Consultation Response

Strengthening the incentive to save: a consultation on pensions tax relief

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About this consultation

This consultation paper from HM Treasury explores possible options for the future of pensions tax relief. There are three possibilities suggested – firstly maintaining the status quo; secondly, switching to a single rate of tax relief for all savers; and thirdly, switching to a system where pension contributions are made from gross salary, but are then received as tax-free income once the consumer is aged 55 or above.

Key points and recommendations

- Age UK welcomes this consultation and agrees it is right to assess how effective tax relief is as an incentive to save.
- It is important to build on the success of automatic enrolment, and this represents an opportunity for the Government, the financial services industry, and other stakeholders to begin considering how to improve outcomes in retirement.
- We support a single rate of tax relief for all pension savers. This should be marketed as a 'top up' or as, for example, a 'buy-two-get-one-free' deal to maximise the incentive to save and allow consumers to better understand the benefits of pension saving.
- We are, however, strongly opposed to the suggested change to a taxed-exempt-exempt (TEE) system. This is for several reasons, including:
    - 48 per cent of people aged 65+ do not pay any income tax. Taking pension contributions from gross earnings for this group (or their future equivalents) would be introducing a 'T' into the system where one does not currently exist.
    - A TEE system would be reliant on trust in future governments not to remove the exemption from income tax for future pensions. If this were to happen, it would be likely to lead to a mass exodus from pension saving.
    - The complexity of the system, especially the legacy of having two opposing systems running concurrently for generations, would be fiendishly difficult for consumers to understand.
    - As all saving would be available tax-free from age 55, there would be a significantly reduced incentive for consumers to make their pension last into their retirement.
- Reforming tax relief is not a magic bullet to enhance engagement with pension saving – to achieve this other factors also need investigating, for example ensuring good value products.
- The development of a 'pensions dashboard', covering all sources of retirement income, is likely to be an important tool for helping boost understanding of and engagement in pension saving.
- Employer buy-in is important, and National Insurance relief for employer contributions should be protected.

1. Introduction

Age UK welcomes this consultation, and we agree with the Government that pensions tax incentives can play an important role in boosting private pension saving. It also has the potential to be used more effectively as a tool to encourage pension saving and engage people in the process. However, the incentive effect is not the only reason to subsidise pension saving: 'topping up' contributions increases the beneficial effect of any investment growth, while also reducing the risk that an individual sees the value of their individual contributions fall (which is a strong *dis*incentive to saving).

Principles for reform

We are particularly pleased that the consultation paper explores how to build on the success of automatic enrolment. With the roll-out ending in early 2018, we believe that now is an appropriate time to begin considering the options for how best to build on this.

From Age UK's perspective, any further changes to pensions must uphold four principles:

1. Give future generations a decent income in retirement.
2. Provide fairer incentives to save, particularly for those on low and modest incomes.
3. Build on the success of automatic enrolment.
4. Ensure stability and certainty for future pensioners.

While the four principles outlined in the consultation document[1] are not necessarily inconsistent with these, we are concerned by the absence of a focus on outcomes in retirement. Delivering good outcomes in retirement for individuals – particularly lower and middle earners – should be the main focus of any reforms.

There is also a degree of tension between the principles proposed by the Government. For example, allowing personal responsibility is not necessarily aligned with building on automatic enrolment, because the latter is largely driven by inertia.

Non-taxpayers and lower earners are at risk of being penalised

48 per cent of over 65s do not pay any income tax,[i] and those that save into a private pension effectively enjoy an 'exempt-exempt-exempt' tax system. The possible switch to a tax-exempt-exempt system gives us significant cause for concern that their counterparts in younger generations will suffer a serious disadvantage – and disincentive to save – if they have to pay tax on their pension contributions.

[1] The four principles are: 1) being simple and transparent; 2) allowing personal responsibility; 3) building on the success of automatic enrolment; 4) sustainability

2. Consultation questions

1. To what extent does the complexity of the current system undermine the incentive for individuals to save into a pension?

2. Do respondents believe that a simpler system is likely to result in greater engagement with pension saving? If so, how could the system be simplified to strengthen the incentive for individuals to save into a pension?

