impacts on more modest earners if they have been long-term members of DB pension schemes.