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PROFESSIONAL PENSIONS

Changing tack on pension tax relief would be a disincentive to save

- By: Jane Fuller
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Jane Fuller says flipping tax relief would undermine the pension system, not reinforce it.

The title of the review of pensions tax relief, launched by the UK's Conservative government, is Strengthening the incentive to save. This exercise threatens to do the opposite.

The UK is only a few years into a set of reforms that will take decades to bear fruit, as up to nine million workers with little or no pension savings join work-based schemes. The government's habit of changing course on pensions has itself been a disincentive to long-term saving. Why contemplate another change at this stage?

In the consultation document published alongside the July 8 Budget, evidence is cited that some pension savers are either "unaware or not motivated by the tax benefits associated with paying into a pension". The evidence dates back to 2013, when the new system of work-based pension saving had barely started. It will take until 2018 for all workplaces to be covered by the new auto-enrolment (AE) system and for contributions to reach 8% of pay.

The post-2013 system is designed to enable a worker, even on below-average pay, to amass a six-figure sum over 40-50 years. The pension pot grows through tax-exempt contributions and tax-exempt investment gains; withdrawals are taxed. The short-hand is EET, as opposed to TEE which is how ISAs work - and which is suggested as a possible change of direction for pension saving in the government consultation.

While investment gains and fund management charges are sexy subjects, a key factor is the level of contributions. For every £4 saved by an employee on the standard tax rate of 20%, the employer will put in £3, and the government £1 - adding a quarter to the individual's contribution. The TEE alternative, with employees contributing out of taxed income, means the government would keep the £1 now - but lose tax revenue on withdrawals later.

Indeed, there is a revenue-neutral case for the government to equalise tax relief at about 30%. This would add more than 40% to the contributions of most employees, while removing the inequitable advantage now bestowed on higher-rate taxpayers. Tax incentives have worked - arguably too well - further up the salary scale. Why not give them a chance of doing so for the less well off?

It should also not be too difficult to explain to novice long-term investors that the bigger the contributions and the longer they accumulate, the larger the final pot will be. After all, a fundamental driver of Conservative policy is that people should take responsibility for providing for their old age, which means treating them like grown-ups.

An important theme is simplicity. ISAs work well on this level, but an important reason for their success is accessibility and they tend to be used for short-term goals. Long-term saving is different: money is tied up, which is a big ask for people without much to spare. It needs additional incentives, and forcing employers to contribute more when they are already being encouraged to increase accessible wages would be counter-productive.

Turning to disincentives to save for old age, the 2010-15 Coalition government removed several. The new state pension will be set above the basic level of means-tested support, suggesting it will start at about £155 a week next year. This will provide a platform for individual pension saving by both men and women.

Liberalisation of access to these funds in later life removes another deterrent: the effective requirement to buy an annuity on "retirement", itself an outmoded concept. Allowing people to pass on residual amounts to heirs also treats it as their money.

Where does fiscal sustainability come into this? After all, a review of tax relief conducted by a government running a deficit is bound to consider savings. These can be found without destroying the principles of the reformed pension system.

To preserve tax incentives for most workers, while limiting rebates for the better-off, the annual contribution allowance could be reduced from £40,000 to £30,000. Following the EET principle, the tax-free element of withdrawals from the fund could be scrapped, saving £4bn. Meanwhile, employers will already be aware that the tax shelter, worth about £14bn, on National Insurance contributions on payments into pension funds is at risk.

Pensioners are entitled to more than 20 benefits, which cries out for rationalisation. With a more generous state pension, private savings and more older people remaining in work, the pension credit should wither away; so does the case for "pensioner perks" such as the winter fuel allowance and free TV licences (whoever provides them) and bus passes.

Potential savings could amount to more than £40bn, without sacrificing tax incentives that encourage individuals to save for the long-term.

Jane Fuller is co-director of the Centre for the Study of Financial Innovation, PIC pensions fellow and author of The Death of Retirement

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