"Tax relief offers important advantages to pension savers, but does little to encourage pension saving, particularly among low and medium earners" says Pensions Policy Institute

The Pensions Policy Institute (PPI) is today publishing *Tax relief for pension saving in the UK*, a report which assesses the extent to which pension tax relief meets its objective of incentivising pension saving, and analyses options for reform. This report has been sponsored by Age UK, The Institute and Faculty of Actuaries, Partnership and the TUC.

The report finds that the current pension tax relief system is tax-advantaged compared to other savings such as ISAs, with the tax-free lump sum of up to 25% of the pension being particularly valuable. Individuals who pay higher rate tax when working – and so get tax relief at the higher rate – but who pay basic rate tax in retirement get an even larger benefit.

Chris Curry, PPI Director said "Pension tax relief offers important tax advantages, particularly to higher rate taxpayers. However, despite tax relief on contributions costing up to £35bn a year after allowing for the introduction of automatic enrolment, tax relief is poorly understood and there is little evidence that it encourages pension saving among low and medium earners."

"The current system of pension tax relief favours higher and additional rate taxpayers. Even with pension saving boosted for lower earners by automatic enrolment, basic rate taxpayers are estimated to make 50% of pension contributions, but receive only 30% of pension tax relief on contributions. "

"Pension tax relief on lump sums, at an estimated cost of £4bn a year, is similarly uneven. While only 2% of lump sums are worth £150,000 or more, they attract almost one-third of tax relief on lump sums. "

Chris Curry added "While recent reforms have reduced the cost of tax relief, they have not increased the value of saving for any individuals. More radical alternatives, such as a single rate of tax relief applied to all pension contributions, could spread the advantages of tax relief more evenly. A tax relief rate of 30% could have a cost similar to the current system. If presented clearly, a 30% rate could give a larger incentive to basic rate taxpayers to save, while still leaving pension saving at least tax neutral for higher rate taxpayers."

"But implementation of a single rate of tax relief would be far from straightforward, with significant changes in the administration of pension contributions required. The resulting tax charges could be very difficult to understand and lead to changes in behaviour by employees and employers."

ENDS

An Executive Summary of the report follows on the next page.

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The report can be downloaded from www.pensionspolicyinstitute.org.uk

Notes for editors

1. The Pensions Policy Institute (PPI) is an educational research charity, which provides non-political, independent comment and analysis on policy on pensions and retirement income provision in the UK. Its aim is to improve the information and understanding about pensions policy and retirement income provision through research and analysis, discussion and publication. Further information on the PPI is available on our website www.pensionspolicyinstitute.org.uk.

2. The report has been sponsored by Age UK, The Institute and Faculty of Actuaries, Partnership and the TUC.

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Sponsorship has been given to help fund the research and does not imply agreement with, or support for, the analysis or findings from the project.

Tax relief for pension saving in the UK
Executive Summary

Tax incentives are seen as a means to encourage pension saving amid concerns that people are not saving enough for retirement. Pension saving attracts a level of tax relief that compares favourably with other types of saving. However, there are concerns that tax relief is expensive, poorly targeted and does not achieve its policy objectives.

This report provides an overview of the pension tax relief system and examines the rationale for tax relief. It also considers the extent to which tax relief incentivises pension saving and considers some alternatives to the current system, including adjustments to the current framework of the tax relief system, changes to the tax-free lump sum, and using single rates of tax relief rather than relief given at the saver's marginal rate.

Rationale for tax relief

The main objective for tax relief on pensions is to support retirement saving by encouraging individuals to save for their retirement and employers to contribute to pension schemes. In this way, tax relief looks to compensate people for the fact that they cannot access their money before a particular date and, when they are able to access this money, it must be accessed in a particular way (for instance, they must take it as an annuity or via a Capped Drawdown arrangement). Tax relief also aims to make the tax system for pension saving neutral by ensuring that people do not pay tax twice on the same income; however, while this is an objective, it is secondary to supporting retirement savings.

The current pension tax relief system

The UK pension tax system is based on an EET system; the principle of contributions being Exempt from tax, investment returns being Exempt from tax and withdrawals from pension being Taxed. However, in practice, the UK system is best referred to as Eet. Contributions (subject to limits) are exempt from tax. Investment growth and income within the pension fund are exempt from tax with the exception that tax on equities at the Corporation Tax rate has been paid and cannot be reclaimed. Pension payments are taxed at the individual's marginal tax rate, apart from tax-free lump sums of up to 25% of the fund.

