CSFI
Centre for the Study of Financial Innovation

To: HM Treasury

Strengthening the incentive to save: a consultation on pensions tax relief (July 2015)

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

   The reforms introduced by the Conservative-Liberal Democrat coalition government 2010-15 have reduced complexity in some important ways:

   1.1 Creating a **single-tier state pension**, at a level above basic means-tested support, provides a **platform for savin**g and removes the disincentive of savings being seen as replacing benefits. Generous state benefits could provide a disincentive to save, so a balance has to be struck between the level of the safety net and reducing dependency on benefits. The single-tier pension should achieve this by lifting people out of basic income support, while remaining at or below both the relative poverty line of 60% of median income and full-time earnings on the national living wage. It could become more generous without providing a disincentive to save, although other benefits – notably housing for those who do not own their own homes – are a complication here. It should at least be high enough to lift people out of pension guarantee credit (c.£165/week) and council tax relief.

   1.2 The complication lies in the NICs-based qualifying criteria for the state pension. A universal benefit would be simpler, but would remove the work-based element and cost more. Short of that, there is plenty of **scope to simplify the NI regime**. Ending contracting out, with abolition of the second state pension, makes a start to this and tackles one of the many disparities in the treatment of defined benefit (DB) and defined contribution (DC) schemes.

   1.3 The ‘triple lock’ is a complicated way to improve the state pension. It would be simpler and more transparent to set out a **target related to either the national living wage or the relative poverty line.**

1.4 **Auto-enrolment** is not as simple as compulsion, but it does **simplify the decision to save** for later life. Leaving the choice of provider to employers makes the exercise simple for employees, and the creation of a default fund – NEST – means there is a simple option for employers. (In an ideal world, individuals would choose the savings vehicle for themselves, from a list approved by The Pensions Regulator. It should be easy for people to do this, but the AE system assumes that most will want the decision to be made for them at this stage.)

1.5 On tax incentives, as the consultation document says, there is a **simple principle at the heart of the current system**: "the contributions you make to a pension during your working life are tax free, and you pay tax on them when you come to take your pension." Higher rate taxpayers seem to understand the incentives well, as evidenced by the widespread use made of them.

1.6 On the different tax treatment of withdrawals compared with contributions: it is not difficult to understand that i**ncome** from whatever source, including the state and private pensions, **will be taxed in the same way** throughout an adult's life. The simplicity of investment gains being tax free should be retained – it is like the exemption from capital gains on a primary residence, which is well understood.

1.7 With long-term saving, which locks money away, **people are concerned that the rules will be changed again** before they draw on their funds. So any change to the principles of the current, relatively new, system would add to complexity and could be a disincentive.

1.8 Changes to the annual and lifetime allowances have complicated the system but only for higher earners. Since the **main target** of pensions policy is to activate long-term saving by the 9m **workers with little or no retirement funds**, who tend to have lower earnings, the reductions will not affect them. **The lifetime cap on fund size is an unnecessary complication** since it is difficult to predict where the amount will end up after investment gains. A lifetime cap on contributions would be more transparent and make it simpler to equalise treatment of DC and DB schemes.

1.9 The main complication in a DC system is that it does not give a defined level of income at a set retirement age. But illustrations can be given (eg the NEST model); and there are misconceptions about the certainty of outcome in DB schemes in a world of changing employment patterns. **The complication that cannot be dealt with is that outcomes will vary.**

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?**

2.1 **Moves to simplify the system have already improved engagement.** The low opt-out rates from auto-enrolment provide some evidence of that. However, with the new AE regime still in its infancy, there is a lack of evidence on what is persuading people to stay in. The "nudge" principle of AE relies on inertia but the deductions from take-home pay are visible – and so should stimulate engagement. So will statements on the size of the pot, showing the relative importance of employee/employer contributions, tax rebates and investment gains. The bigger the pot, the more engaged people will become, especially as they approach the point when they will gain access to it.

2.2 It is a **simple selling point for the AE regime** that for every £1 the employee puts in, others – the employer and the government – put in £1. More broadly, individuals are interested in their total pay package, including benefits such as employer pension contributions.

2.3 It might be **simpler to describe the tax rebate as a government "top-up**", rather than a tax rebate based on the difference between net and gross pay. This would have the advantage of detaching the government's contribution from the individual's tax rate, paving the way for a flat-rate addition (eg plus 25% rather than 'you get the 20% tax back'. But it is a useful benchmark to have the 20% standard rate as the *minimum* that will be returned. For the target group of under-savers, this **sticks with the exempt, exempt, taxed (EET) principle**, which I support.

2.4 Some believe that a flat-rate equivalent to 33% tax relief would encourage engagement through a simple "£1 for £2" slogan. I believe that equalisation at about 30% (actually 29% makes for a simpler message) would be sufficient to **redress the current imbalance between the tax relief for higher and lower rate taxpayers** – and would obviously cost less than 33%. The government's message would still be relatively simple: 'for every £1 you put in, we put in 40p. It could be reduced to 20% – 25p for every £1, as happens now for most people – once the incentive effect had taken hold, or in a later round of government action to rationalise tax breaks.

