18 February 2016

Briefing Note

THE 2016 BUDGET: PENSIONS

MICHAEL JOHNSON

SUMMARY

In the forthcoming spring Budget (16 March), it is widely expected that the Chancellor will make some significant announcements concerning the future of tax relief on pension contributions. Beyond that.....pure speculation.

This paper summarises the advantages and drawbacks of four potential scenarios (some of which could be combined), including cost implications for the Treasury:

(i) the end of all NICs relief on employer contributions;

(ii) the introduction of a single flat rate of tax relief;

(iii) the end of the 25% tax-free lump sum (TFLS); and

(iv) replacement of all Income Tax and NICs reliefs with a 50p incentive for each post-tax £1 saved, housed within an ISA framework.

Ending NICs relief (and snaring salary sacrifice schemes in the process) would be the most simple and politically expedient reform, saving perhaps some £8 billion per year. Introducing any flat rate of Income Tax relief above 20% would, unless accompanied by other cost-saving measures, have to be accompanied by a reduction in the Annual Allowance (from today's £40,000), to generate a similar saving.

Meanwhile, the Treasury would remain exposed to a ridiculously costly tax arbitrage, as those approaching the age of 55 can flip existing savings into pension pots to collect tax relief, only to then take out the 25% tax-free lump sum at 55. The truth is that retaining *any* form of Income Tax relief is fundamentally incompatible with pensions' "freedom and choice", which ended any requirement to annuitise.

The 25% tax-free lump sum should be scrapped in respect of future contributions but, in so doing, there would be minimal fiscal advantage in the near term. One positive consequence would be that this would encourage people to use their entire pension pots to purchase annuities that would be 33% larger than otherwise: potentially significant at this time of low interest rates.

This paper also considers a 50p incentive per post-tax £1 saved embedded in a Lifetime ISA framework incorporating a Workplace ISA for employer contributions. This would provide the simplicity and flexibility that savers crave: a single savings vehicle capable of meeting almost everyone's short-term and long-term saving requirements from cradle to grave.

The Lifetime ISA, detailed herein, combines some ready access to contributions with an up-front incentive, leaving the saver in control. A modest annual allowance, sufficient to accommodate at least 90% of the population's savings capabilities, would facilitate cost control, while leaving scope for the Treasury to save some £10 billion per annum.

The Lifetime ISA would meet the Government's four principles behind any reform of pensions tax relief, as detailed in its consultation document.[1]

A note on nomenclature

Retirement savings products are codified chronologically for tax purposes. Pensions are "EET", i.e. Exempt (contributions attract tax relief), Exempt (income and capital gains are untaxed, bar 10p on dividends), and Taxed (capital withdrawals are taxed at the saver's marginal rate). Conversely, ISAs are "TEE".

[1] *Strengthening the incentive to save: a consultation on pensions tax relief*; HM Treasury, July 2015.

SCENARIO 1: END ALL NICS RELIEF ON EMPLOYER CONTRIBUTIONS

1.1 Advantages

- Ending NICs relief would only impact upon occupational pension provision. If this were the only change to appear in the Budget, it would leave the private pensions saving framework undisturbed, which would delight the industry.

- There would be a substantial annual saving for the Treasury, but not the full £14 billion cost of NICs relief.[2] Over one third of total employer contributions are in respect of public service schemes; any loss of NICs relief cashflow would have to be made up from other public sector funds, for no net saving.[3] In addition, if NICs relief were to continue to be provided on employer contributions in respect of repairing today's DB scheme deficits, the saving would reduce by some £3 billion (initially). Consequently, the net saving from ending NICs relief would be perhaps £8 billion.

- It would (implicitly) end salary sacrifice schemes. Given that they are a tax arbitrage at taxpayers' expense (reflected in the aforementioned £14 billion), and not open to all (including the self-employed), there would be relatively little opposition.

- There would be no adverse impact on the self-employed: they cannot benefit from NICs relief on pension contributions.

- Relatively simple to implement.

1.2 Drawbacks

- Could adversely impact employer engagement with retirement saving. Ending NICs relief could provide an excuse for them to cut contributions by 13.8%, to maintain their overall cost; this would directly affect employees. But the advent of auto enrolment is already testing employers' paternalism; many have been cutting back on their pension contributions (encouraged by auto-enrolment's current 3% minimum).

