PENSIONS POLICY INSTITUTE

PPI

PPI analysis of Aviva proposals for a single rate of pensions tax relief

Introduction

In November 2014 Aviva approached the PPI to ask it to review and validate its public policy proposal for the reform of pension tax relief. The PPI commenced this work at the beginning of December 2014. Aviva's stated purpose for developing the policy proposal is to help inform the ongoing debate surrounding the future of pension tax relief. The following is a summary of the headline measures of the Aviva policy proposal:

- The government should rebrand pension tax relief as the "government's contribution to pension saving" and provide that contribution equally to all.
- In particular it should provide an uplift to employee pension contributions at a rate of 1:2. This is equivalent to providing a flat rate of 33% tax relief. It would be branded as "Buy 2 get 1 free"
- The financial incentives for employers to contribute should be retained. In particular employer national insurance relief should continue to apply to employer pension contributions and employee tax relief on employer pension contributions should remain as it is now.
- Automatic enrolment minimum contributions should be increased (to 6% employee) in 2019, to ensure that increased government contributions result in increased pension saving at no extra cost to employees.
- Action will be required to close the opportunity to obtain higher and additional rate relief through a renegotiation of benefits, notably through salary sacrifice arrangements.
- The annual allowance should be the main lever to control overall HM treasury spend on pension tax relief.

Aviva has commissioned the PPI to:

- Review the estimated cost of moving to a single rate of pensions tax relief for employee pension contributions of 33%
- Review the Aviva estimates of the NIC savings generated by the transfer from salary sacrifice to normal employee contributions.

Summary of main findings

Based on the PPI model of UK pensions tax relief, updated to the latest available HMRC data (2012/13);

- Replacing the current system of tax relief on employee pension contributions at the marginal rate with tax relief on employee contributions at a single rate of 33%, combined with
- The NIC savings generated by the transfer from salary sacrifice to normal employee contributions, would initially cost no more that the current system, and could potentially reduce the annual cost to the Exchequer by £1.7bn - £2.2bn when introduced.

The change to a single rate of tax relief of 33% on all employee contributions from the current marginal rate system would, in isolation, increase the cost to the Exchequer. However, the NIC savings generated by the transfer from salary sacrifice to normal employee contributions would more than offset this.

These estimates only consider the changes in the cost assuming that the pattern and level of contributions stays the same as in the most recent available data from HMRC. No allowance has been made for the increase in contributions and tax relief that will arise from automatic enrolment (this will increase costs for the current system as well as for the single rate policy). No allowance has been made for the reduced top rate of tax (from 50 to 45p) and therefore reduced cost of tax relief, as introduced on 6 April 2013.

As one of the aims of moving to a single rate of tax relief for employee pension contributions would be to change behaviour (by encouraging higher levels of pension saving), it is likely that the actual costs could be higher or lower than the estimates provided in this report, if individuals save more or less in response to the change in policy.

There is little evidence available which could be used to estimate in detail how individuals might respond to these changes.

However, based on evidence of general possible responses to savings incentives (as used in previous PPI) work, the increase in tax relief caused by lower earners saving more could be broadly offset by a reduction in tax relief paid to higher earners saving less. No estimates have been made of the impact of behavioural change of ending salary sacrifice arrangements.

A single rate of tax relief on employee contributions at 33% would lead to a more even distribution of relief, compared to the current system. In the current system, basic rate taxpayers receive 29% of the tax relief while making 53% of employee contributions. Under the Aviva proposal they would receive 49% of the tax relief whilst making 49% of employee contributions.

This analysis has only considered the initial impact on the cost and distribution of tax relief. It does not consider the impact of changes to the annual or lifetime allowance. It also does not consider the following possible issues:

- How such a single rate system for employee contributions and the ending of salary sacrifice could be implemented and enforced. We understand Aviva have completed further work on this internally.
- The relative impact on Defined Benefit schemes compared to Defined Contribution schemes.
- The perceived fairness of any changes.