Limits to tax relief include the Annual Allowance and the Lifetime Allowance. These are currently set at £50,000 and £1.5 million respectively, and will be reduced to £40,000 and £1.25 million respectively from 2014/15.

In addition, where employers pay a proportion of an employee's salary as pension contributions, National Insurance contributions are not payable on this. However, National Insurance contributions are not considered as part of this report.

Is the tax relief system tax neutral?
The tax treatment of pensions in the UK is more tax-advantaged for individuals than that other savings, including ISAs (which are sometimes described as tax neutral). Pension saving in the UK is therefore tax advantaged. An important tax advantage accrues from the fact that it is possible to withdraw a tax-free lump sum of up to 25% of the pension value.

Based on a £1,000 contribution invested from age 40 to age 67, non-taxpayers, basic rate taxpayers and higher rate taxpayers could all receive more from a pension than an ISA, where the only difference between the two products is the tax treatment. The tax advantage of pension saving is higher for higher rate taxpayers than basic rate taxpayers as they would have had to pay tax at the higher rate on the tax-free lump sum. But the largest tax advantage is received by individuals who pay higher rate tax when working, but only pay tax rate tax when retired. This is because their pension contributions attract tax relief at the higher rate but they only pay tax at the basic rate when they receive their pension payments.

The current cost of tax relief
The net cost of tax relief was estimated to be £23.7 billion in the 2010/11 tax year. This cost includes tax relief paid on employees' and employers' contributions to pension schemes (£22.7 billion), as well as tax relief on contributions to personal schemes (£5.8 billion). Tax relief paid on investment returns (£6.5 billion) is added to this while tax liable on pension payments, as they are paid out (£11.3 billion), is offset against tax relief given, to reach the net tax relief cost. This figure does not take into account the changes to the Annual Allowance and the Lifetime Allowance announced which took place from the 2011/12 tax year where the Annual Allowance was reduced from £255,000 to £50,000.

The introduction of auto-enrolment will increase the numbers of lower earners saving into pensions. However, even after automatic enrolment has been fully phased in, the distribution of tax relief will benefit higher rate taxpayers more than basic rate taxpayers. PPI estimates suggest that, while basic rate taxpayers are estimated to make 50% of the total pension contributions, they would benefit from only 30% of pension tax relief. In contrast, 50% pension tax relief goes to higher rate taxpayers and 20% goes to additional rate taxpayers, while these groups make 40% and 10% of the total contributions respectively.

Does the pension tax relief system work?
Individuals gain a tax advantage from pension saving if they receive pension tax relief at a higher rate than the tax rate on their income in retirement. It is difficult to know how many people benefit in this way. However, in 2010/11, higher rate tax was paid by around 2 million (10%) taxpayers whose largest source of income was from employment and by around 200,000 (4%) of taxpayers whose large source of income was from a pension. The percentage

of people paying higher rate tax has been increasing, and in future more individuals are likely to pay higher rate tax both while working and in retirement as the income threshold above which higher rate tax is payable has been falling relative to average earnings. PPI calculations suggest that the proportion of pensioners paying higher rate tax could increase to around 9% of pensioners by 2026, assuming that thresholds are increased broadly in line with prices.

There is limited evidence around the effectiveness of tax incentives in encouraging pension saving. However, such evidence as there is suggests that tax relief is not very effective in incentivising saving.

Reasons for this ineffectiveness related directly to the tax relief system include:

- Understanding around the tax treatment of pensions is low, something that is likely to dilute its effectiveness as an incentive to save.
- Tax incentives on pensions have redirected more money from other savings into pensions rather than incentivising saving overall. One reason for this is that tax relief does not match its target groups as higher earners, who may be more likely to save, are more likely to respond to incentives.
- There remains a 'Savings Gap', the difference between the amount people need to save to achieve a reasonable retirement income and the amount they are actually saving. This may not in itself mean that pension tax relief has not incentivised pension saving; however it does mean that it has not incentivised pension saving to the extent that individuals save enough for their retirement.

There are some general barriers to pensions saving such as:

- People have insufficient income to make pension savings.
- Lack of understanding around pensions.
- Issues related to the current design and delivery of pensions; for instance, pension schemes themselves are unattractive to some people, particularly people with low incomes.

