Pointmaker

RETIREMENT SAVING INCENTIVES

THE END OF TAX RELIEF AND A NEW BEGINNING

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SUMMARY

- This paper proposes the scrapping of all income tax relief on pension contributions, replacing it with a simpler incentive.
- The recent Budget annuity reforms highlight the need to scrutinise the purpose and effectiveness of today's pension-saving incentives, traditionally provided to compensate for pension products' inflexibility.
- Today's tax-based incentives for pension saving are expensive, totalling over £54 billion in 2012-13, primarily in the form of income tax relief (£28 billion) and NICs relief (£15 billion, predominately paid to employers). They are inequitably distributed (the top 1% of earners receive 30% of all tax relief) and have failed to stimulate a broad-based retirement savings culture.
- This tax relief makes the Treasury the fund management industry's largest client. Since 2002, it has injected, through people's pension pots, £270 billion, on which charges and fees are levied.
- International evidence shows that default policies are far more effective for broadening retirement savings across those who are least prepared for retirement, i.e. lower-income workers, in particular.
- The reforms proposed here aim to improve boost the efficacy of the Treasury spend; to achieve a much broader distribution of retirement savings; and to increase the size of the nation's pool of savings.
- Eight proposals for reform are summarised overleaf. They include:
  - replacing today's complex framework of retirement saving with a Treasury contribution of 50p for every £1 saved for retirement, paid irrespective of the saver's taxpaying status;
  - combining annual ISA contributions and pensions allowances to £30,000; and,
  - allowing people to bequeath unused pension pot assets to third parties' pensions pots, free of Inheritance Tax (perhaps limited to £100,000).

EIGHT PROPOSALS

Proposal 1: Pension contributions from employers should be treated as part of employees' gross income, and taxed as such.

Proposal 2: Tax relief on pension contributions should be replaced by a Treasury contribution of 50p per £1 saved, up to an annual allowance, paid irrespective of the saver's taxpaying status.

Proposal 3: ISA and pension products should share an annual combined contribution limit of £30,000, available for saving within ISA or pension products (or any combination thereof). This would replace the current ISA and pensions tax-advantaged allowances.

Proposal 4: The 25% tax-free lump sum should be scrapped, with accrued rights to it protected.

Proposal 5: The Lifetime Allowance should be scrapped. It adds considerably complexity to the pensions landscape, and with a £30,000 combined contributions limit for pensions and ISAs, it would become less relevant over time.

Proposal 6: The 10p tax rebate on pension assets' dividend income should be reinstated.

Proposal 7: People should be able to bequeath unused pension pot assets to third parties free of Inheritance Tax (perhaps limited to £100,000), provided that the assets remained within a pensions framework.

Proposal 8: The annual allowance should be set at £8,000, with prior years' unutilised allowances being permitted to be rolled up, perhaps over as much as ten years, all subject to modelling confirmation.

A note about data

Most data quoted herein pertains to 2012-13, but where there are gaps, 2011-12 data is used (none of which would change any of the proposals). All data is from official sources, unless otherwise stated.

1. INTRODUCTION

In 2012-13, the Treasury "invested" £54 billion to incentivise people to save for retirement, through a combination of cash payments and foregone taxes.[1] This is more than the *combined* budgets for Scotland (£28.3 billion), Wales (£14.6 billion) and Northern Ireland (£10.4 billion), or Defence (£34.3 billion), Transport (£12.1 billion) and the Home Office (£11.6 billion), or Business, Innovation and Skills (£16.7 billion) plus seven other significant government departments.[2]

Few people believe that today's incentives framework for retirement saving is an effective use of taxpayers' funds. The pensions and savings industry's ("the industry") fierce defence of the *status quo* suggests that it knows that it is a primary beneficiary of the Treasury's largesse.

In January 2014, the Chancellor announced that after the next election, a further £25 billion must be cut from state spending in order to help eliminate the deficit. This, plus the public's disenchantment with pensions, its widespread distrust of the industry, and the latter's poor performance, demands a fundamental reappraisal of the purpose and effectiveness of the vast cost of incentivising retirement saving.

2. RETIREMENT SAVINGS TODAY

2.1 Contributions

Estimates vary for the annual contributions to funded private pensions, not least because some of the data is patchy: perhaps a total of £103 billion in 2011-12. What is clear is that most of this came from employers: roughly £74 billion.[3] That year, employees and the self-employed contributed £8.7 billion to personal and stakeholder pensions (down 13% to £7.7 billion in 2012-13), but this figure is flattered by the inclusion of basic rate tax relief.[4] An additional £14.4 billion went into funded occupational schemes[5] and perhaps £6 billion into Self-Invested Personal Pensions (SIPP) and Small Self-Administered Schemes (SSAS), which are excluded from official data.

The total value of assets held in UK occupational pension schemes and personal pensions is over £2.1 trillion (roughly 135% of GDP), including an estimated £100 billion in SIPPs, with far less in SSASs.[6]

2.2 The cost of tax-based incentives

(a) Huge, and under-reported

Today, tax relief is paid at the saver's marginal rate of income tax, up to 45% for additional rate taxpayers, limited to annual contributions of £40,000. Table 1 shows the reported cost to the Treasury of incentivising people to save for retirement.

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[1] HMRC; Table PEN 6: Cost of Registered Pension Scheme Tax Relief, February 2014.

[2] HM Treasury; Public Expenditure Statistical Analyses 2013, July 2013, Table 1.10, Total Departmental Expenditure Limits, outturns for 2012-13.

[3] Employer contributions to occupational schemes: self-administered (£44.9 billion, Pension Trends Ch9 Figure 9.6), plus those into insurance company, notionally funded, unfunded and personal pension schemes. As communicated to the author by HMRC, 6 February 2014.

[4] HMRC; Table PEN 1, February 2014. Data includes FSAVCs and Retirement Annuity Contracts.

[5] ONS; Survey of Personal Incomes, Table 3.8, Deductions and reliefs 2011-12, January 2014.

[6] Citywire, 14 August 2013.

The total of £54 billion is an *under*-estimate of the full cost of retirement saving incentives. It excludes capital gains realised within pensions pots, which are tax-exempt: the Treasury does not publish an estimate for the resulting loss of income because of "estimation difficulties". In addition, it is unclear whether the official data captures the full cost of tax relief associated with SIPPs and SSASs: the HMRC and ONS data tables do not refer to them explicitly.

Looking ahead, auto-enrolment will continue to increase the number of savers claiming tax relief, but this additional cost is offset by the cut in the top rate of income tax (from 50p to 45p, from April 2013) and lower annual and lifetime allowances (reduced from £50,000 to £40,000, and £1.5 million to £1.25 million, respectively, from April 2014). The Treasury has estimated a net saving of £0.7 billion in income tax relief over the two years to 2013-14, although this will increase over time. For example, lower allowances are expected to save £1.1 billion in 2017-18.[7]

A previous paper looked at the cost of incentivising retirement saving in the first decade of the 21st century, a total of £359 billion being provided through income tax relief and National Insurance contributions (NICs) relief related to employer contributions.[8] This was funded through gilts issuance at a real cost of 3.9% per annum. Over the same period, the average annual real return on all UK pension funds was only 2.9%, making for a cumulative loss to the Treasury of £17.5 billion.[9] This is explained by two principal factors: weak markets over the decade, and excessive industry charges.