2.5 More broadly, governments believe that incentives delivered through the tax system work: hence "sin" taxes on alcohol and cigarettes and tax relief on a variety of desirable activities, with saving as a very important one.

2.6 On **engagemen**t, better financial education and guidance from government-backed advice services (MAS and Pension Wise), as well as the marketing of the new regime, will all play a part. Engagement will also rise as pension pots grow.

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?

3.1 Auto-enrolment is about as far as a savings regime based on personal responsibility can go; the next step would be compulsion. If the employer made no contribution and/or there were no government top-up, that would increase individual responsibility but **reduce incentives.** It is welcome that the consultation makes clear that the government wants to build on the early success of AE.

3.2 **Saving for later life needs much more encouragement than short-term saving.** Use of an instant-access savings account, including ISAs, is suitable for short-term needs, such as a "rainy day" or holiday, but for most it is a poor investment vehicle – and that is not how they see it. Long-term saving via DB or DC schemes has both sustained contribution levels and investment at its heart, but this involves deferred consumption, locking money away and an uncertain outcome. Hence, the **need for financial support from employers and the government** to provide sufficient incentives. The "free money" provided by others is easier to explain than the miracle of compound growth rates and it does not rely on trust in the financial services industry.

3.3 **DC schemes represent a shift to individual responsibility**. The savings pots are individual and the freeing up of access to them takes this a step further. Employers are no longer prepared to take responsibility for guaranteeing DB schemes, and collective DC schemes do not guarantee income. So we are left – rightly – with individual responsibility.

3.4 The theme of encouraging people to maintain responsibility for supporting themselves throughout their lives could be taken further by **removing pensioner-specific benefits**. An important way to simplify the system would be to rationalise the 20+ benefits that pensioners are entitled to, keeping only the ones applied to all on a needs basis.

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

4.1 Why not the ISA 'taxed, exempt, exempt' formula, or TEE, for long-term saving? As argued in 3.2, **long-term saving requires incentives,** especially for lower earners for whom affordability is a big issue. Contributions from the employer and the government are essential to achieve adequate input, and the upfront nature of EET maximises the benefits of compound growth rates.
The 8% AE formula is designed to make weekly contributions affordable for individuals, while holding out the prospect of adding a significant supplement (see the NEST illustrations) to the state pension. Planning in a DC scheme comes down to **accumulating as large a pot as possible**.

4.2 As the consultation paper suggests in *pars 1.23 and 1.24*, **contribution levels should be higher**. Taking 5% of employee's (qualifying) salary, a matching employer contribution and a c.30% government top-up (see 2.4), the formula would be **relatively simple: 5+5+2 = 12%**. This is in line with the Pensions Policy Institute models for low-mid earners to have a good chance of achieving two thirds of late-career salary (*What level of pension contribution is needed to obtain an adequate retirement income?* October 2013).

4.3 Some believe that collective DC schemes, or "defined ambition", are an economic way to mitigate the risk of uncertain outcomes by pooling savings and having a common goal. I agree with the point made in a parliamentary briefing in September 2014, that the better outcome for CDC compared with DC is "primarily driven by **lower costs and remaining for longer in risk-seeking assets**". Both have been tackled by the recent reforms, although the importance of the latter needs to be emphasised as individuals take responsibility for turning their pension pots into income.

4.4 The **disadvantages of CDC are related to reduced individual responsibility**. It would be good to have these schemes as an option, but those entering them must understand that the target income is not guaranteed; contributions can be increased; benefits can be decreased; fairness between generations is difficult to achieve; you cannot cash out at 55; and you give up the right to pass on unused pots to heirs. None of this seems in tune with the direction of travel in the UK.

4.5 The ability to take 25% of the savings pot as a **tax-free lump sums is a simple and popular idea**, but it costs about £4bn and is not strictly in line with the EET principle. Phasing it out would preserve more funds to provide later-life income. However, the flexibility to use the lump sum to pay off debt eg the mortgage is currently an important incentive. The **cost could, however, be halved** by capping the amount that can be withdrawn tax-free. The Pensions Policy Institute, in *Tax relief for saving in the UK* (July 2013), found that limiting the lump sum to £36,000 would halve the cost and would not affect most people.

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

5.1 The short answer is **no. As far as possible the treatment of DB and DC saving should be equalised**. The end of contracting out is a step towards this. Further rationalisation of employer exemptions from NIC contributions (see 7.2 and 8.2) would also apply across the board.

5.2 Annual and lifetime allowances should also be equalised since the present multiples applied to DB contributions produce a more generous limit than that imposed on DC savers.

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?

6.1 This is more an issue for employers and the providers of pension vehicles, who tend to say that all system changes are very difficult. This becomes **increasingly less convincing as the technology advances** for handling individual accounts and automating transactions. If cost is a genuine barrier, the government could consider providing a tax-break, or other support, for the necessary investment – perhaps along the lines of the R&D tax credit.