The current system of tax relief has not overcome these barriers.

The report considers three different aspects of tax relief that have been recently changed or where reforms have been suggested:

- Recent adjustments to the current system
- Restrictions to the tax-free lump sum
- Single rate of tax relief

Recent adjustments to the current system
Recent changes to the system include restrictions to the Annual Allowance (from £50,000 to £40,000) and the Lifetime Allowance from (£1.5 million to £1.25 million). If contributions, or the real increase in the value of pension rights, exceed the Annual Allowance, the excess is subject to tax at the individual's marginal tax rate. Unused Annual Allowance from the three previous years can be carried forward and added to the Annual Allowance. If the individual's pension savings exceed the Lifetime Allowance tax is paid on the excess at the 25% rate if the excess is taken as an annuity and at the 55% rate if the excess is taken as a lump sum.

The reforms will affect members of Defined Benefit schemes and Defined Contribution schemes differently. After allowing for carry-forward, an individual who earns £40,000 with 20 years of service in a Defined Benefit pension scheme would need a 49% pay increase to breach the Annual Allowance. In contrast, without the carry-forward provision, the same individual would need just a 15% pay increase to breach the allowance. An individual in the same scheme who earns £120,000 with 20 years of service would need just a 3% pay increase to breach the allowance. This is not significantly changed by the carry-forward provisions, as the individual is likely to have little unused Annual Allowance to carry forward. In this way, the carry-forward provision significantly reduces the level of pay rise that would lead an individual to exceed the Annual Allowance. Overall the change to the Annual Allowance is most likely to affect high earners and may affect moderate earners with long service histories, with the carry forward provisions limiting the impact on lower earners.

An individual who is a member of a Defined Contribution scheme may decide to cap their contributions in order to avoid paying a tax change. In turn this will limit the value of their pension fund and their income in retirement.

While these changes will reduce the cost of tax relief and reduce the value of tax relief available, they will not improve the incentives for anyone to contribute to a pension.

Restrictions to the 25% tax-free lump sum
Currently individuals are able to take a tax-free lump sum up to the value of 25% of their pension fund. Under the current system, 77% of individuals have a lump sum of under £40,000 while only 24% of the tax on lump sums goes to these individuals. Similarly, while 2% of lump sums are worth £150,000 or more, they attract 32% of tax relief on lump sums. The projected cost of this tax relief on lump sums is £4 billion.

The report considers two potential restrictions to the tax-free lump sum. The figures below do not take into account any possible behavioural change, in that individuals are assumed to take their full lump sum entitlement in all scenarios.

If the tax-free portion of the lump sum were limited to 20% of the pension fund, the reduction in tax relief received would be proportionately the same for all individuals. In practice, any change would be likely to only apply to future contributions, so initial savings would be small and take a number of years to build up. If such a change were applied to current lump sums the cost of tax relief could decrease from £4 billion to £3.5 billion.

An alternative approach would be to cap the size of lump sums that are available tax-free. For example, a cap of £36,000 would mean that 75% of current lump sums would be unaffected but the largest 25% of lump sums would be capped. Again, this is most likely to be applied to new pension contributions so would not make significant savings for many years.

If tax relief were limited to the first £36,000 of the current tax-free lump sums, the proportion of tax relief going to lump sums of £150,000 and over would reduce from 32% to 7%. The cost of tax relief on lump sums could halve to £2 billion. In practice individuals may choose to take larger amounts of the pension fund as an annuity, which would reduce the tax foregone on the lump sum but increase the amount of tax on pension income.

Like the recent changes to tax relief, these changes to the lump sum would mean that pension tax relief is more evenly distributed and reduces the cost of tax relief; however they will not improve incentives for anyone to contribute to a pension, and will reduce the value of tax relief.

Single rate of tax relief
The estimated cost of tax relief on pension contributions from employers, employees and individuals, allowing for the full introduction of automatic enrolment, under the current tax system, is around £35 billion.

Compared to the current cost of tax relief on contributions for employers, employees and individuals of £35 billion, and assuming no change in pension contributions, a single rate of tax relief at the basic rate of income tax on employers', employees' and individuals' contributions could cost £22 billion, a single rate at 30% could cost £35 billion and a single rate at the higher rate of income tax could cost £50 billion. The distribution of tax relief would be more equitable under a single rate of tax relief, with 50% of tax relief going to higher and additional rate taxpayers compared to 70% in the current system, assuming no change in contributions.