(b) The opaque cost of salary sacrifice schemes

Salary sacrifice schemes take advantage of a tax arbitrage at the Treasury's expense: pension contributions from employers attract neither employer, nor employee, NICs. The prospect of a £100 pension contribution, rather than £77.32 in salary (before income tax), is obviously appealing to many employees.[10] The schemes' cost to the Treasury is not clearly, nor fully, reported: part of

7 HM Treasury; Autumn Statement 2012 Table 2.1.

8 Put the saver first: catalysing a savings culture, p106; Michael Johnson, CPS, 2012.

9 Calculated as £359 bn/2 (to establish the average over the decade) x 1% (the real cost of gilts issuance less average real pension fund returns).

10 £100 of salary-related expenditure comprises gross salary of £87.87p plus employer NICs of 13.8%. The employee then pays 12% NICs on £87.87p, leaving him with £77.32p.

Table 1: The reported cost of retirement saving tax incentives, 2012-13

	Cost, £ billion	
Up-front tax relief on employer contributions	£21.3	Cash
Up-front tax relief on employee contributions	£6.7	Cash
Tax-exempt 25% lump sum at retirement (approx.)	£4.0	Tax foregone
NICs relief	£15.2	Tax foregone
Untaxed pension products' income	£6.9	Tax foregone
Total	**£54.1**	

Source: HMRC; Table PEN 6: Cost of Registered Pension Scheme Tax Relief, February 2014. Note that NICs relief is a combination of NICs relief in respect of employers' contributions (cost c.£10 billion) and the saving for individuals from the employers contributions not being treated as part of their gross income, and thus not subject to employee NICs (cost c.£5 billion).

it is subsumed within the £15 billion reported cost of NICs relief on employer contributions, as £4.8 billion relating to foregone employee NICs.[11] But there is an additional cost, because lower gross incomes means that less income tax is paid. Any estimate for this is unreported. In the interests of transparency, employer contributions to pensions should be treated as part of gross income, and taxed as such.

Proposal 1: Pension contributions from employers should be treated as part of employees' gross income, and taxed as such.

[11] From HMRC; Table 1-5, Estimated costs of tax expenditure and structural reliefs, which provides the cost of employer NI contributions relief, but not that of employees' NIC relief. The latter was confirmed by HMRC to the author as £4.8 billion for 2011-12 (and 2012-13 will be similar).

A more dramatic approach to achieving the same end (complete cost transparency in respect of incentivising retirement saving) would be to consolidate income tax and NICs into a single tax on income, a move that many people feel is long overdue.

2.3 Incentives; inequitable distribution

(a) Tax relief on contributions

Income tax is progressive, so tax relief is regressive, as Tables 2, 3 and 4 clearly illustrate.

Table 3 considers the whole population of UK taxpayers, not just the 35% who claimed tax relief in 2011-12. The proportion of taxpayers claiming tax relief rises with income, unsurprising given that low earners have little, if any, disposable income to save. The impact of the Lifetime Allowance partly explains the flattening off in the participation rate for additional rate taxpayers (those earning more than £150,000).

Table 2: 2011-12 tax relief: distribution by income

Income	Total tax relief £ billion	% of total tax relief	# recipients of tax relief	Average tax relief per recipient, £
Up to £15,000	£1.0	3.4%	1,604,000	£604
£15,001 to £20,000	£1.3	4.7%	1,440,000	£916
£20,001 to £30,000	£3.5	12.6%	2,620,000	£1,352
£30,001 to £50,000	£7.2	25.6%	3,110,000	£2,311
£50,001 to £150,000	£8.8	31.4%	1,676,000	£5,265
Above £150,000	£6.3	22.3%	186,000	£33,785
Total	**£28.1**	**100%**	**10,636,000**	

Table 3: 2011-12 tax relief: distribution amongst all taxpayers

Income	# taxpaying individuals	Average tax relief per taxpayer, £	% of taxpayers claiming relief
Up to £15,000	9,539,000	£102	17%
£15,001 to £20,000	5,530,000	£238	26%
£20,001 to £30,000	7,000,000	£506	37%
£30,001 to £50,000	5,850,000	£1,229	53%
£50,001 to £150,000	2,540,000	£3,474	66%
Above £150,000	295,000	£21,302	63%
Total	**30,754,000**		

Sources: HMRC; Personal Incomes Statistics 2011-12, Table 3.8, Deductions and reliefs and Table 3.3, Distribution of total income before and after tax, January 2014

Analysis of HMRC's data prompts a number of observations, summarised in Table 4, not least that the top 1% of earners receive 30% of all tax relief (costing £8.8 billion), more than *double* the total amount paid to half of the whole working population.

Frustratingly, the official data does not cleanly show the allocation of tax relief by income tax threshold, but one estimate is shown in Table 5.

This is broadly consistent with the earlier tables, which all illustrate, in different ways, just how inequitably tax relief is distributed.

(b) The 25% tax-free lump sum

As with tax relief on contributions, the tax-free lump sum is hugely regressive. Some 77% of individuals receive a tax-free lump sum of under £40,000, yet they benefit from only 24% of the total lump sum tax relief. Conversely, 2% of lump sums are worth £150,000 or more, yet they attract 32% of all lump sum tax relief.

3. A HUGE SUBSIDY FOR THE INDUSTRY

3.1 Tax incentives: eroded by charges

Much has been written about the UK's inefficient, under-performing pensions industry, some of which is dysfunctional, and almost of all of which is distrusted. It appears to have long forgotten that its customers provide the scarce resource upon which it relies: their savings capital. Excessive costs, including high levels of remuneration (particularly within fund management), and overly-long chains of agents, only fuel public opprobrium. Little, however, has been said about what actually happens to the Treasury's vast retirement saving subsidy. Where does it actually go to?

Consider a single contribution of £100 net, paid into a higher rate taxpayer's personal pension pot (such as a SIPP, SSAS or stakeholder product). This is grossed up to £166.67p by 40% tax relief.

Table 4: Income distribution and tax relief[1]

Income distribution	% of all contributions	% of total tax relief	Corresponding annual income (approx.)
Bottom half	16%	14%	less than £24,000
Next 40%	35%	32%	£24,001 to £51,000
Top 10%	49%	54%	Over £51,000
	100%	***100%***	
Top 1%	15%	30%	Over £100,000
Top 0.5%	10%	22%	Over £150,000

Sources: HMRC; Personal Incomes Statistics 2011-12, Table 3.8, Deductions and reliefs and Table 3.3, Distribution of total income before and after tax, January 2014.

