PPI analysis of TISA proposals for pensions tax relief

Introduction
In the Budget of 8 July 2015, the Chancellor announced a consultation into the use of tax relief to "strengthen the incentive to save" for retirement. TISA asked the PPI to assist them in calculating the impact on the cost to the Treasury of a proposal for a new tax relief system that they had conceived. The TISA proposal consists of the following:

- 33% tax relief on all employee contributions to pension schemes
- 20% tax relief on employer contributions in respect of basic rate taxpayers
- 33% tax relief on employer contributions made in respect of higher or additional rate taxpayers
- Abolish salary sacrifice
- The changes to the system apply to Defined Contribution (DC) schemes only

This note sets out the impact on the Treasury if the above proposal had been in place in the tax year 2012/13.

The analysis presented in this note uses the methodology presented in the PPI report *Tax relief for pension saving in the UK*[1]. In particular for the purposes of this note 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 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. 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.

For the split between Defined Benefit (DB) and DC pension schemes we have used the split that was assumed in TISA's own calculations that were sent to the PPI for validation. That is that approximately 40% of occupational pension contributions are in respect of DC pension schemes, and that all of contributions to personal pensions are to DC schemes.

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

Results

Table 1 shows the distribution of tax relief to defined contribution pension contributions in the 2012/13 tax year under the existing tax rates. The total cost to the exchequer of tax relief on contributions to DC schemes was around £13.5 billion, of which £10.1 billion was in respect of employer contributions and £3.3 billion was in respect of employee contributions.

Basic rate taxpayers receive 27% of the tax relief while making 51% net of contributions. Higher rate taxpayers receive 55% of tax relief while making 39% of net contributions. Those who pay additional rate tax receive 17% of tax relief and make 10% of net contributions.

Table 1: Distribution of tax relief in 2012/13 (£bns)

Tax band	Tax relief	Contributions	Total Contributions
Basic Rate	3.7 (27%)	14.8 (51%)	18.5 (44%)
Higher Rate	7.5 (55%)	11.2 (39%)	18.6 (44%)
Additional Rate	2.3 (17%)	2.8 (10%)	5.1 (12%)
Total	13.5 (100%)	28.8 (100%)	42.3 (100%)

Table 2 sets out the distribution of tax relief in the 2012/13 tax year if tax relief were to be awarded at a flat rate of 33% on employee contributions, and at 33% for higher and additional rate taxpayers, but 20% on basic rate taxpayers for employer contribution. The total cost to the exchequer of tax relief on contributions to DC schemes would have been £11.4 billion, a reduction in cost of £2.1 billion.

Table 2: Distribution of tax relief in 2012/13 assuming TISA tax relief proposals (£bns)

Tax band	Tax relief	Contributions	Total Contributions
Basic Rate	4.5 (39%)	14.8 (51%)	19.3 (48%)
Higher Rate	5.5 (48%)	11.2 (39%)	16.7 (42%)
Additional Rate	1.4 (12%)	2.8 (10%)	4.2 (10%)
Total	11.4 (100%)	28.8 (100%)	40.2 (100%)

Under the modelled reform option, basic rate taxpayers receive 39% of the tax relief while making 51% of net contributions. Additional rate taxpayers receive 48% of tax relief while making 39% of net contributions. Those who pay additional rate tax receive 12% of tax relief and make 10% of net contributions. This represents a shift of tax relief to the basic rate taxpayers, from higher and additional rate taxpayers.

Removal of Salary Sacrifice
Salary sacrifice enables employees and employers to take advantage of a quirk of the National Insurance system, because employer contributions to a pension scheme are not subject to National Insurance but employee contributions from salary are. So an employee gives up part of their salary, and an equal amount is made as an employer contribution.

Abolishing Salary Sacrifice would have the effect of moving those contributions from employer contributions, back to being employee contributions, where they would be subject to NI contributions from the employer and employee, and also, under the TISA proposal, subject to different tax relief treatment for basic rate taxpayers. It is assumed that 30% of all employee contributions are made in the form of salary sacrifice.

Table 3 sets out the distribution of tax relief in the 2012/13 tax year if Salary Sacrifice were abolished, in addition to the adjustments to tax relief on contributions set out in Table 2. The total cost to the exchequer of tax relief on contributions to DC schemes would have been £11.7 billion, an increase to the cost of £0.3 billion.

Table 3: Distribution of tax relief in 2012/13 assuming TISA tax relief proposals and abolishment of Salary Sacrifice (£bns)

Tax band	Tax relief	Contributions	Total Contributions
Basic Rate	4.8 (41%)	14.8 (51%)	19.6 (48%)
Higher Rate	5.5 (47%)	11.2 (39%)	16.7 (41%)
Additional Rate	1.4 (12%)	2.8 (10%)	4.2 (10%)
Total	11.7 (100%)	28.8 (100%)	40.5 (100%)

But there is also an increase in NI contributions received by the State to offset this cost. Table 4 sets out the impact on NI contributions as a result of abolishing Salary Sacrifice.

Table 4: Distribution of impact on National Insurance Contributions of abolishing Salary Sacrifice (£bns)

Tax band	Increase in salary	Employer NICs increase	Employee NICs increase	Total NICs increase
Basic Rate	2.04	0.28	0.24	0.53
Higher Rate	1.73	0.24	0.03	0.27
Addnl Rate	0.57	0.08	0.01	0.09
Total	4.3	0.6	0.3	0.9

The measure might raise revenue for the government at around £0.9billion.

Taking this all into account, the TISA proposal results in a net saving to the government of around £2.7 billion; consisting of a £2.1 billion saving on changing the contributions and a net £0.6 billion saving from abolishing salary sacrifice.

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 5 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. This does not allow for the salary sacrifice abolishment

Table 5: Impact of behavioural changes on cost of tax relief in under a 33% flat rate tax relief system (£bns)

Tax band	Tax relief assuming TISA relief proposals	Tax relief (50% of behavioural impact)	Tax relief (100% of behavioural impact)	Tax relief (150% of behavioural impact)
Basic Rate	4.5	4.5	4.6	4.7
Higher Rate	5.5	5.2	4.9	4.6
Additional Rate	1.4	1.2	1.1	0.9
Total	11.4	11.0	10.6	10.3

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.

Cost to Government of the TISA proposal
Under the TISA proposal where that employees receive a 33% flat rate of tax relief on employee contributions, higher and additional rate taxpayers receive tax relief on employer contributions restricted to 33%, while tax relief on employer contributions to basic rate taxpayers remains at 20%. This leads to a cost of tax relief of £4.4 billion.

The TISA proposals would abolish salary sacrifice, there is therefore no cost of lost NICs. The total cost of the automatically enrolled individuals is therefore around £4.4 billion, an increase of £0.5 billion on the £3.9 billion under the current system.

The impact of the restriction on employer contributions to higher and additional rate tax payers, beyond the impact of the flat rate on employee contributions, is not very large. This is because the employer contributions are the smaller share of AE contributions, and most AE people are likely to be basic rate taxpayers, rather than higher and additional rate taxpayer. This limits the scope of the restriction as a cost control measure on AE contributions.