PPI policy seminar: Tax relief for pension saving in the UK

The Pensions Policy Institute (PPI) held a policy seminar on 15 July 2013 to launch its latest report *Tax relief for pension saving in the UK.* The research was sponsored by Age UK, The Institute and Faculty of Actuaries, Partnership and the TUC and its main goal was to consider whether the current system of pension tax relief meets the UK Government's objectives and whether some alternatives would better meet these objectives. In addition, the research considered the impact of recent adjustments to the current system where from 2014/15 the Annual Allowance will be reduced from £50,000 to £40,000 and the Lifetime Allowance will be reduced from £1.5 to £1.25 million.

The seminar was attended by around 80 people representing a broad range of interests within Government, the pensions industry and the third sector.

Nick Salter, President-elect of the Institute and Faculty of Actuaries, chaired the seminar.

Chris Curry, PPI Director, presented the findings of the report.

- Tax relief goes disproportionately to higher earners. While basic rate taxpayers make 50% of the total pension contributions they only benefit from 25% of the relief. When figures are projected to take into account the impact of auto-enrolment, the proportion of tax relief received by basic rate taxpayers increases to 30%.
- Reasons for the ineffectiveness of tax relief directly related to the tax system include low levels of understanding around the tax treatment of pensions, the fact that tax incentives have redirected money from other savings rather than incentivising savings overall. General barriers to pension saving include people having insufficient income to make pension savings, lack of understanding around pensions and issues related to the current design and delivery of pensions.
- The impact of the reduction of the Annual Allowance on Defined Benefit pension scheme members would be limited by the carry-forward provisions. For instance, an individual earning £40,000 and with 20 years of service would require a 49% pay rise to breach the Annual Allowance. However, in the case of Defined Contribution pension schemes, individuals may reduce contributions to keep below the Annual Allowance, reducing the value of their pension funds.
- In the current system a third of tax relief goes to individuals with lump sums of more than £150,000. If the tax-free portion were limited to 20%

of the pension fund, the reduction in tax relief would be proportionately the same for all taxpayers. If this were applied to current lump sums, the cost of tax relief could decrease from £4 billion to £3.5 billion. If the tax-free portion of the lump sum were capped at £36,000, the proportion of tax relief going to lump sums of £150,000 and over would reduce from 32% to 7%. If this were applied to current lump sums, the cost of tax relief could halve from £4 billion to £2 billion.

- Higher earners would lose out from a single rate of tax at both the basic rate and 30%. Low and mid-range earners would benefit from a single rate at both 30% and the higher rate. Under all single rate options between 45% and 50% of tax relief would go to higher and additional rate taxpayers compared to 70% in the current system. A single rate at the basic rate could cost £22 billion, at 30% could cost £35 billion and at the higher rate could cost £50 billion.
- In terms of practical considerations, it would be more difficult to give tax relief at a single rate, as it would be difficult to operate Net Pay Arrangements. The system may appear less transparent to members of Defined Benefit pension schemes and it may be more difficult to understand. However, presenting tax relief as matching contributions may be easier to understand and may further incentivise pension saving.
- Behaviour may change in a number of ways. The change in return on individual's own contributions could change, leading them to charge their behaviour – if they understand the system. It may affect perceptions and ease of use of the tax relief system and may also affect employers through administrative complexity and cost.
- Estimates of the extent of behaviour change are limited to those linked to changes in return on the individual's own contribution. However, even with wide sensitivity testing, ranges of outcomes are reasonably narrow. The cost of basic rate tax relief could be between £19 and £22 billion, of tax relief at 30% could be between £34 and £35 billion, and of higher rate tax relief could be between £50 and £57 billion.

The PPI presentation can be accessed here.

Charlotte Clark, Deputy Director for Pensions and Savings at HM Treasury, provided a view of the findings from the Government's perspective. She highlighted the question of whether tax relief should incentivise or reward saving, stating that ideally tax relief should incentivise saving. Other important attributes for HM Treasury are that tax relief and any changes to tax relief should be understandable, should offer value for money to the Exchequer, ensure fairness both between individuals and across an individual's lifetime, and minimise the burden on both employers and the pensions industry. She highlighted the importance of pensions as an important part of the UK's saving culture.

Moving to recent developments, Charlotte highlighted the fact that pension tax relief must be affordable for the Exchequer, particularly within the current climate. Reductions to both the Lifetime and Annual Allowance reflect this. While auto-enrolment has meant that pension tax relief is better targeted, it remains expensive for the Government. She noted that the lump sum can be seen as an anomaly in a system where payments in are exempt but payments out are taxed, but noted that it is valuable in that it is the most widely understood element of pension tax relief so could be successful in incentivising savings. Charlotte highlighted that it is essential that in looking at any changes to the system that the Government understand how any changes might affect behaviour. So in looking at flat-rate tax proposals it is important to think about how this may change savings behaviour.

Jane Vass, Head of Public Policy, Age UK, provided a view of the findings from a consumer perspective. She observed that pension tax relief should be considered in conjunction with other developments such as the single-tier pension and auto-enrolment. Against this backdrop, it is critical that any changes to tax relief are seen as both fair and as strengthening pensions rather than destroying them. Therefore, Age UK wants to see improvements in incentives for the bulk of savers rather than the Government taking large amounts of money out of the system. However, they do question whether the current system is fair or effective.