The gains and losses from a single rate of tax relief on pension contributions will depend on the single rate used. Higher rate taxpayers would lose out relative to the current system if a single rate of tax relief were set at the basic rate. Low and mid-range earners would benefit while higher rate taxpayers would lose out from a single of tax relief set at 30%. Low and mid-range earners would benefit from a single rate of tax relief set at the higher rate.

A single rate at the basic rate of income tax would mean that higher rate taxpayers face a tax disadvantage unless they pay basic rate tax in retirement. However, the 25% tax-free lump sum means that a single rate at 30% would be broadly tax-neutral for higher rate taxpayers.

A single rate of pension tax relief may be more difficult to understand than the current system. However, if tax relief were presented as matching contributions this may be easier to understand.

While it is relatively straightforward to give tax relief at an individual's marginal rate, it is more difficult to give tax relief at a single rate. It would be difficult to operate Net Pay Arrangements with a single rate of tax relief. In such cases employers could use alternate arrangements, which might require them to make changes to their payroll software. Alternately a compensatory mechanism could be used, for instance changes to the employee's PAYE code or the requirement for them to pay or claim back outstanding tax through the Self-Assessment system.

It would also be more difficult to implement for Defined Benefit pensions. In a Defined Benefit scheme, contributions are paid by the employer and employee into a common fund, which is invested to provide all retirement benefits. In the current system, unless there is a risk of the deemed contribution – an estimate of the increase in the individual's Defined Benefit pension entitlement in the previous year - for an individual exceeding the Annual Allowance the deemed contribution is not calculated. A single rate would require the employer to calculate the deemed contribution for a larger number of employees. As the deemed contribution is based on the increase in value of the fund, the deemed contribution and the extra tax may not bear any resemblance to the employer's and employee's contributions made on behalf of that employee. As such, this system may not appear transparent to pension savers, and could reduce the attractiveness of pension saving to employers and employees if they face higher income tax payments and more complexity.

One objective of tax relief is to incentivise saving. If single rate of tax relief were introduced behaviour might change in a number of ways:

- As the Government contribution to pensions changes, the rate of return on individual's own pension contributions will change; this could lead to individuals changing their behaviour.
- It may affect perceptions and ease of use of the pension tax relief system. This may affect individual's interaction with the system (for instance, if they are required to pay extra tax at the end of the year).
- It may affect employers through administrative complexity and cost, and indirectly through their employees' perception of value of pensions.

Restriction of tax relief to the basic rate or to 30% may lead those people who currently receive higher rate tax relief to divert their savings from pensions. A single rate of 30% may incentivise lower and middle earners to make more pension saving. The introduction of a higher single rate of tax relief may incentivise lower and middle earners to make more pension saving.

It is possible, using existing research, to estimate how individuals may respond to changes in the rate of return on their pension saving. However, there is little evidence as to how individuals and employers might react to broader changes in tax relief on pension contributions.

The outcomes of the introduction of the single rate of tax relief could be different if, for instance, people reacted to a greater extent to the changes in tax relief, and if individuals and employers responded differently to the way in which the tax relief system operates. A range of different assumptions has therefore been used to give an indication of how much behaviour would need to change to have a substantial impact on the overall levels of tax relief on pension contributions above the direct impact.

The results provide an overview of the potential impact of pensions tax reforms on the distribution and cost of tax relief.

- If the single rate were set at the basic rate of income tax the cost could decrease from £35 billion to between £19 and £22 billion. Under this option the tax relief going to higher and additional rate taxpayers would decrease from 70% to between 45% and 50%.
- If the single rate were set at 30% the cost of pension tax relief could decrease from £35 billion to between £34 billion and £35 billion. Under this option the tax relief going to higher and additional rate taxpayers would decrease from 70% to between 45% and 50%.
- If the single rate were set at the higher rate of income tax the cost could increase from £35 billion to between £50 billion and £57 billion. Under this option the tax relief going to higher and additional rate taxpayers would decrease from 70% to between 45% and 50%.

However, these projections are driven by assumptions as well as data and, as a consequence, the analysis does not provide detailed specific forecasts, but rather projections of broad orders of magnitude under different scenarios.