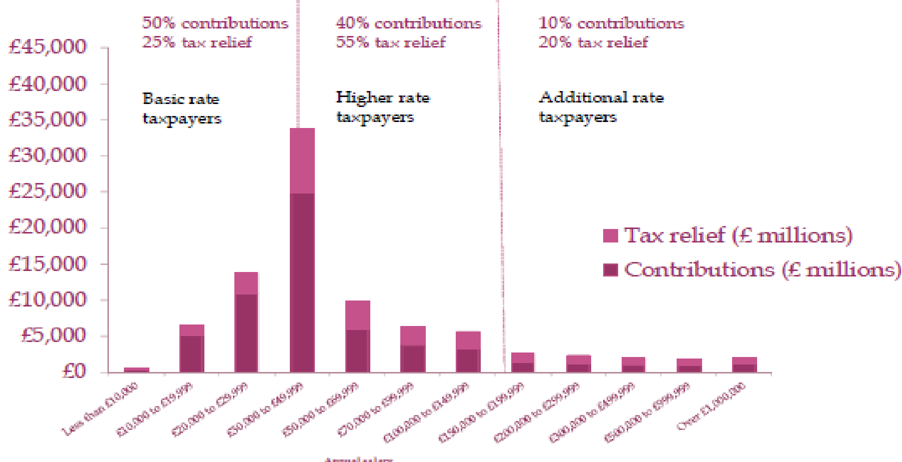
Age UK does not believe the current system of pension saving is particularly complex for the majority of savers. For many people, including the vast majority of those who are automatically enrolled and basic rate taxpayers who pay income tax via PAYE, saving ‘just happens’ without them having to take any affirmative action.

While we do not think that the current system undermines incentives to save, we agree that tax relief is not well understood by the public.[ii] However with improved communications and explanation for consumers, there is significant scope for tax relief to play a considerably more important role in incentivising saving, and increasing engagement with pensions more generally.

Even with automatic enrolment, many individuals are still saving too little to achieve a decent standard of living in retirement.[iii] There is a clear need to support people to save more, and having a fair and easy-to-understand system of tax relief – perhaps re-badged as a ‘government contribution’ – has an important role to play in achieving this.

We also recognise that the current system cost the Treasury £34.3 billion in 2013/14, of which about two thirds goes to additional or higher rate taxpayers.[iv] As the incentives to save are clearly skewed in favour of higher earners (see chart 1), Age UK believes that the system should be reformed to increase the incentives for low and middle earners.

Chart 1



Source: Pensions Policy Institute[v]

Although tax relief is the focus for this consultation, it is important to note it is not the only relevant factor that can play a part in incentivising further saving – for example, employer behaviour and the general trust people place in pensions are important motivators too.

Option for reform – a flat rate of tax relief

Age UK supports a flat rate of tax relief, which – if designed, marketed and implemented effectively – has the potential to incentivise pension saving and help deliver decent outcomes in retirement.

Various organisations have set out proposals that allow for a flat rate of tax relief to be set at anywhere between 25 and 33 per cent. We support calls to rebrand the tax relief as, for example, 'buy two get one free' (for a 33 per cent relief rate) and believe this would help engage more consumers in saving. Automatic enrolment contribution levels have been tentatively referred to as 'buy four, get three from your employer and one from government', so such moves would be building on this.

While we do not propose a precise level at which the rate should be set, it needs to ensure it is fair to lower and middle earners in particular and that these groups derive a good incentive to save, while remaining generous enough for higher earners to retain a strong interest in private pension saving.

We believe this broadly meets the Age UK principles set out earlier.

It is also the 'best fit' option for the four government principles, as (with the correct marketing) it is simple to understand, supports individual responsibility for building up a pension pot, sustainable as it combines affordability with consumer and employer buy-in, and builds on automatic enrolment.

Option for reform – a Taxed-Exempt-Exempt system

Age UK has carefully considered the likely impact of switching to a taxed-exempt-exempt (TEE) system of saving, and has concluded that it would not be in the best interests of consumers, employers or (in the longer-term at least) the government.

An immediate cut in up-front tax relief would reduce the incentive to save into a pension, and particularly disadvantage future generations of savers. There are various reasons to avoid a TEE system, some of which are briefly explored here:

1) ***People on lower incomes face a tax penalty***

Under the current system, 48 per cent of people aged 65+ do not pay income tax.[vi] This effectively means that people with low levels of private pension saving benefit from an 'exempt-exempt-exempt' system, and would be penalised if they had to pay tax upfront. Anyone who is a basic rate taxpayer when working and then a non-taxpayer in retirement would be penalised this way. With the income tax personal allowance having risen to £10,500 – and set to rise to £12,500 per year by the end of this Parliament – this is likely to include increasing numbers of over 65s.