Table 5:Tax relief as income tax threshold

Taxpayer theshold	Proportion of taxpayers	Contributions	Share of tax relief
Basic rate (20%)	87%	50%	25%
Higher rate (40%)	12%	40%	55%
Additional rate (45%)	1%	10%	20%

Source: Pensions Policy Institute; Tax relief pension saving in the UK, July 2013.

Assume that the cash is then invested in an actively managed UK equity fund. Annual costs total roughly 3% for a retail investor, comprising the Total Expense Ratio (TER, roughly 1.6%[12], including the annual management charge, AMC, typically 1.5%[13]) and annual transaction costs of 1.4%[14]. Also assume that the assets subsequently return a net 2.9% per annum (the average for pension funds over 2001-2011).[15] As a result:

- after just over ten years, the cumulative costs exceed the initial tax relief from the Treasury;
- after 17 years, the cumulative AMC received by the industry exceeds the initial tax relief from the Treasury; and
- after 29 years, the cumulative AMC received by the industry in respect of the initial tax relief exceeds said tax relief.

Treasury-funded tax relief boosts the volume of assets that fund managers have to manage, and therefore their income. Indeed, the Treasury is the fund management industry's largest client: since 2002, it has injected, through people's pension pots, £270 billion of cash, on which charges and fees are levied.[16]

It is evident that within the timeframe over which many people save for a pension (30 years), fund managers will have taken, through their annual management charge (AMC), a sum that exceeds all of the tax relief. This is akin to a state subsidy of the industry. In the meantime they will have assumed no risk, and the Treasury fields the consequences of industry failure, via welfare payments, made manifest by an under-saving nation. Perhaps an AMC should not be chargeable on the Treasury's contribution to pension pots?

3.2 Tax relief is not tax deferred

The proponents of higher and additional rates of tax relief, in particular, claim that income tax is merely being deferred. The data does not support this assertion. The Treasury is effectively co-investing with recipients of higher rate relief (40%), anticipating repayment through post-retirement income tax. But only one in seven of those who receive higher rate tax relief while working go on to *ever* pay higher rate income tax in retirement.

Another way to look at this is to consider tax relief from an intergenerational perspective. In 2011-12, 10.6 million workers received tax relief of £28.1 billion on their (and employer) contributions, while a similarly sized pensioner population of 11.3 million paid only £11.5 billion in income tax. Notwithstanding the baby boomers who are mostly still in work and receiving tax relief (the largest, and wealthiest, generation), higher and additional rates of tax relief represent a huge net cost to the state: a bad investment of taxpayers funds.

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12 1.56%: IMA press release, 27 January 2012 (active retail UK equity funds), 1.66% from Lipper data.

13 Note that the average AMCs for workplace-based schemes are lower, at 0.71% and 0.84% for DC trust-based and contract-based schemes respectively (DWP research, February 2014), care of economies of scale.

14 Implicit and explicit transaction costs, based upon the median turnover of UK actively managed equity funds of c.58%, i.e. once every 20 months.

15 TheCityUK; Pension Markets 2012 report, March 2012.

16 HMRC; Personal Pension Statistics, Table Pen 6, February 2014.

4. INEFFECTIVE TAX INCENTIVES

4.1 Powerful evidence now emerging

The Treasury has never publicly quantified the return on its investment in pensions incentives.[17] But the tide is now turning, following publication of a major report by a joint venture between Harvard and Copenhagen Universities.[18]

This examines the effectiveness of both tax subsidies and default "nudges" (requiring no active choices by individuals) in terms of broadening the retirement saving participation rate, and also the total size of Denmark's pool of savings. The researchers observed the consequences for savings behaviour of:

(i) changes in tax incentives, including reducing pensions tax relief for the top income bracket (which Denmark did in 1999);

(ii) "nudges", such as automatic enrolment and default contributions; and

(iii) other initiatives that require no active choices to be made, including individuals' switching to jobs with higher or lower employer pension contributions, and mandatory retirement saving (imposed from 1998 to 2003).

[17] It is accepted that this would not be an easy exercise, because it would require dealing with the counterfactual and anticipating changes in savings behaviour with and without incentives. One simple question to ask current savers could be "would you change your retirement saving without tax relief and, if so, how?"

[18] Subsidies vs. nudges: which policies increase savings the most? November 2012, Prof. Raj Chetty, Harvard University and NBER, Prof. John N. Friedman, Harvard University and NBER, Prof. Soren Leth-Petersen, University of Copenhagen and SFI, Torben Heien Nielsen, The Danish National Centre for Social Research, and Tore Olsen, University of Copenhagen and CAM.

The team found that:

(i) there are two types of people in the economy. 15% are "active" savers, people who plan for their retirement (i.e. they save irrespective of any inducements to do so), and who actively pursue tax incentives. Essentially, active savers are financially-aware top quartile earners. The other 85% are "passive" savers; they are not focused on retirement saving, and do not pay attention to policy changes. Consequently, tax incentives have no impact on passive savers' behaviour;

(ii) tax incentives encourage the limited number of active savers, who save anyway, to reallocate their savings from taxable accounts to tax-subsidised pensions savings. Their motive is often more about personal tax planning than retirement saving. Thus, subsidies result in a negligible increase in Denmark's overall savings. This was confirmed when Denmark cut tax relief for high earners: 90% of the reduction seen in retirement saving reappeared in non-retirement accounts. Consequently, assets under management did not contract as some had anticipated, so the impact on the fund management industry was limited.

The researchers concluded that each DKr1 of Danish government tax expenditure on incentivising retirement saving generated only one ore (DKr 0.01) of net new savings across the nation;

(iii) passive savers benefit from automatic "nudge" policies which rely on passive acceptance, such as automatic enrolment and default contributions. They tend not to reduce their saving elsewhere, so they experienced a net increase in savings; and

(iv) when Denmark required people to contribute 1% of their gross earnings to a pension account, the increase in total national savings suggested that 90% of this led to additional saving, rather than a reallocation from non-retirement accounts.

Note that this research was based on a large volume of high quality data: 45 million observations of Danish citizens' savings habits, between 1995 and 2009.

4.2 Denmark: conclusions

Subsidies are expensive, and largely ignored by the 85% of savers who are passive: they respond to nudge policies that promote default-based saving. This increases retirement savings across the *whole* workforce, including lower-income workers who are least prepared for retirement – and at a dramatically lower cost to the taxpayer.

Culturally and economically, Denmark is not wildly different to the UK: there is no reason to believe that tax and employers' NICs relief on pensions contributions are any more effective here. Consequently, the research should be of considerable interest to both the DWP (keen to promote saving) and the Treasury (keen to save money).