- Places additional funding pressure on DB schemes which is, increasingly, a public sector-focused issue, as the private sector exits DB provision. It could be temporarily ducked by continuing with NICs relief for DB schemes alone, until public opinion forces the Government to introduce DC across the public sector. An interim measure could be to reduce NICs relief to 7%, say, halving the Treasury saving.

---

[2] Comprising £9.5 billion in respect of employer contributions and a consequential £4.5 billion attributed to NICs not collected from employees (2013-14).

[3] Unlike the private sector, public sector schemes have no flexibility to reduce pension benefits. This is also the case in respect of the forthcoming loss of NICs rebates following the end of contracting out (April 2016).

1.3 Conclusion: ending NICs relief

- As a stealthy "technical" change to the savings landscape, ending NICs relief would be, politically, relatively easy. The public at large is completely oblivious of NICs relief, which primarily benefits company shareholders rather than employees.
- As an aside, an on-going Office of Tax Simplification inquiry might recommend that National Insurance and Income Tax be combined into a single Earnings Tax. The question of NICs relief would then assume a different complexion.

SCENARIO 2: A FLAT RATE OF INCOME TAX RELIEF ("EET")[4]

2.1 Advantages

- The fiscal benefit would depend upon the rate of relief and the future Annual Allowance (AA), but it could be substantial. The higher the flat rate, the more the AA would have to be cut to generate any meaningful savings for the Treasury. Assuming a minimum required annual saving of £10 billion, the likely outcomes are as follows:

Figure 1: Likely outcomes of a flat rate of income tax relief

Flat rate of relief	Annual Allowance			
	£10k	£20k	£30k	£40k
20%	√	√	√	£12.0
25%	√	√	?	£7.0
30%	√	X	X	£1.2
33%	?	X	X	-£3.2

X Insufficient saving for HMT
√ Acceptable to HMT
? Unclear

- Note that distributional effects are hard to anticipate. For example:
  - if the flat rate were set above 20%, how much additional saving would be generated amongst basic rate taxpayers?; and
  - would 40% and 45% taxpayers cut back on saving? International evidence suggests that this is unlikely. The Danes, for example, concluded that tax relief is ineffective in catalysing additional savings creation, by the wealthy in particular, who save anyway. Their focus is primarily on tax planning, which encourages the reallocation of existing savings into tax-efficient vehicles. For each DKr1 of government expenditure spent on incentivising retirement saving, the Danes found that only one ore (DKr 0.01) of net new savings was generated across the nation.[5]

---

[4] The small "e" indicates partial exemption in respect of 40% and 45% taxpayers.

[5] *Active vs. passive decisions and crowd-out in retirement savings accounts: evidence from Denmark;* Chetty, Friedman, Harvard University, Leth-Petersen, Nielsen, University of Copenhagen, Tore Olsen, Centre for Applied Micro-econometrics, December 2013.

- If a flat rate of 20% were adopted, the Treasury could retain today's £40,000 AA and still save more than £10 billion per year.
- If 33%, it would be highly redistributive, potentially encouraging a lot more basic rate taxpayers (83% of all workers) to save more. If this were to occur, then we should expect the nation's aggregate pool of savings to increase, thereby increasing capital investment and economic growth (and evidencing that Treasury funds were indeed being deployed more effectively).
- If a high flat rate were adopted, a modest AA would be required to control the cost to the Treasury: probably less than £10,000. This would not, however, adversely affect over 90% of the population; indeed, they would be better off because of the higher rate of relief.

2.2 Drawbacks with a flat rate of relief

- It would fail to fully address the biggest tax leakage of all: band slippage, i.e. people paying a lower rate of Income Tax in retirement than the rate of tax relief they received while working. Today, most 40% and 45% taxpaying workers end up paying 20% in retirement. Indeed, any flat rate higher than 20% could *increase* this cost to the Treasury because *most* savers would become beneficiaries of band slippage (i.e. those who pay basic rate both in work and in retirement).[6]
- The Treasury would remain exposed to other costly tax arbitrages, such as people flipping existing savings into pension pots just before reaching the age of 55, receiving tax relief, and then at 55 taking the 25% tax-free lump sum (further discussed below).
- Were a 33% flat rate of relief introduced, most people (i.e. those who paid basic rate tax while working and in retirement) would end up paying an effective rate of Income Tax of less than 4% on their saved gross earnings.[7]
- Meanwhile, the Personal Allowance continues its rapid rise, up 70% over seven years, to £11,000 in 2017-18, with £12,500 "promised" by 2020. Consequently, an increasing number of pensioners will not be paying any Income Tax. In addition, following the end of any annuitisation requirement ("freedom and choice"), wealthy retirees can use controlled decumulation to optimise their Income Tax positions (primarily to stay below the higher rate threshold).
- A flat rate of relief would introduce additional operational complexity to DC occupational pension schemes. Schemes that use net pay would have to change to relief at source, and payroll systems would have to be adjusted. DB schemes would have the additional challenge of having to calculate every individual's annual accrual (i.e. deemed