Jane highlighted the importance of outcomes for individuals. Tax incentives compensate people for tying up their money for many years, boost the value of their savings and also provide some 'headroom' to protect people from the volatility of long-term equity investment..

Moving to the tax-free lump sum, Jane observed that it is valuable in that it fits in with people's lives. They may use it to pay down debt and it offers some protection against the situation where people die early, leaving nothing to their family. Age UK came to the topic of the tax-free lump sum via the issues around trivial commutation. Jane compared the tax-free lump sum that an individual with the current maximum lifetime savings can take, £375,000, with that of someone at the trivial commutation limit of £18,000; in this case the maximum tax-free lump sum that the individual can take is £4,500. Jane observed that, while this is logical, it seems unfair. Other options around the tax-free lump sum that Age UK would like considered might include increasing the percentage of the pension fund that can be taken as a tax-free lump sum by those people with smaller pension funds.

Jane concluded that, regardless of people's views on tax relief, it is essential to understand the behavioural impact and the report shows that there is scope for change to the system. Tax relief should be reformed to provide better incentives, particularly for people with modest incomes and, at least, it should be ensured that people understand pension tax relief.

Steve Groves, Chief Executive Officer, Partnership, provided a view of the findings from a pensions industry perspective. Steve observed that few phrases are as likely to bore as pension tax relief. Despite this, it is important to get this right and this paper reflects one aspect of a larger debate as society seeks to rebalance the obligations and responsibilities of states and citizens. Steve emphasised that key factors in this debate are demographics and wealth and stated that tax relief, which is an incentive granted by the Government but funded by working age people, sits at the heart of this debate. This is because tax relief looks to incentivise people to make adequate requirement provision for themselves, so the burden of underfunding does not fall on future generations.

Steve stated that pension tax relief does not currently work in the most efficient way, as it benefits high earners disproportionately – and he was surprised by the extent of the mismatch demonstrated by the PPI research. He observed that it would be sensible for the government to focus on people on low and middle incomes, as they are the group most likely to have insufficient retirement incomes and consequently those most likely to become reliant on the state in their retirement.

Steve concluded that it is important to incentivise pension saving today as it is not realistic to expect the current generation to fund pensions for the older generation. Steve reflected that a single rate of pension tax relief would be relatively straightforward to implement, but this is a debate that will evolve.

Nick Salter, President-elect of the Institute and Faculty of Actuaries, provided a view of the findings from the Institute and Faculty of Actuaries' perspective.

Nick described how he had considered the pension tax relief system to be tax-neutral before the publication of the PPI research, except for the tax free nature of the lump sum on retirement. He also highlighted how the cash flow approach to calculating the cost of tax relief will provide the wrong answer. He noted that the current system is not an EET system and that he would be happy to see a straightforward EET system, but believes that this would be difficult to achieve as it would be a major change and deeply unpopular.

Nick observed that he would be interested to see the actual impact of auto-enrolment, particularly as the opt-out rate has to date been lower than expected. Similarly, he remarked that he would like to see further research around accessibility of pensions, people's inability to save and lack of understanding around pensions. He concluded with a plea to the Government that if they change pension tax arrangements they should leave the new system in place for some time as change makes it difficult for people to plan for the future and the pensions industry needs time to implement any changes.

The following points were raised during the questions and discussion section. They do not necessarily reflect the views of the PPI or the PPI seminar speakers.

- There was discussion around the Impact Assessment of the cost of a single rate of pension tax relief to the pensions industry.
- It was pointed out that 30% tax relief rate would not be easy to implement in terms of the presentation of tax relief as matching contributions. A 25% rate would mean that it could be presented as the government paying £1 for every £3 paid by the individual while a 33⅓ rate could be presented as the government paying £1 for every £2 paid by the individual. It was also observed that a flat rate could not accurately be described as tax relief.
- It was pointed out that employers' reactions to any changes should be taken into account as they play an important role in encouraging take-up of pensions. There was a discussion around the importance of outcomes and the difficulties around finding evidence of the role of pension tax relief in incentivising or rewarding pension savings. It was pointed out that adequacy of pensions needs to be taken into consideration for the government to decide which groups need help.

In connection with this topic, it was pointed out that some higher rate taxpayers are not saving enough for their retirement.

- There was a question around whether there had been any research around the risk of separating directors' interests, in terms of pensions, from those of the rest of staff, and the impact of this on decisions around pensions. The PPI published a report on this subject in 2010 '*The impact of tax policy on employer sponsored pension provision*'.
- There was a question around the level of pension saving which would be optimal while at the same time improving the UK economic output. In response it was pointed out that the UK has the 2nd lowest savings ratio in the developed world and, as things currently stand, over-saving is not an issue. It was also pointed out that retirement income can come from a number of places, including human capital.
- It was pointed out that it would be useful to a have an overview of the entire pensions landscape, including auto-enrolment and the single-tier, for the government to make effective decisions around pension tax relief.
- A point was raised as to why there is an emphasis on the private provision of pensions over corporate or state provision of pensions.