5. THE 2014 BUDGET

5.1 More flexibility so less incentive required?

The 2014 Budget put an end (from April 2015, subject to consultation) to any requirement to purchase an annuity with a pension pot. This represents a significant improvement in pension pot flexibility, and was widely welcomed (albeit not by annuity providers). That said, it reinforces the case for a thorough scrutiny of tax relief's purpose, traditionally provided to compensate for pension products' *inflexibility*.

5.2 Tax incentives: less effective, post-Budget

Post-Budget, it will be much easier for high earners approaching the age of 55 to harvest 40% or 45% tax relief, and then, at 55, to almost immediately take a 25% tax-free lump sum and the rest as cash, to then be taxed at only 20%. (Many people's incomes reduce once they pass the age of 55, perhaps as a result of going part-time, or even having retired.) This would appear to be an ineffective use of Treasury funds (as well as encouraging some people to leave retirement saving until later), which are supposed to encourage a term commitment to saving.

A recent report from the National Audit Office specifically makes the point that:[19]

"*HMRC does not evaluate tax reliefs systematically, and has commissioned few evaluations of their impact. The Treasury depends on HMRC's feedback on the use of specific reliefs. Evaluation is important to understand the extent to which a tax relief is misused, its behavioural consequences and, in the case of tax expenditure, whether it is meeting its social or economic objectives*".

HMRC has commissioned 19 external evaluations of tax expenditures since 2003. None of them has looked at pensions' tax reliefs, which is odd given that they represent the largest amount allocated to a specific policy objective. In addition, the value of reliefs in relation to tax revenue and public spending has increased in recent years, rising from 16% to 21% of GDP since 2005-06 (while tax revenues have decreased marginally). Furthermore, the Budget's removal of any annuitisation requirement significantly diminishes the Treasury's ability to recoup its investment in pensions tax relief.

[19] National Audit Office; Tax reliefs, HC 1180 Session 2013-14, 28 March 2014.

6. REFORM: PRELIMINARY STEPS

6.1 Up-front tax relief: scrap it

Section 4 suggests that up-front tax relief does not significantly incentivise passive savers (85% of the population) to increase their savings; nor does it increase the nation's total savings pool, because many active savers merely use it to reallocate existing savings. It should be scrapped.

6.2 Do not forget the strategic objective

Scrapping up-front tax relief would immediately prompt the question of what should the Treasury do with the resulting huge annual saving. In 2012-13, up-front tax relief and foregone NICs cost over £43 billion (Table 1), and there would be additional income as a consequence of Proposal 1, that pension contributions from employers should be treated as part of gross income, and taxed as such. The Cabinet would not be short of ideas. Tempting as it may be to pay down some of the national debt, or end all corporation tax (total net receipts were £39.5 billion in 2012-13), the original strategic objective for pension tax reliefs should not be forgotten: to encourage saving, to provide an income in retirement, leading to reduced pensioner poverty (and welfare costs).

6.3 Boost the State Pension?

The £43 billion saving from ending reliefs could be used to enhance the basic State Pension (BSP, which cost some £56 billion) by roughly 75%.[20] It is hard to think of a more simple way of tackling pensioner poverty. It would be politically appealing, the beneficiaries (future pensioners) outnumbering the recipients of tax relief.

But there would be some significant downsides. Up-front tax relief, in particular, provides a cash flow that is invested through markets via individuals' pension pots: vital for fuelling investment (and economic growth). In addition, less investment would represent a move from funded to unfunded retirement provision.

Finally, simply ending tax relief *in isolation* would contradict the objective of increasing the nation's aggregate pool of savings, and it would do little to help encourage a savings culture. Another approach is required.

7. A NEW INCENTIVE FRAMEWORK

7.1 In the beginning…

Ten years ago, David Willetts MP suggested the Lifetime Savings Account. The Treasury would match, £1 for £1, any money put in by the saver ("buy one get one free", or BOGOF), up to a small annual limit (£240 was mooted).[21] Crucially, the account would allow savers to retrieve their own contributions at any time, but not the Treasury's contributions until retirement age.

At the time, Mr Willetts said:

"Moreover, people in their 20s, 30s or 40s can be deterred from putting money into a pension scheme because that means putting their cash beyond reach for decades."

The Lifetime Savings Account was envisaged to operate *alongside* the existing tax relief framework. It is now time to develop the original idea of a Treasury matching incentive, using it to *replace* today's tax relief framework.

[20] This has been proposed by Frank Field MP.

[21] See Bogof – the easy way to fairer pensions, Neil Collins, writing in the FT, 28 December, 2012.

7.2 £1 for £1 matching: too risky

It is tempting to propose £1 for £1 matching for pension contributions, up to an annual matching allowance, but this raises a major risk. If *no one* saved for the long term without any matching, the total amount being saved annually would be limited to the Treasury's maximum potential budget: £43 billion if we just consider ending tax and NICs relief. But this is considerably less than the total amount contributed to pensions (including employer contributions). Risking such a large potential reduction in aggregate long-term personal saving would not be acceptable.

7.3 A flat rate of tax relief

The most frequent proposal to reform tax relief is to introduce a flat (i.e. single) rate of relief for everyone, irrespective of their marginal rate of income tax. Table 6 shows a range of alternatives.

A flat rate set above the 20% basic rate of income tax would make for a more progressive (i.e. redistributive) framework, and it would be popular: the 87% of workers who today only pay basic rate income tax would clearly benefit. It would also retain most high earners' interest in pensions, because most of them will only ever pay the basic rate of income tax in retirement; hence they would not lose out. The exception would be the tiny minority of people who, in retirement, expect to pay income tax at 40% or 45%. That said, some of them could be attracted by what is still an interest-free loan from the state, to be used for investment purposes.

If a 20% flat rate of tax relief were to be introduced, retaining the existing framework of allowances, it would save the Treasury roughly £6 billion per year, and a 30% flat rate would be roughly cost neutral.[22]

7.4 50p per £1 saved

If we are to catalyse a broad based savings culture, we need a highly redistributive incentives structure. A 33% flat rate of tax relief (i.e. 50p from the Treasury per £1 saved from net income, which would include employer contributions) would *double* the incentive that basic rate taxpayers currently receive.[23] But, for cost control purposes, it would have to be accompanied by a much lower annual allowance, i.e. well below today's £40,000. In addition, to help broaden the savings base, the saver's taxpaying status should be irrelevant.

Proposal 2: Tax relief on pension contributions should be replaced by a Treasury contribution of 50p per £1 saved, up to an annual allowance, paid irrespective of the saver's taxpaying status.

It would make sense for employees' income tax and NICs to be deducted from employers' contributions, with the Treasury's 50p paid gross, thus avoiding a potential cashflow issue for employees.

Table 6: Flat rate tax relief

Rate of tax relief, %	Post-tax contribution	£ tax relief from Treasury	Pot total	Communication
33.3%	£100	£50.0	£150.0	£2 in for £1 "free"
30%	£100	£42.9	£142.9	£7 in for £3 "free"
25%	£100	£33.3	£133.3	£3 in for £1 "free"
20%	£100	£25.0	£125.0	£4 in for £1 "free"

22 Pensions Policy Institute's paper Tax relief pension saving in the UK, July 2013.

23 This is not necessarily intuitive; the doubling arises because tax relief is calculated on gross (i.e. pre-tax), rather than net amounts.