[6] The net cost to the Treasury would need to take into account the 40% and 45% taxpayers who would now be receiving tax relief at a lower (flat) rate.

[7] As {£1 gross income less 20p Income Tax plus 33.3p relief} = £1.133 less {25% tax-free lump sum} = 85p, less 17p (as 20% Income Tax in retirement) = 68p. Total net tax paid = 20p less 33.3p relief plus 17p = 3.7p on £1 gross income. (Assumes no interim asset growth).

contributions) for AA tax assessment purposes, and they would also face potential cashflow issues (there being less tax relief entering schemes).

- If a lower AA were introduced, it is likely to prompt a further reduction in executive participation in pension schemes. This could be *partly* mitigated by ending the Lifetime Allowance (LTA), but it would cost the Treasury roughly £1.5 billion per year.

2.3 Conclusion: a flat rate of tax relief

- While a flat rate of Income Tax relief is preferable to today's regressive structure, it fails to tackle the fundamental issue: tax relief (flat rate or otherwise) is wholly incompatible with pensions' freedom and choice. Since April 2015, there has been no obligation to annuitise a pension pot, shattering the historic unwritten contract between the Treasury and retirees that the latter, having received tax relief on their contributions, would subsequently secure a retirement income through annuitisation.

- Recall Lord Turner's Pensions Commission:[8] *"Since the whole objective of either compelling or encouraging people to save, and of providing tax relief as an incentive, is to ensure people make adequate provision, it is reasonable to require that pensions savings is turned into regular pension income at some time."*

- The Treasury holds a similar view:[9] *The fundamental reason for giving tax relief is to provide a pension income. Therefore when an individual comes to take their pension benefits they can take up to 25 per cent of the pension fund as a tax-free lump sum; the remainder must be converted into a pension – or in other words annuitised.*

SCENARIO 3: THE END OF THE 25% TAX-FREE LUMP SUM (TFLS)

- Today, most retirees take advantage of the 25% TFLS so that basic rate taxpaying pensioners only pay 15% Income Tax on their pension assets. This cohort includes almost all those who once received 40% and 45% tax relief while working. This makes no sense from the Treasury's perspective. In addition, the TFLS does nothing to motivate Generation Y to save for the long term.

- The TFLS "opportunity cost" to the Treasury is roughly £4.5 billion per year but, with the advent of freedom and choice, and prevailing weak annuity rates, this figure will most likely rise more quickly than in the past. That said, politically it would be very difficult to entirely scrap the TFLS retrospectively, such is the emotional attachment to it. It could be capped at £36,000, as suggested by the PPI, which would save £2 billion per annum, the political damage being limited because this would affect only the largest 25% of lump sums.[10] This could, however, be perceived as introducing a retrospective tax; difficult.

---

8 The Second Report of the Pensions Commission; *A New Pension Settlement for the 21st Century*, 2005.

9 HM Treasury; *The Annuities Market,* December 2006.

10 See *Tax relief for pension saving in the UK*; Pensions Policy Institute, July 2013.

Conclusion: the 25% TFLS

- The TFLS should be scrapped in respect of future contributions but, in so doing, there would be minimal fiscal advantage in the near term. One positive consequence would be that pension pots could then be used to purchase annuities that would be 33% larger than otherwise: potentially significant at this time of low interest rates.