Review of the cost of the single rate of tax relief at 33%

The PPI have re-run the PPI tax relief cost model used in the 2014 PPI report *Tax relief for pension saving in the UK*, using a 33% rate of relief. The model has been updated with 2012/13 data to check the costs of the current system and the 33% single rate option. This update in the data is important to pick up the potential impact of known policy changes on the actual distribution and cost of tax relief, such as the significant reductions in the annual allowance which was in place from the start of the 2012/13 tax year.

The analysis in this report uses the methodology presented in the PPI report *Tax relief for pension saving in the UK*[1]. In particular for the purposes of this report we keep **gross contributions constant for defined benefit pension schemes** and we keep **net contributions constant for defined contribution pension** schemes. In deciding how to keep contributions constant, the characteristics of the different types of pension schemes were considered.

Defined benefit pension schemes

Defined benefit pension schemes use their contributions to meet and maintain the required funding level. The gross contributions being paid into the scheme are set out in advance. The amount required to finance the scheme does not depend on the tax relief system. Therefore the gross contributions should be held constant for the analysis of defined benefit pension schemes.

Defined contribution pension schemes

Defined contribution pension schemes do not have funding targets; there is therefore no need to maintain the level of contributions being paid into the pension scheme so the argument used for defined benefit pension schemes does not apply.

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[1] http://www.pensionspolicyinstitute.org.uk/uploadeddocuments/20130715_Tax_Relief_for_Pension_Saving_in_the_UK.pdf

Instead it was assumed that employees would be interested in maintaining the same level of take-home pay after making pension contributions into a defined contribution pension scheme. This means keeping the same level of net contributions, and allowing the impact of a change in the tax relief offered to fall on the gross contribution to the scheme.

Cost of the current system of tax relief
Table 1 shows the distribution of tax relief in the 2012/13 tax year under the existing system. The total cost to the exchequer of tax relief on pension contributions was £27.2bn, this consists of £21.3bn of tax relief on employer contributions and £5.9bn of tax relief on employee contributions.

Table 1: Cost of tax relief on pension contributions in 2012/13 (£bns)[2]

	Tax relief on employer conts	**Tax relief on employee conts**	**Total tax relief on conts**
Current system	21.3	5.9	27.2
33% flat rate	21.3	6.1	27.4
Impact of abolition of salary sacrifice	-3.0	+3.0	+0.0
Total 33% flat rate, remove salary sacrifice	18.3	9.1	27.4
Impact of proposals	-3.0	+3.2	+0.2

Moving to a flat rate system of 33% tax relief on all employee contributions might increase the cost of tax relief on employee contributions to around £6.1bn, an increase of around £0.2bn. The total tax relief on pension contributions would therefore increase slightly to £27.4bn.

If salary sacrifice were to be abolished and the existing sacrificed contributions that are classified as employer contributions became normal employee contributions, they would then be subject to the 33% tax relief on employee contributions. The result of reclassifying these contributions could be to reduce the tax relief on employer contributions by around £3bn. Then, under the restructured employee tax relief system, the reclassified contributions could increase employee contributions by around £3bn, making a negligible overall impact on the total cost of tax relief in respect of the reclassification.

[2] PPI Calculations. Assumes salary sacrifice is approximately 30% of existing employee contributions.

Revenue generated in National Insurance contributions by removing salary sacrifice.
While the abolition of salary sacrifice may have a very minor effect on the cost of tax relief on pension contributions, it is likely to have a more significant effect on National Insurance contributions. Currently, if an employee sacrifices an amount of their salary in return for an employer pension contribution, neither the employer nor employee pay national insurance on that amount. Under the Aviva policy proposal, salary sacrifice would be abolished, leading to an increase in National Insurance contributions revenue (Table 2). For the benchmark results it is assumed that salary sacrifice represents around an additional 30% of existing employee pension contributions. For sensitivity a "Higher Sacrifice" scenario, was also performed, where it is assumed that salary sacrifice represents 35% of existing employee contributions.