6.2 It should be recognised that **the advantages of DC for employers are considerable** compared with DB. They have to collect contributions – as they already do for income tax, NICs and even court-imposed fines – and make a contribution of their own. There is no obligation to stand behind a pension promise and the accounting is far simpler.

6.3 In the current AE system they are responsible for choosing the savings vehicle. **A simple option is to default to NEST**, but other providers aimed specifically at this market (Now: Pensions and The People's Pension) and the big insurers already providing group pensions provide a choice. The consolidation trend mentioned in *par 1.28* may well have further to go to produce economies of scale.

6.4 As individuals become used to saving into pension pots, more of them will **make their own choice**, as they do with car and house insurance (see 1.4). It is important that is made easy for individuals to do this, while providing some regulatory protection through an approved list of providers.

6.5 A crucial element in this is the ability for individuals to see all their savings in one place. The technology exists to provide **"pensions dashboards**", as mentioned in *par 1.26,* but it relies on the input of data about pension pots. As well as collecting **standardised data** from providers, the **Pensions Tracing Service** should actively provide information on legacy schemes, rather than just trying to put customers in touch with the provider.

6.6 As well as ease of access to information, **transfers should be made easier.** Individuals should be able to rationalise their savings pots. The "pot follows member" policy is not ambitious enough on this front. The arguments against a central database are not convincing; all pots should be eligible, not just those started since 2012; and there should be no limit on the size of pot that can be transferred. Michael Johnson, *Aggregation is the Key* (September 2013), is right on this.

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

7.1 The **EET principle** should continue to apply to employer contributions so that they are paid as a tax-allowable expense.

7.2 However, the **exemption from NI contributions looks too generous** at a cost of £14bn (see 8.2). Once the exercise of ending contracting out, which raises NI contributions for employers with DB schemes, is completed, the exemption should be phased out for all employer pension contributions. This can be linked to the effort to improve the basic state pension.

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

8.1 The consultation says *(par 2.7)* that the gross cost of tax relief was nearly £50bn in 2013-14. With the government still running a deficit, the need to make savings is clear. It is welcome that **£6bn is already set to be cut** by reducing allowances. A **further cut in the annual allowance to £30,000** was mooted before the general election. Since this is higher than median annual pay, it would be a justifiable further cut.
It would be useful to see the comparative costing for replacing the lifetime cap of £1m on fund size with a lifetime contributions cap at levels of £300,000 and £500,000, and at a revenue-neutral level.

8.2 It would have been helpful if the consultation had provided a full breakdown of costs. What follows uses this list of potential savings:

NICs on employers' contributions	£14bn
Equalising income tax relief @ 20%	£13bn-£16bn
Equalising income tax relief @ 30%	£1bn
Tax-free lump sum	£4bn

As mentioned in 5.1 and 7.2, I believe there is a strong **case for phasing out the employers' exemption from NI** on pension contributions.
To create a **fairer system of tax-based incentives** for pension saving, the current advantage enjoyed by higher-rate taxpayers should be removed via a flat-rate government contribution. At about 30% this may save £1bn. If cost saving has priority, rather than tax incentives to save, the relief could be left at 20% for standard rate taxpayers and taken down to that level for the rest.
As mentioned in 4.5, the **tax-free lump sum should at least be capped** at a level that would save £2bn.

8.3 **Savings can also be made on pensioner-specific benefits**. As the state pension rises, with the aim of reducing dependency on benefits, the winter fuel allowance, free bus passes and TV licences (now a burden on the BBC) could be phased out, saving £3bn. And the pension/guarantee credits that are now available should wither away, saving £6.5bn.

8.4 Adding the savings in 8.3 to those in 8.1 (ex-potential further cuts in allowances) and the minimum in 8.2 produces **total savings of around £32.5bn**, which are substantial compared with a £50bn cost.
8.5 In addition, as the consultation mentions in *par 2.4,* £13.1bn was raised by **tax on pension payments** in 2013-14. With about 1m people over 65 still in work and that number set to rise, the broader outlook for taxation income from that age group is positive. This suggests **a move to TEE would not be fiscally sound** in the long term.

Conclusion
The existing pension regime, as reformed in 2010-15, has established the right principles: a rising state pension age; a flat-rate state pension above the basic means test; auto-enrolment into long-term savings schemes; an EET system of tax incentives; flexible access to funds. This entails a shift towards individuals taking responsibility for their later years, just as they do for the rest of their adult lives. Government policy is righty focused on helping people to help themselves.

The framework is already relatively simple in principle, but there is scope to simplify it further in practice, to make the incentives fairer and more transparent, and to rationalise both tax breaks and pensioner benefits. The last two can produce sufficient savings to make the system fiscally sustainable.

Policy and rule changes to establish the new system, while justifiable, have created anxiety that the goalposts will be moved again. This consultation, while tackling important issues, has increased that anxiety. If it results in a shift of principle, or in changes that reduce incentives for the mass of workers to save, it will exacerbate doubts about the predictability of government policy. In the context of long-term saving and planning for later life, this would risk being counter-productive.