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Pensions costs, benefits and tax incentives

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This summary of pension costs and pensioner benefits discusses the UK government's reaction to the challenges posed by both an under-saving workforce and an ageing population. It is a follow-up to submissions to HM Treasury's consultation: *Strengthening the incentive to save: a consultation on pensions tax relief* (see http://www.csfi.org/pensions).

This paper takes in tax relief for retirement saving and makes some other points about the state pension and other pensioner-specific benefits. It contends that:

- the government has considerable scope to rationalise both tax breaks and benefit payments, saving at least half the combined cost of income tax and NI tax relief (potential savings are in bold type);
- it can do this while enhancing the incentive to save for the vast majority of workers by switching to a flat rate of tax relief above the standard rate;
- It does not need to abandon the EET principle altogether (contributions and investment gains tax exempt and income on withdrawal taxed) to achieve both savings and an enhanced incentive.

The EET tax regime is already limited by various allowances: the question now is how best to employ public funds available for the saving incentive. While a focus on tax relief is not surprising in the run-up to the 2016 Budget, the debate should be seen in the wider context of the government's response to increased longevity, including state pension reforms that aim to lift pensioners off other benefits.

In the background are complaints from some politicians and other commentators about public policy favouring older people. A subsidiary aim of this paper is to act as an antidote to that.

Tax relief

Income tax

The debate following HM Treasury's publication of *Strengthening the incentive to save: a consultation on pensions tax relief* has taken place during a period of nervousness about the UK's budget deficit. Yet it is important not to lose sight of the 9m workers who have been saving little or nothing for later life. These are the targets of the new auto-enrolment regime, which nudges them into work-based schemes into which 8% of their qualifying salary will (by 2019) be saved. Overall, the vast majority of the UK's 31m-strong workforce receives far less tax relief for pension saving, both individually and as a group, than the one in six earners who are in higher tax bands.

Fortunately, the government can both cut the overall level of tax relief and provide a greater incentive to save for most workers. This can be done without reversing the EET principle that pension contributions and investment gains are tax exempt, while the income withdrawn in later life is taxed.

According to HMRC's PEN 6 table, income tax relief amounted to £34.3bn in 2013-14, while pensioners paid £13.1bn in tax. So the net cost alluded to in the Treasury consultation paper is £21.1bn. How can this be reduced?

1. The paper refers to reductions in the lifetime and annual allowances that are "projected to save around **£6 billion per year**". A further cut in the annual allowance could be made to £30,000 – it would be helpful to see potential savings on that. While the cap on the lifetime fund size will yield substantial tax revenue, it is difficult for individuals to predict where they will end up after investment gains. A lifetime contributions cap would be simpler.

2. A flat rate of tax relief would target the incentive at those earning less than about £42,000pa, where the higher tax rate kicks in. According to the Pensions Policy Institute, in a report published in October 2015 (*Comparison of pension outcomes under EET and TEE tax treatment*), "the break-even rate of flat-rate tax relief is between 30% and 33%" based on year one costs.

At 30%, the PPI estimates that £1.2bn could be saved compared with the current system; at 25%, about £6bn; and if all were equalised at the standard rate of 20%, nearly £11bn – other estimates have been around £9bn. There is a question about how much would be offset by increased tax relief as auto-enrolment reaches more workers and contribution rates increase.

If redistribution is the priority, then 28-30% would be the best rate to go for, **saving perhaps £2bn**. I favour this because of the importance of upfront contributions to the eventual outcome. It would be better to curb the overall cost by reducing the annual contribution cap further. (My goal for contributions would be 12% of salary made up as follows: 5% (post-tax) from employees; 2% tax relief; and 5% (exempt from income tax but not NICs – see below) from employers.

If cutting the cost of tax relief is the priority, then 20% can be justified – but would disappoint expectations that an additional incentive will be given. A 25% flat rate would tilt the balance of priorities towards raising the tax take.

3. The tax-free lump sum on withdrawal of savings has been estimated to cost £4bn a year. Under a strict EET principle, it would be phased out altogether. But it is popular and so provides an incentive. According to the PPI (*Tax relief for pension saving in the UK*), this amount could be halved by capping the tax-free sum at a level that would only affect the top 25% of pension pots. Calculations for the 2013 report showed a cap of £36,000 saving **£2bn.**

Adding the above together, the £21.1bn net cost of income tax relief could be nearly halved. Assume rising tax revenues from pensioners, who are staying in work in larger numbers, and a cut in the annual allowance to £30,000 and it could be more than halved.