2) Behavioural evidence suggests savings would be undermined

Younger people are more likely than older people to succumb to a present bias[vii]. The absence of up front tax relief might well dissuade many people from saving, as it effectively makes it a decision based on current consumption need. For example, if the question 'shall I use this £20 to buy food or 'buy' some pension income?' is posed, because the latter is some distance in the future it will be deprioritised. While offering a form of government contribution could overcome some of this bias, the lack of trust in future government policy might still dissuade saving.

The research shows that having lower numeracy skills, which is directly associated with working in lower skilled roles, makes people more likely to value the present over the future, and become more susceptible to the framing effects of how an option is presented. This is likely to make it more difficult to optimise outcomes in retirement for lower income groups in particular.[viii]

3) Lack of trust in future governments' tax policy

Even if the current government undertook such a change with the best of intentions, it would still be easy for future governments to renege on the agreement. This inevitable uncertainty would act as a disincentive to save, in particular for lower earners who are more likely to place a higher present value on their salary than are higher earners.

4) Loss of compounding

Investing more money upfront into your pension has historically, over the long-term, yielded a substantial return. At face value, making contributions from gross pay leads to a considerable detriment by the time retirement is reached.

Age UK modelled the impact of saving into a pension tax-free and post-income tax and NI for a basic rate taxpayer saving £500 per year from age 30-64. Saving tax-free, they would build up a pot by age 65 of £47,418, while saving out of taxed income would produce just £32,244. Even though, under the current system the income drawn down would be taxable (after the tax-free lump sum), they would pay very little income tax, and would therefore derive a significant benefit when compared to the saver under a TEE system.

The Government could, as suggested in the consultation paper, provide a 'matching contribution' to correct (some of) this imbalance. However, to derive the same income from private pension saving in retirement as under the current system, a match equivalent to 43 per cent of the contribution would be needed.[ix]

Similarly, the Pensions Policy Institute estimated that the uplift for a higher rate taxpayer when below age 65 who becomes a basic rate taxpayer on retirement would need to be over 40 per cent to maintain the same gross fund value.[x]

5) Complexity of concurrent legacy systems

If a switch to TEE took place, we assume that existing pension saving would continue to operate under the current tax system. This would mean that many consumers would accrue pension saving under two different systems, and at the point of retirement it would

be extremely difficult for many people to determine how much tax they would be paying overall and hence their level of income. This fails to meet the government's principle of 'simple and transparent'.

6) Automatic enrolment would need re-examining

Changing to a TEE system would alter outcomes in retirement for consumers. This would mean automatic enrolment would need to be taken back to its first principles, and re-modelled to determine whether it is still a 'fair deal' for consumers, particularly those on lower incomes. It fails to meet the important principle of 'building on automatic enrolment' that the government laid out.

7) Lower tax take for the Treasury over the longer-term

A TEE system would bring forward the tax take, but it would be reduced over the longer-term. This is largely because returns on investment generated before retirement then translate into a higher retirement income, which would effectively be untaxed. Such 'windfall' gains would also disproportionately benefit higher earners, who are more likely to invest in riskier assets.[xi] Conversely, under an EET system the additional income these returns generate is subject to some tax as part of a consumer's income. This fails to meet the principle of sustainability.

Cost of different systems

The Pensions Policy Institute has calculated the cost of different possible systems.[xii]

Tax Treatment scenario	Cost of employer contributions	Cost of employee contributions	Total cost to Exchequer
Current system	£21.3bn	£5.90bn	**£27.2bn**
Flat rate @ 20%	£13.0bn	£3.4bn	**£16.4bn**
Flat rate @ 25%	£16.7bn	£4.4bn	**£21.1bn**
Flat rate @ 30%	£20.5bn	£5.5bn	**£26.0bn**
Flat rate @ 33%	£22.9bn	£6.1bn	**£29.0bn**
TEE – no match	£0.0	£0.0	**£0.0**
TEE – 10% match	£5.7bn	£1.5bn	**£7.2bn**
TEE – 20% match	£10.7bn	£2.8bn	**£13.5bn**
TEE – 30% match	£15.3bn	£4.0bn	**£19.3bn**
TEE – 40% match	£19.4bn	£5.1bn	**£24.5bn**
TEE – 50% match	£23.2bn	£6.2bn	**£29.4bn**

Given that under a TEE scenario a match payment of at least 40 per cent is required to generate parity of outcomes in retirement with the current system, there is very little gain for the Exchequer from switching if consumers are to avoid losing out.

