PENSIONS POLICY INSTITUTE

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Future trends in pensions tax relief

Executive summary

This report is based upon modelling commissioned by The Resolution Foundation.

Resolution Foundation

A Technical Modelling Report by Tim Pike and John Adams

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Report Summary

In the July 2015 Budget, the Chancellor, George Osborne, announced a consultation into the use of tax relief to "strengthen the incentive to save"[1] for retirement. The Resolution Foundation commissioned the PPI to analyse the impact of a number of potential reforms to the tax and National Insurance relief system, ranging from adjustments to the current system, through to more fundamental changes in the way the pension tax relief and employer National Insurance relief works.

There were no changes made to the current system of tax relief in the March 2016 Budget, though it did introduce the Lifetime ISA (LISA) as an addition to the current pension system.[2]

This report sets out the impact that the potential policy reforms might have on the projected cost to the Exchequer, the impact upon particular individuals and how the impact would be spread across the pension saving population.

Chapter one: the saving population under the current system

Chapter one considers the current saving population how the current system of tax relief applies to the individuals within it.

Chapter one: key points

- The number of pension savers is projected to rise to 22 million due to the roll out of automatic enrolment by 2018.
- By 2018 the projected cost of tax relief could be over £30 billion (in 2016 terms).
- The average rate of tax relief claimed is projected to be 29% in 2018.
- The proportion of tax relief claimed by higher and additional rate tax payers will decrease to 65% by 2018.

Chapter two: projected aggregate tax relief costs

Chapter two sets out the projected impact of pension tax relief reforms to the Exchequer. Flat rate EET (Exempt, Exempt, Taxed) and TEE (Taxed, Exempt, Exempt) variants are compared to the current system, and the projected impact to the Exchequer is calculated as the alternative systems mature. Appendix one details the aggregate modelling used to perform these projections.

Chapter two: key points

- A flat rate of tax relief could increase the proportion going to basic rate tax payers from 35% to 55%.

[1] HM Treasury (2015-16)
[2] It is a restricted ISA style savings vehicle following the ISA tax system with a 25% matching bonus to contributions, however it is not considered further within this report.

- The implementation of a TEE system will reduce the future income tax stream as the amount of income tax paid on pension withdrawals decreases.
- A pure TEE system could lead to a £17bn net windfall to the Government in 2018, as tax is still collected on virtually all pensions in payment, but without the cost of tax relief on contributions.

Chapter three: the impact of tax relief systems upon an individual

Chapter three sets out the projected impact of pension tax relief and National Insurance contributions (NICs) relief reforms upon an individual, considering key earnings levels including the National Living Wage (NWL). Flat rate EET and TEE variants are compared to the current system, and the projected impact upon the individual is calculated as the alternative systems mature. Appendix two details the individual modelling used to perform these projections.

Chapter three: key points

- A high earner will lose out in a flat rate EET system unless the rate is set at least 40%.
- For a low earner introducing employee NICs relief could result in an increase in taxed pension value of 8.5%.
- A low earner is unlikely to be paying income tax in retirement under the current EET system. As a result a 25% matching contribution in a TEE system generally yields the same outcome, as both systems are effectively exempt from tax throughout.