National Insurance

The scope for increasing tax revenues from this source is considerable. This is partly because of measures already in place and partly because it does not align with the EET principle. Pensioners do not pay NI so, for the individual (beyond NICs linked to the state pension and other benefits), it looks like EEE. The following have a bearing on NI revenues:

1. According to the fiscal supplementary tables (November 2015), revenue from NICs is set to jump from £114.6bn in 2015-16 to £127bn in 2016-17. Over the life of this parliament the normal addition to each year's NI tax take is forecast at about £6bn-£7bn. The main reason for the jump is the end of contracting out by defined benefit schemes (substituting the occupational scheme for part of state pension entitlements). In the 2013 Budget, this change was forecast to increase revenue from NICs by **£5.5bn.** This is not part of the current consultation but, in the wider context of reducing tax breaks for pension schemes, it is a significant amount.

2. The PEN 6 table shows the cost of National Insurance relief on employer contributions as £14bn in 2013-14. This not only covers relief for employers on the pension contributions they make, but also the saving for individuals because the employers' contributions are not treated as part of their gross income. Removing the exemption on the employers' side alone would save **about £10bn**, according to the Institute for Fiscal Studies. The case for this is strong, but the timing would be sensitive for employers with DB schemes because of the increase in NICs already looming from the end of contracting out. Public sector employers are particularly affected by this. This suggests that any further move to increase employer NICs would need to be phased in.

3. NICs help fund the state pension, which is being raised at a time when benefits for those of working age have been capped or cut. So the case for extending its reach can be made in this context. A further potential step would be to charge NICs on pensioners' income. Carl Emmerson at the IFS (*Green Budget 2014)* has suggested that this could be introduced at a very low rate. A previous IFS paper had calculated that each percentage point charged

would **raise £350m**. Another way to justify this would be to link it to implementing the Dilnot reforms to care costs, following the postponement of the Care Act, or to the cost of an ageing population to the NHS.

The cost of pensioner benefits

DWP: expenditure directed at pensioners, summer budget 2015
(selected numbers)

2015-16		Forecast 2020-21
State pension	£89.7bn	105.3bn
Pension credit	6.15bn	5.40
Housing benefit	6.39	5.00
Attendance allowance	5.49	6.11
Disability living all'ce	4.84	2.79
Winter fuel, TV	2.71	1.98
…		
Total	116.7bn	129.2

1. As the state pension becomes more generous, pensioners are lifted off other benefits, **saving about £3bn** a year by 2020-21. Further falls in pension credit might be expected. The case for the winter fuel allowance (**cost £2bn**) and free TV licences (already tackled by switching responsibility to the BBC **saving c. £700m**) also withers away.

2. The transition to the new single-tier state pension regime is inevitably expensive and this should be better explained. The risk is that it is seen as part of a permanent increase in public spending on pensioners rather than as revenue neutral (or even positive) long-term:

- The single-tier pension is higher than the old basic pension and applies equally to men and women. This is fair: the UK state pension, which was among the meanest in the developed world, is being increased by the triple lock. This ratchet should be abandoned once the state pension reaches a target level for income replacement eg 60-66% of the National Living Wage, to which it would then be linked. This would reduce long-term projected costs.
- Legacy costs of higher S2P payments will start to fall, from a peak of more than £18bn) during this parliament.
- Raising the state pension age (SPA) for women and then for all by 2020 limits the number of people above SPA to just over 12m between now and 2020. The saving was forecast to be **about £5bn** in 2020-21, including additional income tax and NI receipts (Pensions Act 2011, Impacts – Annex A).
- Beyond the transition, the new regime is designed to be revenue neutral or even to cost less from about 2040.