Table 7 compares the proposed 50p per £1 incentive with today's framework of tax relief.

Clearly, basic rate taxpayers would benefit under the proposed 50p per £1 arrangement, with higher and additional rate taxpayers receiving a reduced incentive relative to today, consistent with a more redistributive structure. A crucial question is what should be the maximum annual contribution from the Treasury (which would be half of the individual's annual allowance). This is discussed in section 11, after five other proposals are introduced.

7.5 The Treasury's perspective: TEE preferred?

The 50p Treasury contribution would preserve today's EET framework for pensions, for employer and employee contributions.[24] Contributions in excess of the annual allowance would, however, experience an unappealing TET arrangement. This prompts an intriguing question: should there be a medium-term goal to scrap all pensioner income tax, moving pensions to a TEE framework, the same as for ISAs?

This would be hugely attractive from a Treasury cashflow perspective: essentially, it would move its cash outflow back a generation: up-front tax relief, paid out to today's workers, would be replaced by income tax foregone on pensions. Given the relative sizes of the two amounts (£28 billion and £11.5 billion, respectively), it would be financially attractive (even taking into account how the nation's demographic shape will change over time). And, given the size of the (more voting-inclined) pensioner population, this could be politically attractive too.

7.6 Employer schemes and contributions

(a) What of NICs relief?

Today, employers receive NICs relief on their contributions (at 13.8%), but what makes pension contributions so different from other business expenses? This is a theme that was identified in the Mirrlees Review, which suggested *"ending the excessively generous treatment of employer contributions".*[25]

But before scrapping employer NICs relief, which cost over £10 billion in 2012-13, we should consider how employers may respond to such a move, particularly in respect of their contributions and, more broadly, their attitude towards occupational pension schemes. We would not want to put at risk the tripartite covenant that emerged between the state, employers and employees following the Pensions Commission's work led by Lord Turner. This is further considered in section 11.

[24] EET: exempt, exempt, taxed. The first letter refers to contributions (of capital), the second to investment income and capital gains, the last letter to post-SPA income (i.e. a pension).

[25] The Mirrlees Review (2010, chaired by Nobel laureate Sir James Mirrlees) was set up to identify what makes a good tax system for an open economy in the 21st century, and to suggest how the UK tax system could be reformed to move in that direction.

Table 7: Treasury incentive per £1,000 (post-tax) pension contribution

Marginal rate of income tax	Today's tax relief	Proposed 50p per £1	£ change	Increase / decrease
20%	£250	£500	+£250	+100%
40%	£667	£500	-£167	-25%
45%	£818	£500	-£318	-39%

(b) Employer or employee contributions?

We should consider the relative attractiveness of employer and employee contributions, were the proposed 50p per £1 incentive to be adopted, along with Proposal 1, that employer contributions be treated as part of the employee's gross income and taxed as such. Table 8 shows the relative tax efficiency of employer and employee contributions, for the three main groups of taxpayers (while working and then in retirement), and includes today's system of tax reliefs.

The results are presented as the ratio of post-tax pension pot size divided by the post-tax contribution, the cost to the employer being fixed (so that he would be indifferent between contributing to a pension pot or giving cash to the employee to contribute himself). Four scenarios are considered, relating to the 25% tax-free lump sum and relief from employer NICs on employer contributions. Some observations:

- the attraction of today's salary sacrifice schemes is evident: contributions from employers are more "tax efficient" than those made by employees. Employer and employee NICs are payable with employee contributions, whereas neither is with employer contributions;
- for 20% / 20% taxpayers (i.e. most people), if the 50p per £1 incentive were adopted, the advantage of employer, over employee, contributions would remain similar to today. If, however, employer NICs relief were scrapped, employer contributions would still remain more tax efficient (than giving employees cash to then make their own contributions), but less so than today;
- for 40% taxpaying employees, the new incentive would improve the relative attractiveness of employer contributions (up to the annual allowance), perhaps reinforcing the tripartite covenant that emerged between the state, employers and employees; and
- the presence (or otherwise) of the 25% tax-free lump sum makes no difference to the debate concerning the relative attraction of employer or employee contributions; it is employer NICs relief that makes the difference.

(c) Contributions to defined benefit (DB) schemes

It is acknowledged that a lower annual allowance would have adverse tax implications for some DB pension scheme members.[26]

[26] The value of DB pensions is based upon accruals, not contributions, for annual and lifetime allowance purposes. The pension input amount used to calculate any tax charge is based on the cash value of the increase in pension benefits during the year, multiplied by 16.

Table 8: Efficiency of employer vs. employee contributions

		Today	50p per £1 incentive			
	25% tax-free lump sum	Yes	Yes	Yes	No	No
	Employer NICs relief	Yes	Yes	No	Yes	No
Income tax working / retirement:	20% / 20%	134%	132%	116%	132%	116%
	40% / 20%	118%	141%	124%	141%	124%
	40% / 40%	118%	141%	124%	141%	124%

The author would like to acknowledge the assistance provided by Peter Williams and Kevin Wesbroom, of consultants Aon Hewitt, in the modelling underlying this table.

Some employers have on-going contractual obligations to fund their DB schemes, and a much reduced annual allowance could impose a tax burden on lower earners, as well as high earners. Consequently, it may be appropriate to introduce some transitional (tax) arrangements; for example, DB plans following a formal recovery plan (probably receiving relatively high "catch up" contributions to reverse scheme deficits) could be eligible for an exemption.

But a sense of perspective is required. A tiny minority of the private sector's working population is participating in an open DB scheme: less than 4% of the sector's 24 million employees.[27] This figure is down 50% since 2007, and still declining. This paper's proposals are concerned with the future, which is defined contribution (DC). The public services' DB pension schemes, are, of course, another issue.[28]

8. A COMBINED CONTRIBUTION LIMIT FOR ISAS AND PENSIONS

Industry surveys[29] confirm people's growing preference for stocks and shares ISAs over pensions; with ready access, they are immensely popular (and the brand is still reasonably trusted), attracting £16.5 billion in 2012-13 (plus £40.9 billion into cash ISAs).[30] This is, for example, more than double the £7.7 billion that individuals contributed to personal and stakeholder pensions. Consequently, it would make sense to combine ISAs' annual subscription limit with pensions' tax-advantaged allowance (£11,880 and £40,000, respectively, from April 2014).

A £30,000 combined contribution limit should replace the existing regime. It would provide savers with flexibility to choose between an ISA *or* a pension product, or any combination thereof.[31] Thus one could, for example, put £20,000 into an ISA and £10,000 into a pension product.