Table 2: Additional revenue generated by abolishing National Insurance contributions (£bns)[3]

	Benchmark (30% of current employee contributions)	**Higher Sacrifice (35% of current employee contributions)**
Additional employee contributions	9.4	11.8
Employer NIC	1.3	1.6
Employee NIC	0.6	0.7
Total additional NIC	1.9	2.4

The PPI have checked through the spreadsheet provided which contains the data and methodology used, and have referred back to the original source material through the CPS publications – the figures can be traced back to the original Government sources.

The PPI can confirm that the methodology, assumptions and data use appear to be reasonable and credible.

[3] Aviva calculations based on HMRC table 3.8

Total impact of tax relief reform and abolishing salary sacrifice

As seen in Table 1 above, the change to a flat rate of 33% tax relief may have a small increased cost to the exchequer. However, this may be more than offset by the additional revenue from increased National Insurance receipts as a result of abolishing salary sacrifice (Table 3).

Table 3: Combined net impact of 33% Flat rate tax relief and abolition of salary sacrifice (£bns)

Cost to the Exchequer	Benchmark (30% of current employee contributions)	Higher Sacrifice (35% of current employee contributions)
Current system	27.2	27.2
Move to 33% flat rate	+0.2	+0.2
Impact of abolition of salary sacrifice	+0.0	+0.0
***Less* increase in NI Contributions**	-1.9	-2.4
Net Impact of proposals	-1.7	-2.2
Net cost to exchequer	25.5	25.0
Change from current system	-1.7	-2.2

Impact on distribution of tax relief

Under the existing system of tax relief being awarded on employee contributions at the marginal rate, the tax relief on employee contributions was £5.9 billion. The distribution of this tax relief by tax band is not proportional to the amount of contributions (Table 4). Basic rate taxpayers receive 29% of the tax relief while making 53% of contributions. Higher rate taxpayers receive 56% of tax relief while making 38% of contributions. Those who pay additional rate tax receive 15% of tax relief and make 9% of contributions.

Table 4: Distribution of tax relief in 2012/13 on employee contributions under current tax relief system (£bns)[4]

Tax band	Contributions	Tax relief
Basic Rate	6.8 (53%)	1.7 (29%)
Higher Rate	4.9 (38%)	3.3 (56%)
Additional Rate	1.1 (9%)	0.9 (15%)
Total	12.9 (100%)	5.9 (100%)

[4] PPI calculations based on HMRC tables PEN6 and Table 3.8

Table 5 sets out the distribution of tax relief in the 2012/13 tax year if tax relief on employee pension contributions were to be awarded at a flat rate of 33%.

Table 5: Distribution of tax relief in 2012/13 assuming 33% tax relief (£bns)

Tax band	**Contributions**	**Tax relief**
Basic Rate	6.1 (49%)	3.0 (49%)
Higher Rate	5.2 (42%)	2.6 (42%)
Additional Rate	1.1 (9%)	0.6 (9%)
Total	12.4 (100%)	6.1 (100%)

Under the Aviva proposal, basic rate taxpayers receive 49% of the tax relief while making 49% of contributions. Additional rate taxpayers receive 42% of tax relief while making 42% of contributions. Those who pay additional rate tax receive 9% of tax relief and make 9% of contributions.

It may be noticed that the distribution of employee net contributions is different when there is a 33% flat rate of pension tax relief compared to the current system of marginal rate tax relief. This is because basic rate taxpayers who are members of defined benefit pension schemes are assumed to reduce their net pension contributions under a 33% flat rate tax relief in order to target the same total gross contribution as under the marginal tax relief system. Higher and additional rate taxpayers have to make a larger net contribution in order to make up for a reduced level of tax relief to achieve the same gross contribution.