A flat tax relief rate of 30% would cost approximately the same as the 43 per cent matching contributions that Age UK estimates would be needed to maintain parity of outcome in retirement for basic rate taxpayers, and we believe would better meet the principles for reform.

Other factors for incentivising saving
Age UK accepts that introducing a flat rate of tax relief is not, even when coupled with good marketing to persuade consumers of its value, a magic bullet for increasing pension saving. Rather, it is one (important) part of a system, which contributes to 'pensions' being viewed as a good investment and good value by individuals. Nonetheless it is a vital reform if individuals are to be incentivised to save more effectively.

Employer buy-in
Ensuring employers' continued engagement and support of pension saving is also important. If employers become disengaged there is a risk they will offer less generous pensions to employees, or communicate the benefits of pension saving less effectively. We believe that employers should continue to receive relief on National Insurance contributions.

Clear communications – a pensions dashboard needed
Regardless of tax relief, a clear statement of pension saving, including State Pension entitlement would help consumers understand, plan – and take personal responsibility – for their retirement income. Age UK is pleased that the Financial Conduct Authority and part of the financial services industry remain committed to developing this. It should help to make pension saving clearer and more engaging for typical consumers, and also enable people to calculate any tax and benefit implications of their decision-making.

The lump sum
This would be lost under a TEE system. Under the current system the lump sum provides an incentive to lock money away for a long period of time, and is a strong incentive to save into a pension for some people, particularly those approaching retirement.[xiii]

3. Would an alternative system allow individuals to take greater personal responsibility for saving an adequate amount for retirement, particularly in the context of the shift to defined contribution pensions?

Moves to change the system must also recognise the tension between savings policy designed to promote saving generally, and one designed to promote savings *for retirement.* The latter is extremely important, and as is well-documented individuals often have less motivation to lock money away for a lengthy period of time.[xiv]

Some proposals have suggested locking away only the government and employer contributions until age 55, while individual contributions would be accessible at any point.[xv] While this might enhance incentives to save generally, unless government and employer contributions are significantly increased, this would be highly unlikely to secure a decent standard of living in retirement – it would do nothing to enhance personal responsibility for *retirement* saving. In fact it may undermine it.

4. Would an alternative system allow individuals to plan better for how they use their savings in retirement?

The current system and a flat rate of tax relief are both more relevant to the accumulation phase and would not, in themselves, make much difference to retirement planning.

A TEE system, however, would create a perverse incentive to withdraw the money at 55 or soon after. As the money would be available tax free, there would be fewer checks and balances on taking it as a lump sum, and less incentive to spread income over several years (for example to minimise income tax payments). This would be likely to particularly affect typically smaller savers without access to good quality advice. For people with substantial assets, it would also create a strong incentive to withdraw the money and pass it on early to family in order to avoid inheritance tax.

We do not believe that the suggested 'bonus' for leaving private savings alone until State Pension age is workable or fair. It runs contrary to the principles behind the Freedom and Choice agenda, and would give a particular advantage to people who can afford not to touch these savings – conversely, it would penalise those who were forced out of work early because of a health condition, caring responsibilities or age discrimination.

Under any system, a 'Pensions Dashboard' would be the most effective way of helping plan their retirement income and expenditure. This should include all sources of income, including State Pension and a benefits calculator, which for many people make up the majority of their income in retirement. We appreciate that this is a challenging agenda and it may take time to incorporate all forms of income, but we believe it is important to start even if only initially for private pension saving.

5. Should the government consider differential treatment for defined benefit and defined contribution pensions? If so, how should each be treated?

Creating a two-tier system where income received from a defined benefit (DB) pension is taxed differently from defined contribution (DC) income would be extremely confusing for individuals and employers and could lead to inequitable treatment.

This would make planning income and spending for people in and approaching retirement extremely difficult – exacerbated when combined with the State Pension, the tax status of which is often misunderstood – and runs contrary to the government's stated principle of 'simplicity'.

6. What administrative barriers exist to reforming the system of pensions tax, particularly in the context of automatic enrolment? How could these best be overcome?

TEE

The greatest administrative barriers would be encountered by switching to a TEE system. As explained earlier in this response, this means that existing pension saving would continue to operate under the current EET system, with future saving under TEE.

This would create a legacy of differentiated retirement income, with different systems that would need to run parallel for at least 50 years.[xvi] It would be fiendishly complicated for consumers to understand, and would make it much more difficult for people to take personal responsibility for their retirement income.

For employers and trustees, this system would be extremely difficult and expensive to administer. We are aware of severe potential problems for DB saving, which could result in schemes being closed, as well as for payroll systems.