From the Treasury's perspective, the purpose of a combined contribution limit would be to control the opportunity cost (it is not a cash cost) of the income tax exemption for investment income and realised capital gains. It costs some £7 billion per year, in respect of pensions alone.

The proposed £30,000 limit is lower than today's total for ISAs and pensions (£51,880 from April 2014), so the opportunity cost should, in future, reduce. A £30,000 limit would surely meet the savings needs of 95%+ of the population. Those who wanted to save more could, of course, still do so, albeit without any taxpayer-funded incentive.

> **Proposal 3:** ISA and pension products should share an annual combined contribution limit of £30,000, available for saving within ISA or pension products (or any combination thereof). This would replace the current ISA and pensions tax-advantaged allowances.

27 ONS; Pension Trends Chapter 6: Private Pensions, 2013 edition.

28 See Self-sufficiency is the key and The Local Government Pension Scheme: opportunity knocks, Michael Johnson, CPS, 2011 and 2013, respectively.

29 For example, more people (38%) view cash savings (including ISAs) as a better route to a reasonable standard of living in retirement than personal pensions (30%). Source: Scottish Widows, UK Pensions Report 2009, June 2009.

30 HMRC; Individual savings accounts statistics, Table 9.4, September 2013.

31 As more fully discussed in Chapter 9 of Put the saver first, Michael Johnson, CPS, 2012.

9. THE 25% TAX-FREE LUMP SUM

9.1 Expensive, inequitable and ineffective

The prospect of 25% of some distant, uncertain lump sum being tax free is unlikely to persuade most people to save within a pensions framework.[32] As an incentive for long-term saving, it is wholly ineffective, yet it costs the Treasury some £4 billion per year. It is also hugely regressive: 2% of lump sums are worth £150,000 or more, yet they attract 32% of all lump sum tax relief.

9.2 Some alternatives

The Pensions Policy Institute has suggested that the tax-free lump sum should be limited to a modest sum: £36,000. This has the merit of simplicity, and would not impinge upon 75% of savers, yet save the Treasury £2 billion per year.[33]

The Mirrlees Review[34] discussed *"replacing the tax-free lump sum with an incentive better targeted at the behaviour we want to encourage"*. It proposed replacing the right to withdraw a tax-free lump sum at age 55 with a 5% "reward" (or "top-up"), based on the size of the pension pot, paid into the pot just prior to annuitisation.

A pre-annuitisation reward would effectively spread a Treasury-funded incentive over the period of retirement. Consequently it would be of much more lasting benefit to savers, and it would be cost neutral. For basic rate taxpayers (i.e. some 87% of workers), today's tax-free lump sum means that the Treasury is effectively waiving 20% income tax on 25% of any annuity purchased from the pension pot, i.e. 5% of the pot……which is the reward proposed by Mirrlees. But annuities are unpopular, and following the Budget, far fewer people are likely to buy them, so a (Mirrlees inspired) annuity by itself is likely to be small and therefore expensive to administer.

9.3 Scrap the tax-free lump sum

Given that recipients of a tax-free lump sum will have already received up-front tax relief on their contributions, then scrapping it altogether is perfectly justifiable. Accrued rights to a tax-free lump sum should be protected, limiting the disappointment of those already approaching retirement: consequently, the saving to the Treasury would materialise only very slowly.

> **Proposal 4:** The 25% tax-free lump sum should be scrapped, with accrued rights to it protected.

10. THREE QUID PRO QUOS

10.1 Acknowledge emotions

The removal of higher and additional rates of tax relief, as well as the tax-free lump sum, would be, for a small minority of people, emotive issues. For example, in the years leading up to retirement, some people envisage, post-retirement, a long cruise, purchasing high cost consumer goods or finally paying off their mortgage……financed by their tax-free lump sum. Where emotions run strong, some politicians fear to tread. Consequently, the reforms should be accompanied by some specific *quid pro quos*.

[32] This means that a quarter of contributions are, today, effectively subject to a very generous EEE (exempt, exempt, exempt) treatment for income tax purposes.

[33] Pensions Policy Institute; Tax relief for pension saving in the UK, July 2013.

[34] The Mirrlees Review; see Tax by Design, Chapter 14, Reforming the Taxation of Savings, September 2011.

10.2 The Lifetime Allowance

The Lifetime Allowance (LTA) has been one of the Chancellor's cost cutting tools of choice, being reduced from £1.8 million to £1.5 million (for tax year 2013-14), and down to £1.25 million from April 2014.[35] Each time it is cut, it potentially exposes high earners, particularly members of final salary (i.e. DB) schemes, to complex, adverse, tax implications, notably in respect of the value of an accrued pension relative to lifetime (and annual) allowances. This spawns an array of economically unproductive consulting opportunities: the white collar equivalent of digging a hole and paying people to fill it in. Furthermore, by applying for "fixed protection 2014" the Lifetime Allowance from April 2014 can be protected at the 2013-14 level of £1.5 million. Why not just provide that protection to everyone *automatically*, rather than distract people with the need to fill in a form to notify HMRC?

That aside, one consequence of lowering the annual contributions allowance for pensions, and including ISAs within it, would be that, in the long term, the Lifetime Allowance becomes less relevant (a point reinforced by the on-going demise of DB-based schemes, and also the move from final salary to career average schemes within the public sector). It should simply be scrapped, not least as a simplification measure.

Proposal 5: The Lifetime Allowance should be scrapped. It adds considerably complexity to the pensions landscape, and with a £30,000 combined contributions limit for pensions and ISAs, it would become less relevant over time.

[35] The Lifetime Allowance is the maximum amount of pension saving that can be built up over a lifetime that benefits from tax relief. Any excess faces a tax charge.

One consequence of abolishing the LTA would be that some (wealthy) people who had stopped further pension accrual, having reached the LTA, may restart a pension plan. But the cost to the Treasury would be low, not least because (i) the number of people would be small, and (ii) they would only be eligible for a much lower contribution from the Treasury (as opposed to up to £18,000 today, as 45% of £40,000).

10.3 Resuscitate the 10p rebate on dividends

Few industry insiders have forgotten Gordon Brown's 1997 scrapping of the 10p rebate on dividends received within a pension pot. This effectively imposed a 10p income tax on what were supposedly non-income tax paying bodies, notably pension funds, because dividends are paid out of companies' *post*-tax income. It should be said, however, that it was Norman Lamont who, in 1993, first cut tax credits on share dividends paid into pension funds. Clearly, Chancellors, irrespective of their political hue, understand how to harness the power of compounding to their advantage.

Reinstating the 10p rebate would bring additional income into pension pots, and the positive power of compounding would then initially benefit the individual rather than the Treasury. It would cost less than £2 billion per year, but larger retirement incomes would result.[36]

Proposal 6: The 10p tax rebate on pension assets' dividend income should be reinstated.