We assume that members of defined benefit schemes target an unchanged gross contribution, in order to pay for the accruing benefits, whereas we assume that defined contribution members maintain their take home pay, and therefore keep their net contributions unchanged, and as a result the gross contribution changes.

Behavioural impact

The PPI report *Tax relief for pension saving in the UK* considered the impact on contributions if there were a change in savings behaviour as a result of a change in the amount of tax relief offered on pension contributions. This is intended to allow for the fact that a positive change in the return on contributions may induce people to save more in their pension. For example, basic rate taxpayers may be expected to save a bit more, while higher and additional rate taxpayers may save a little less.

In order to reflect this in the distributional analysis for the PPI report, assumptions regarding 'pension saving elasticity' are required. Using research by the ABI it was possible to estimate savings elasticities of pension saving, to both existing savers, and the inducement to start saving to those who do not currently save. See Annex 7 of *Tax relief for pension saving in the UK* for more information.

Using the same methodology as the PPI tax relief report, the results in Table 6 set out the impact on the cost of tax relief of a change in the behaviour of savers in response to the change in the tax relief. In addition, the analysis varies the power of the behavioural impact; what would happen if the behavioural response was 50% less, or 50% more than the standard assumptions.

Table 6: Impact of behavioural changes on cost of tax relief in under a 33% flat rate tax relief system (£bns)

Tax band	Tax relief assuming 33%	Tax relief (50% of behavioural impact)	Tax relief (100% of behavioural impact)	Tax relief (150% of behavioural impact)
Basic Rate	3.0	3.1	3.2	3.3
Higher Rate	2.6	2.5	2.4	2.4
Additional Rate	0.6	0.5	0.4	0.4
Total	6.1	6.1	6.1	6.1

Please note that this makes no allowance for the impact of abolishing salary sacrifice.

Automatic Enrolment

We used the government figure that Automatic Enrolment will lead to around an additional 9 million people saving and used the Wealth and Assets Survey data to identify the distribution of people who would qualify for automatic enrolment. We have made the assumption that these 9 million people all contribute at the minimum level. That is, the employee contributes 5% of band salary and the employer contributes 3% of band salary.

Cost to Government under the current system

Applying the current tax relief system to the resulting distribution of people suggests that the Exchequer cost of tax relief on the employer and employee Automatic Enrolment contributions would be around £3.3 billion in 2012/13 earnings terms.

Automatic enrolment legislation requires contributions of 8% of band salary with at least 3% of which being paid by the employer, it does not stipulate how the remaining 5% of contributions must be made. It could therefore be subject to salary sacrifice on those 5% of contributions.

If all individuals who are automatically enrolled were to take part in salary sacrifice, it would lead to a cost of around £2.0 billion in lost NICs. Assuming

30% of employee contributions would be salary sacrificed, this would lead to a cost of salary sacrifice of £0.9 billion.

The total cost of the automatically enrolled individuals under the current system would therefore be around £3.9 billion. Aviva proposes that the annual allowance is reduced to offset the additional cost of tax relief forecast in 2019.

Cost to Government of the Aviva proposal
Under the Aviva proposal that employees receive 33% tax relief on contributions, the total cost of tax relief on AE contributions would increase to around £4.5 billion. The increase is due to the fact that most automatically enrolled employees are basic rate taxpayers, who therefore receive a sizable increase on their tax relief.

The Aviva proposals would abolish salary sacrifice, there is therefore no cost of lost NICs. The total cost of the automatically enrolled individuals is therefore around £4.5 billion, an increase of around £0.6 billion.

Potential further areas of debate in the proposals
This analysis has only considered the initial impact on the cost and distribution of tax relief. It does not consider the impact of changes to the annual or lifetime allowance. It also does not consider the following possible issues:

- How such a single rate system for employee contributions and the ending of salary sacrifice could be implemented and enforced.
- The relative impact on Defined Benefit schemes compared to Defined Contribution schemes.
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