SCENARIO 4: ONE, SIMPLE, INCENTIVE TO SAVE, IN AN ISA FRAMEWORK

4.1 Personal saving

- Replace all Income Tax and NICs reliefs on pension contributions with one 50p incentive per post-tax £1 saved, and end all pensioner Income Tax: TiEE ("i" for incentive).
- The 50p would be paid independent of tax-paying status, thereby addressing the conundrum that because Income Tax is progressive, tax relief is inevitably regressive.
- Suggested savings vehicle: a Lifetime ISA. Established when a baby's name is registered, to include a £500 starter bonus (locked in until 60).
- A low-cost default diversified fund would be available (with an opt-out), to encourage a culture of "investing" rather than cash "saving".
- Ready access to pre-50 contributions, after repaying the 50p per £1 withdrawn. Note that this would serve as a disincentive to make withdrawals, being akin to a 33% tax.
- Contributions made from the age of 50 should remain *in situ* for ten years, to curtail round-tripping of the Treasury's 50p.
- Tax-free withdrawals from 60.
- Today's Cash ISAs could be attached to the Lifetime ISA, with a 50p incentive bridge between them to encourage cash transfers into the Lifetime ISA's default fund.

4.2 Occupational provision

- Employer contributions (taxed as a benefit in kind) would be made into a Workplace ISA, housed within the Lifetime ISA. They would be eligible for the Treasury's 50p.
- The Workplace ISA would be included in auto-enrolment legislation.
- No withdrawals until the age of 60; thereafter, they would be tax-free.
- Workplace ISA assets should enjoy the same inheritance tax benefits as today's pension pots.
- Employee contributions (as part of auto-enrolment) would be made from post-tax income, and eligible for the Treasury's 50p. These would go directly into the Lifetime ISA, to be treated as the same as other Lifetime ISA savings.

4.3 Fiscal position

- Scrapping all Income Tax and NICs relief would save the Treasury some £35 billion per annum.[11]
- Ending pensioner Income Tax would cost £13 billion per annum. Note that any anticipated demographic-led increase in pensioner Income Tax receipts is likely to be more than offset by a rising tax relief bill driven by auto-enrolment, as well as the rapidly rising Personal Allowance.
- The net £22 billion annual saving (£35 billion less £13 billion) should be redeployed as the 50p incentivise (£12 billion, say) and reducing the Budget deficit (£10 billion).

4.4 Annual allowance (AA)

- The Lifetime ISA and Workplace ISA would share an annual allowance of between £5,000 and £10,000, to be determined by Treasury modelling incorporating an annual spend limit of no more than £12 billion. It could include a five or ten year roll-up of any unutilised AA.

4.5 An ISA Pension

- Part of the £12 billion available for the 50p incentive could, instead, be used to top-up annuities purchased from the Workplace ISA, perhaps termed ISA Pensions.

4.6 The "what of DB?" question

- Whenever the end of tax reliefs on pension contributions is considered, the "what of DB?" question emerges. Accrued defined benefits could either be grandfathered as EET, or a one-off asset haircut could be imposed to take the past EET world into the future world of TEE. The latter would remove the need for two different systems to co-exist for decades to come.
- The most simple way to deal with on-going accruals would be to tax employer contributions as a benefit in kind, the tax being paid using the current Scheme Pays mechanism.[12] Other "technical accommodations" may be found, including introducing different allowance and tax regimes for DC and DB schemes. These could include scrapping the LTA for DC (it punishes investment performance) and scrapping the AA for DB.
- Note that the "what of DB?" question is not specific to the introduction of an ISA-centric, TEE world. It is relevant if there were to be any further reductions to the Annual and / or Lifetime Allowances.

---

[11] As £27 billion in Income Tax relief plus £8 billion in NICs relief, taking into account some on-going NICs relief in respect of employer contributions for DB scheme deficit repair (see section 1).

[12] Employer contributions, driven by periodic valuations, would, over time, serve as an approximately reasonable proxy for the value being received by employees. There would, however, be many sources of imperfection in this approach: a ballet between fairness and simplicity. Further details in due course.

4.7 Implementation

- Other nations have successfully transitioned from an EET savings framework, including Australia (to ttE, since 2007) and New Zealand (to TTE; all up-front tax incentives were ended overnight, on 17 December 1987).[13] It can be done.