[36] A crude calculation of the cost of restoring the rebate is to assume that the UK has £2.1 trillion in pension assets, 50% of which comprise shares, and 40% of this are UK shares (data source: Towers Watson; Global Pensions Assets Study 2014). Also assume an average prospective dividend yield (for FTSE 100) of 3.6%. Then £2.1 trillion x 50% x 40% x 3.6% x 10p = £1.5 billion per annum.

The rebate would particularly benefit those with large savings, so it could also be presented as a *quid pro quo* for the lower total contribution limit of £30,000. However, its political value may be limited because some people (most?) would fail to grasp the economic significance. That said, reintroducing the rebate could be trumpeted as a common sense reversal of Gordon Brown's "notorious" raid, as well as subsequently reducing some people's reliance on means-tested benefits (and thus Treasury expenditure). It would, however, expose the Treasury (via a lost income opportunity) to future rises dividends (likely, given just how low interest rates and dividends are today).

10.4 Post-death treatment of pension assets

One of the principal emotional issues that people have with pension saving is that following their death, their estate may lose capital held in *their* pension pots. This reinforces people's lack of understanding of pensions, and sows distrust of pension saving in general. This doubt could be removed by making it clear that the capital at retirement belongs to the saver (or scheme member) and his estate.

One approach would be to exempt pension assets from inheritance tax (IHT), *provided* that the funds were passed on within the confines of a pensions framework, i.e. as pension benefits. Leaving something for children (and grandchildren) is a powerful motivator: this could encourage a controlled trickle-down of wealth through the generations, and reinforce a sense of personal ownership of pension savings. This would, however, only benefit the relatively rich (i.e. those with estates in excess of the IHT threshold, £325,000 for 2014-15), so a limit could be imposed.

> **Proposal 7:** People should be able to bequeath unused pension pot assets to third parties free of Inheritance Tax (perhaps limited to £100,000), provided that the assets remained within a pensions framework.

This proposal (first proposed by the author in 2010)[37] would have a modest cost to it, but could be presented to the wealthy as a third *quid pro quo* for the removal of higher and additional rates of tax relief (along with Proposals 5 and 6).

11. THE NEW ANNUAL ALLOWANCE

The annual allowance would provide the Treasury with a simple cost control lever: the question is at what level to set it, to ensure that the Treasury remained within budget.

11.1 The Treasury's potential budget

In light of concerns raised in section 7.6 (how employers may respond to the loss of NICs relief on their contributions), we should consider the Treasury's potential budget both without, and with, NICs relief on employer contributions.

(a) Scrap NICs relief on employers' contributions

In 2011-12, employers contributed some £74 billion to employee pensions, roughly 70% of total contributions (and they received NICs relief of £10.2 billion). Let us assume that with employer NICs relief scrapped, employers would subsequently maintain their total cost at £74 billion by reducing their contributions to £65 billion, and paying £9 billion in NICs.[38] The latter is a tax-deductible expense for Corporation Tax purposes, so it would net off against the £9 billion *reduction* in contributions (also a tax-

[37] See Proposal 10 in Simplification is the key, Michael Johnson, CPS, June 2010.

[38] £65 billion of contributions plus £9 billion of NICs (at 13.8%) = £74 billion total cost.

deductible expense) to leave no impact on the employer's bottom line.

The annual net saving generated by this paper's proposals would then include the following components:

(i) income tax raised from treating employer contributions as part of employees' gross income (Proposal 1): c. £16 billion, assuming an *average* rate of employee income tax of 25% on £65 billion of employer contributions;

(ii) additional payments of employee NICs (part of Proposal 1) on employer contributions. We will assume an *average* rate of 7%, so this would raise £4.5 billion on £65 billion of employer contributions;[39]

(iii) £28 billion from having scrapped income tax relief (Proposal 2);

(iv) £9 billion raised by ending employer NICs relief;

(v) savings derived from reducing today's separate ISAs contribution limit and pensions allowance (together, £51,880 from April 2014) to a combined £30,000 (Proposal 3). Consequently, the "opportunity cost" of the income tax exemption for investment income and realised capital gains would reduce over time; a guestimate for this saving is £5 billion (which would rise with interest rates);

(vi) some £4 billion (ultimately) saved from scrapping the 25% tax-free lump sum (Proposal 4);

(vii) an additional cost of perhaps £2 billion from removing the Lifetime Allowance (Proposal 5);

(viii) a £2 billion additional cost from reinstating the 10p tax rebate on pension assets' dividend income (Proposal 6); and

(ix) an additional cost of £1 billion, say, arising from permitting people to bequeath unused pension savings assets to third parties free of Inheritance Tax (perhaps limited to £100,000), provided that the assets remained within a pensions framework (Proposal 7). Note that the *total* net cash received from inheritance tax in 2012-13 was £3.1 billion.[40]

This all comes to a net saving of roughly £62 billion: enough to incentivise up to £124 billion of retirement savings, at a rate of 50p from the Treasury per £1 saved. Thus the maximum amount that could be contributed to pension pots would be £186 billion (including the Treasury's 50p). This is 80% *more* than the £103 billion saved in 2011-12 (which *included* a relatively small amount of basic rate tax relief on individuals' contributions).

(b) Retain NICs relief on employers' contributions

Alternatively, if we were to retain employers' NICs relief, and assume that employers maintained their contributions at £74 billion, then the net saving to the Treasury would fall by some £6

[39] Assume a 50:50 split in contributions between employees earning less / more than the upper earnings limit (UEL): see Table 4's income distribution and tax relief. Employees' primary Class 1 NICs rate between the primary threshold and the UEL is 12%, and 2% above the UEL.

[40] HMRC; Inheritance Tax Statistics, Table 12.1.

billion, to roughly £56 billion.[41] In this light, the financial benefit to the Treasury of scrapping employers' NICs relief might not outweigh the risk that employers may (further) disengage from pensions (notwithstanding the findings concerning the relative (tax-inspired) advantage of employer, over employee, contributions, discussed in section 7.6).

So, the Treasury's potential maximum budget for the 50p per £1 incentive could be between £56 to £62 billion (with and without employer NICs relief, respectively). But these figures were arrived at using a very simplistic approach, so let us also approach the question of what level to set the annual allowance from a different angle.

11.2 Estimating the annual allowance: guiding observations

The key parameters to consider, prior to introducing the new incentive framework, are (a) how many people would then save for the long term, and (b) how much would they save? The impact of auto-enrolment should also be considered.

(a) The number of long-term savers today

(i) Not enough

It is striking, and worrying, just how narrow the nation's savings base is. In 2011-12, out of a working population of some 30 million, only 5.4 million people (18%) made contributions to personal pensions, including stakeholder (down from 7.6 million four years earlier).[42] There were 7.8 million active members of occupational pension schemes, including 5.1 million in public sector schemes. Consequently only 2.7 million of the UK's 24 million private sector workers (i.e. 11%) participated in an occupational scheme, although this figure is now rising with auto-enrolment.[43]

Clearly, participation rates are low, but there is a crucial point to note. It is often the *same people* contributing to each of the aforementioned sources of retirement income. The Danish data suggests that 15% of Danish savers are "active" savers (section 4): based on the above, this feels about right in respect of the UK too.