3. According to the ONS, the number of people above the SPA is forecast to rise to more than 13m by 2025, nearly 14m by 2030 (SPA to 67 in 2028) and to 16.6m by 2040 (SPA to 68 in mid-2030s). The best way to tackle this is by accelerating the rise in the state pension age. There is already an explicit target of 70, but it is only pencilled in for the 2060s. The 2006 Pensions White

Paper estimated that the one-year increase from 65 to 66 for men and women would save 0.3% of national income – about £5bn (see above). With a rising number of pensioners offsetting the shorter period in receipt of a state pension, a £5bn saving should be repeatable and would mitigate the problem of ageing baby boomers over the next three decades. Transparency on potential savings would be welcome.

The CSFI report *The Death of Retirement (2015)* advocated abandoning the policy principle that people should spend a third of their adult life receiving a state pension. Instead, the review of the SPA due to take place in this parliament should set out an accelerated plan to raise the age to 70. Coupled with abandoning the triple lock once the state pension equals 60-66% of the National Living Wage, this would boost long-term fiscal sustainability.

4. Compared with other developed nations, the UK is economical in its pensions spending. According to the OECD, "On average pension expenditure is forecast to grow from around 9.0% of gross domestic product (GDP) in 2010-15 to 10.1% of GDP in 2050". The UK is projected to peak at 8.4% in 2040. This is not a bad prognosis.

Other considerations

Inheritance Tax

Inheritance tax is mostly levied on pensioners' wealth. The additional transferable nil-rate band of up to £175,000 that will be available for bequests of a couple's home to children is forecast to cost £940m by 2020-21.Even with this additional allowance, IHT receipts are forecast to rise from £4.4bn in 2015-16 to £5.8bn 2020-21, an **additional £1.4bn**. In any case, the cost is more than covered by the introduction of a tax-relief taper to the annual allowance for those with total income over £150,000.

Pensioners pay tax

The number of people working beyond the SPA has been rising, helped by the abolition of a compulsory retirement age. It is now well over 1m people. This suggests that the 2013-14 figure of £13.1bn for the amount of tax they pay will have continued to rise. The same is true of the broader cohort of pensioners. According to HMRC's Survey of Personal Incomes, the number of taxpayers aged 65 and over has risen from 4.91m in 2010-11 to an estimated 5.75m in 2015-16.

Contributions to DB schemes

HM Treasury's consultation points out (2.5): "This rising cost of pensions tax relief in recent years has been driven by a number of factors. Most notably, contributions to pensions by employers have increased, partly due to the need to finance deficits in defined benefit schemes."

DB pension scheme deficits remain high. According to the February 2016 update from the Pension Protection Fund, in its PPF 7800 Index, the aggregate deficit in nearly 6,000 schemes was £304.9bn at the end of

January 2016, up from £222.4 billion at the end of December 2015. The funding ratio worsened from 84.9 per cent to 80.5 per cent. Even without help from (higher) market prices for assets and (higher) discount rates for liabilities, the tide of DB scheme closures to both new entrants and future accruals will eventually curb this source of tax relief, as will the general reductions in annual and life-time allowances.

The Care Act

The government has postponed implementation of the Care Act to 2020-21, **saving £6bn over five years**. This would have capped lifetime care costs borne by the individual and protected more of their savings, including the value of their home. Instead local authorities are allowed to add 2% to council tax bills to help pay for social care. By 2019-20, this could **shift £1.5bn** of spending from central government to the local level.

Conclusion

The government has many options for reducing tax relief on pensions saving, several of which are already in hand. It can also rationalise pensioner benefits by raising the state pension age and reducing other credits and allowances – some of which will fall automatically as the single-tier state pension lifts more people off benefits.

The structural problem of retiring baby boomers will also recede from about 2040. So will the transitional costs of raising the basic state pension while phasing out legacy entitlements to a higher second state pension.

Current tax incentives to save for later life have worked well for the better-off but not so well for the cohort of low-to-moderate earners who are under-saving. Keeping the EET regime and using a flat rate of tax relief that is more generous to the vast majority of the workforce will add to their incentives.

The system of allowances is designed to help everyone accumulate a private pension fund to top up the state pension. Even high earners will continue to take advantage of this up to the limits, just as they use the annual ISA limit in another part of their savings portfolio.

It is not the duty of the state to help everyone to keep themselves in old age in the manner to which they were accustomed when working full-time. The aim, as ever, in public policy is to provide a safety net that is fair to most citizens and affordable – in the form of public spending – to all taxpayers.