- Note that both these countries moved to tax, to some degree, "middle E" (i.e. tax foregone on investment income and capital gains). It is assumed that, for simplicity, "middle E" will be retained in the UK.[14]

4.8 Conclusion: Lifetime and Workplace ISAs, with a 50p incentive

- A Lifetime ISA, incorporating a Workplace ISA for employer contributions, would be a single savings vehicle capable of meeting almost everyone's short-term and long-term saving requirements from cradle to grave. This would mark a huge simplification of the savings arena.

- The 50p incentive per post-tax £1 saved would be highly redistributive and a far more effective use of Treasury funds than today's tax reliefs. Communicating it to basic rate taxpayers (i.e. most people) would be a politically attractive proposition: "we are *doubling* your rate of incentive to save".[15] The widely misunderstood concept (and language) of tax relief would disappear.

- The 50p incentive would help reduce pressure to increase contributions under auto-enrolment. Today's 4% + 3% + 1% = 8% framework would become 4% + 3% + 3.5% = 10.5% (for basic rate taxpayers). Indeed, an additional 2% from both the employee and the employer would produce 6% + 5% + 5.5% = 16.5%, thereby exceeding Lord Turner's target contribution rate for median earners, of 16%.

- An annual allowance of between £5,000 and £10,000, accompanied with a five or ten year roll-up of any unutilised allowance, would be more than adequate for at least 90% of the population. A modest AA would substantially reduce the use, by the wealthy, of pensions tax relief as a personal tax planning tool (rather than as an incentive to save).

- The Lifetime ISA would act like a chameleon, with the saver in control. It would combine an up-front incentive with some ready access. The tax treatment of pre-60 withdrawals would be ISA-like, whereas post-60 withdrawals would be tax-free *and* permit the saver to retain the up-front incentive.

---

[13] Australia's small "t" represents partial taxation, rather than at full marginal rates. After ending up-front incentives, New Zealand transitioned to TTE over 28 months, via TET and TTT.

[14] Note that from April 2016, taxpayers will have tax-free dividend and interest allowances of £5,000 and £1,000 (£500 for higher rate taxpayers), respectively, weakening pensions' and ISAs' "middle E" advantage over other savings frameworks.

[15] Today, basic rate taxpayers receive tax relief of 25p per post-tax £1 saved (which is £1.25 pre-tax, less 25p, being 20% Income Tax).

- Introducing the Lifetime and Workplace ISAs, with the 50p incentive, would:
  - meet the Government's four principles behind any reform of pensions tax relief, as detailed in its consultation document.[16] A reformed framework should:
    - (i) be simple and transparent (one 50p incentive for all, not "tax relief");
    - (ii) allow individuals to take personal responsibility for ensuring they have adequate savings for retirement;
    - (iii) build on the early success of automatic enrolment (of which the Workplace ISA would be a part); and
    - (iv) be sustainable (the Lifetime and Workplace ISAs would share a modest Annual Allowance, adjustable to control the cost to the Treasury); and
  - help catalyse the broad-based savings culture that the UK desperately needs. It would also provide the Treasury with an opportunity to save some £10 billion per annum.

THE BUDGET: CONCLUSION

When it comes to pensions' tax relief, now is the time to act decisively. Endless tinkering with allowances, for example, helps no one, and perpetuates uncertainty as to what the next dose of tinkering may entail. But if the Chancellor is to reform the manner in which he incentivises saving, he should focus on simplification, while also securing a substantial saving to the Exchequer to help address the deficit. And then, for the remainder of this Parliament, the savings arena should be left well alone.

[16] *Strengthening the incentive to save: a consultation on pensions tax relief*; HM Treasury, July 2015.

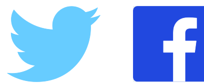
THE AUTHOR

Michael Johnson is a Research Fellow of the Centre for Policy Studies and a highly regarded pensions analyst. He originally trained with JP Morgan in New York and, after 21 years in investment banking, joined Towers Watson, the actuarial consultants. More recently he was Secretary to the Conservative Party's Economic Competitiveness Policy Group.

He is the author of more than 25 influential pensions-related papers for the Centre for Policy Studies (all of which can be freely downloaded from www.cps.org.uk). He is occasionally consulted on pension reform by serving Ministers and shadow Ministers, the DWP Select Committee and the House of Lords Select Committee on Public Service and Demographic Change.

DISCLAIMER: The views set out in the 'Briefing Note' are those of the individual author only and should not be taken to represent a corporate view of the Centre for Policy Studies

Follow CPS:



Forward to a friend