(ii) Impact of auto-enrolment

Auto-enrolment is expected to introduce another six to eight million workers to workplace saving, and this will add to the nation's retirement savings pool, but probably by less than £10 billion on a net basis, i.e. after taking savings substitution into account.[44] Inevitably some people would simply switch their saving, rather than save more, not least because over the next few years (or decade?), disposable incomes are unlikely to rise significantly, particularly once interest rates start to rise (pushing up mortgage rates). Conversely, others (including some employers) would contribute more than the minimum required. All-in-all, the impact of auto-enrolment alone on the cost of the Treasury's

[41] Savings component (i) would increase by £2.5 billion, (ii) would increase by £0.6 billion, and (iii) would disappear, i.e. an additional cost of £9 billion: a net £5.9 billion reduction in HMT's potential budget.

[42] HMRC; Table PEN 3 Personal Pensions, September 2013.

[43] ONS; Occupational Pension Schemes Survey, 2012, September 2013.

[44] Based upon seven million average earners contributing the minimum of 4% of qualifying earnings, plus 3% from employers. Qualifying earnings are the amount earned before tax between £5,772 and £41,865 a year (for 2014-15). So, contributions = 7% x (average earnings of £26,500 less £5,772) x 7 million = £10.1 billion.

contributions (replacing tax relief) could be under £5 billion (as 50p on £10 billion).

(b) The size of contributions

In 2011-12, 5.4 million individuals contributed an average of £1,630 to personal and occupational pensions (and that *includes* basic rate tax relief), with another £1,670 from employers: £3,300 in total.[45] It should be noted, however, that this average figure is distorted by very large contributions from relatively few high earners. That said, if *everyone* in the 18 to 55 age range were, for example, to save this average amount (for retirement) each year, the cost to the Treasury would be about £55 billion.[46]

In reality, the participation rate would be a lot less than this: optimistically 60%, at a cost of £33 billion, far below the potential maximum £56 to £62 billion budget (with and without employer NICs relief, respectively). This suggests that we could be more accommodating of those who save (for retirement) more than the average £3,300 per year, while also leaving the Treasury with scope to save a significant amount (on an annual basis).

11.3 The new annual allowance: £8,000

Instinct, informed or otherwise, suggests that the Treasury should be prepared to contribute up to £4,000 per year to retirement savings, to add to contributions of up to £8,000 from individuals and employers. The ability to save a total of £12,000 per year in a pension pot should be more than adequate for almost everyone. However, there should perhaps be some accommodation for people (such as owner-managers of businesses) who are unable to start saving for a pension until relatively late in their working lives. This could be provided in the form of being able to roll up (i.e. accumulate) unused allowances, perhaps over five, or even ten years, say.

But before adopting £8,000 as "the figure", more work is clearly required, including Treasury modelling to explore for the most effective size for the annual allowance, given budgetary constraints.

> **Proposal 8:** The annual allowance should be set at £8,000, with prior years' unutilised allowances being permitted to be rolled up, perhaps over as much as ten years, all subject to modelling confirmation.

Proposal 8 would render redundant today's (less generous) arrangement whereby those with no earnings can benefit, each year, from basic rate relief on the first £2,880 contributed to a personal pension scheme.

11.4 The annual allowance: modelling required

(a) Recall the objective: effectiveness

The primary objective for proposing a new, simpler, incentives structure is to boost the effectiveness of the Treasury spend. More specifically, this means achieving a material increase in the *number* of long-term savers, thereby broadening the distribution of retirement savings, currently concentrated amongst the wealthiest ten percent, to include far more basic rate taxpayers, in particular.

Increasing the aggregate size of the nation's savings pool is a secondary, although desirable, objective. But recall the lessons from Denmark: when saving incentives for the wealthy were reduced, savers mostly reallocated their savings, rather than dramatically cutting them.

[45] HMRC; Tables PEN 1 and PEN 3, Personal pensions, September 2013.

[46] The UK has c. 33 million people aged 18 to 55, x £3,300 x 50p = £54.4 billion.

(b) Modelling considerations

The Treasury (ideally working with the DWP) should research the potential demand for its 50p incentive, in respect of both workplace and private pension provision, following the end of income tax relief and, potentially, employers' NICs relief on pension contributions. Particular attention should be paid to behavioural considerations, particularly in respect of employer contributions. Scenario modelling should then follow, for a range of different annual allowances, not least to develop an understanding of the potential for savings redistribution, the primary objective behind the proposals.

Other questions to address include the following.

- What would be the net increase in the number of people saving for the long-term, and where would (i) increases, and (ii) reductions come from (as measured by income)?
- How much would people save, on average? Total nationwide retirement saving?
- Substitution effects? For example, how much reallocation could there be, producing no net increase in savings?
- Should the Treasury contribution, of up to £4,000 per year, operate entirely independent of the means-tested benefits regime?

12. INTRODUCING THE LIFETIME ISA

12.1 A single ISA for everyone

The proposed new framework of retirement saving incentives does not address a fundamental issue, which is the subject of a sister paper. Pension products, and parts of the allied industry, are widely distrusted, which partly explains why many passive savers do not respond to financial incentives, however simple or generous. Something extra is required to encourage the mass market (i.e. everyone other than the 15% who are active savers) to save for retirement.

The sister paper proposes the introduction of a Lifetime ISA, which would be eligible for the new 50p incentive, as well as offering ready access to contributions. Today's Junior ISAs, and the forthcoming New ISA (NISA) would be assimilated within it, leaving the market with a single ISA product, capable of serving savers from the cradle to the grave: a marked simplification of the savings landscape.

12.2 A hint from the 2014 Budget

It is noteworthy that the Budget substantially increased the annual ISA allowance, to £15,000 (combining cash ISAs and stocks and shares ISAs as the "New ISA" or NISA), with effect from 1st July 2014.[47] By offering a hint as to the future of retirement saving, the Treasury could be seen as anticipating the continuing demise of private pensions.

CONCLUSION

The pensions industry is supported by a huge state subsidy, in the form of an ineffective framework of regressive tax-based retirement saving incentives.

Income tax and employer NICs reliefs persist partly because successive governments have failed to recognise that many people just do not make enough money to save for retirement. This should be addressed through a new incentive framework, to ensure that low earners at least

[47] Prior to the 2014 Budget, the stocks and shares ISA allowance for 2014-15 was to total £11,880, with up to half, £5,940, being eligible for a cash ISA.

have the *possibility* of acquiring a retirement savings habit, and hence a decent income in retirement.

Given that the wealthy have a propensity to save irrespective of financial incentives, the industry could expect assets under management to increase under a more redistributive framework, once a broader base of savers had developed. More people saving would not only benefit those individuals and the nation, but also the industry: a rare policy "win-win".

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