Flat rate

As previously stated, Age UK supports the move to a single rate of tax relief. We believe this is in the best interests of lower and middle earners, and – when combined with effective marketing (e.g. 'buy two get one free') – will be the most effective incentive to save and the best way of encouraging people to take personal responsibility.

We do, however, acknowledge that this may again create difficulties for payroll systems, albeit less substantive ones than under a TEE system, and it is likely that employers will bear any adjustment costs. We not think such issues would be insurmountable, but we believe that other employer benefits such as the National Insurance contribution exemption on pension contributions should be safeguarded or there is a risk that employer engagement in pensions will be reduced.

7. How should employer pension contributions be treated under any reform of pensions tax relief?

Age UK believes employer buy-in to pensions is essential in making them a success. As employers are likely to bear much of the cost of implementing changes to payroll systems or DB funding as a result of this consultation, ensuring that employers remain engaged and recognise the benefits of pension saving for their employees is important.

We recommend that relief on employer National Insurance contributions is maintained, or there is a real danger of employers scaling back their pension offer.

8. How can the government make sure that any reform of pensions tax relief is sustainable for the future?

A system of pensions tax relief will only be sustainable if, as well being affordable, it is fair to lower and middle earners, is well understood by consumers, and maintains the support of employers.

Sustainability also requires a long-term commitment by the government. Although it is not possible to guarantee this, the government should endeavour to seek a degree of cross-party political agreement as this agenda develops.

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[i] Age UK calculation based on ONS population projection figures and Hansard 22 Oct 2014 WA (numbers of taxpayers) http://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2014-10-14/210604/

[ii] Polling by YouGov for The Peoples' Pension found 59% of people had heard of tax relief but did not understand what it meant, while 15% had never heard of it. Taken from Professional Pensions, 22 Sept 2015

[iii] Pensions Policy Institute (2013), What level of pension contribution is needed to obtain an adequate retirement income?

[iv] HMRC Statistics Table PEN6 – Registered pension schemes: cost of tax relief – figures taken from Budget 2015

[v] Pensions Policy Institute (2013), Tax relief for pension saving in the UK

[vi] Age UK calculation based on ONS population projection figures and Hansard 22 Oct 2014 WA (numbers of taxpayers) http://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2014-10-14/210604/

[vii] Helson R, Jones C & Kwan VS (2002), Personality change over 40 years of adulthood: hierarchical linear modelling analyses of two longitudinal samples', J of Personality and Social Psychology, taken from ABI/Ideas 42 (2015), Freedom and choice in pensions: a behavioural perspective

[viii] Mirrlees et al (2011), Tax by design, the final report of the Mirrlees Review, Institute for Fiscal Studies. For an overview of the evidence see also Banks J and Diamond P (2010), The base for direct taxation, Institute of Fiscal Studies, http://www.ucl.ac.uk/~uctp39a/Banks%20and%20Diamond.pdf

[ix] The Age UK model assumed that someone started saving £500 a year at age 30 and did so until 64, generating 5%pa investment returns. They then accessed their fund via a 25% lump sum and income drawdown at 8%pa, the average American rate, see Poterba J, Venti S, and Wise D, The Drawdown of Personal Retirement Assets: Husbanding or Squandering? (2013), p26, http://economics.mit.edu/files/6318. The pot remaining after annual drawdown was assumed to generate investment returns of 3% and be subject to a 0.75% charge), paying tax as appropriate when the value of their drawdown combined with the New State Pension (indexed to a 2.5%pa increase) exceeded the income tax personal allowance (increased annually from £11,000 in year 1).

[x] Pensions Policy Institute (forthcoming), Comparison of pension outcomes under EET and TEE tax treatment

[xi] Mirrlees et al (2011), Tax by design, the final report of the Mirrlees Review, Institute for Fiscal Studies.

[xii] Pensions Policy Institute (forthcoming), Comparison of pension outcomes under EET and TEE tax treatment

[xiii] Pensions Policy Institute (2015), Supporting DC members with defaults and choices up to, into, and through retirement

[xiv] For example, Institute for Fiscal Studies (2007), Final Evaluation of the Saving Gateway 2 Pilot: Main Report, http://www.ifs.org.uk/docs/savings_gateway_evaluation_report.pdf

[xv] Michael Johnson, article published in the Financial Times 22 August 2015

[xvi] A 21 year old saver could well still working 50 years later, and therefore have some income to which tax would need to be applied.