Centre for Policy Studies

# Pointmaker

## WHAT OF DB, IN A TEE WORLD?

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### SUMMARY


- This paper considers the potential tax treatment of three distinct components of a defined benefit (DB) pension scheme operating within a TEE framework.

1. **Accrued defined benefits as at Demarcation Day (D-Day), the day of cessation of the EET framework**. Grandfathering (i.e. ring-fencing as EET) is conceptually simple, but an alternative, a one-off reduction in D-Day accruals, accompanied by a matching charge to DB funds, would take the past EET world into the future world of TEE. It would avoid the operational complexity of two tax frameworks co-existing for decades to come, and would also be more attractive from a Treasury perspective.

2. **DB deficits as at D-Day**. If TEE were to become universal, the Chancellor would come under pressure to retain Income Tax and NICs reliefs on employer contributions in respect of repairing D-Day deficits. Consequently, the annual saving to the Treasury from ending these reliefs would be *initially* some £10 billion lower than what may otherwise be expected, i.e. some £30 billion, partially offset by Lifetime ISA (and, ideally, Workplace ISA) bonuses. In addition, Income Tax receipts from pensioners (£13 billion last year) would diminish over time.

3. **Taxing post-D-Day DB accruals as a benefit in kind**. The choice of methodology is essentially between simplicity, fairness, and a mid-range compromise. Given that DB schemes are already inherently "unfair" to many individuals, simplicity should trump fairness: employer contributions should be used as a readily-quantifiable proxy for the annual accrual.

- As the default, Income Tax on benefits in kind should be paid by the pension scheme ("Scheme Pays"), net of any HMRC incentive due on those contributions, with the scheme being reimbursed by a pro rata reduction in the annual accruals. Members should have the right to opt out of this arrangement to pay the tax themselves: there would then be no reduction in their annual accrual.

- Whenever the "what of DB in a TEE world?" question is posed, it focuses attention on the elephant in the DB room: public service pensions. Indeed, the question is becoming synonymous with the public sector. The introduction of an omnipresent TEE framework could serve as a catalyst for replacing DB public service pension schemes with funded DC provision. This could be in the form of a Lifetime ISA for employee contributions, and a Workplace ISA for employer contributions, nestling within the Lifetime ISA.

***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", although the forthcoming Lifetime ISA, with its 25% bonus, could be more accurately described as TiEE ("i" for incentive).*

## INTRODUCTION

If our pensions and savings arena is to be simplified through unification under a TEE tax framework, the "*what of DB in a TEE world?*" question has to be answered. Some within the industry present it as a reason to maintain the *status quo*, an implication being that it is too difficult a question to answer. Perhaps this is an issue of perspective. Bear in mind the underlying objective: to create a coherent ISA-based savings framework with a single savings vehicle combining both private and workplace-derived savings, serving from cradle to grave. Simplicity to the fore.

The recently announced Lifetime ISA, immersed in the auto-enrolment regime and incorporating a Workplace ISA, could be such a vehicle.[1]

## 1. THREE DISTINCT CONSIDERATIONS

This paper considers the tax treatment of three distinct components of a defined benefit (DB) pension scheme operating in a TEE framework:

(i) accrued defined benefits as at Demarcation Day (D-Day), the day of cessation of the EET framework;

(ii) DB deficits as at D-Day; and

(iii) taxing post-D-Day accruals as a benefit in kind.

From D-Day there would be:

(i) no Income Tax and employer National Insurance contributions (NIC) relief on contributions in respect of post-D-Day accruals. Consequently, in such a TEE world, there would be no tax distinction made between employee salary and employer pension contributions; and

(ii) no Income Tax liability on pension payments.

## 2. TAXING ACCRUED DEFINED BENEFITS, AS AT D-DAY

Two distinct choices for the ongoing tax treatment of defined benefits accrued as at D-Day are outlined below: "grandfathering", and a one-off haircut of accruals.

### 2.1 Grandfathering

Grandfathering (i.e. ring-fencing) would mean that D-Day DB accruals would continue to be treated for tax purposes as EET, i.e. taxed in retirement, leaving two co-existing systems for decades to come (grandfathered EET, and the new TEE for future accruals). This begs several questions, including whether such operational complexity really *is* a problem in this age of (what ought to be) digital administration. Those industry providers who have failed to invest in 21st century systems have only themselves to blame: their operational challenges are no reason *not* to adopt an ISA-centric framework. There are likely to be several digitally-enabled new entrants waiting in the wings. Meanwhile, many people are, of course, already living with both EET and TEE frameworks.

### 2.2 A one-off haircut to accruals

Income derived from post-D-Day accruals would be tax-exempt, no tax relief having been received on allied contributions. If D-Day accruals were reduced by 20% (or perhaps 15% as a political sweetener), accompanied by a matching charge to DB funds, then *all* subsequent pension incomes for basic rate

[1] See *The Workplace ISA: reinforcing auto-enrolment* (April 2016); *An ISA-centric savings world* (October 2015), *The Workplace ISA and the ISA Pension* (July 2015); *Introducing the Lifetime ISA* (August 2014); and *Retirement saving incentives; the end of tax relief, and a new beginning* (April 2014); Michael Johnson, Centre for Policy Studies.

taxpayers could be tax-free. This would avoid the need for separate pre- and post-D-Day systems to co-exist for decades to come.

Some considerations:

- a 20% tax credit would have to be provided in respect of D-Day accruals. Self-assessment should capture higher and additional rate taxpaying retirees, with non-taxpayers being reimbursed via an income top-up;
- payment could be via asset transfer, to avoid the need to liquidate assets for cash….but which assets? Assets would have to be marked to market on D-Day;
- quantifying the one-off charge would require a D-Day valuation: what should the actuaries use for key assumptions such as discount rates? GAD could set some national standards, to limit the scope for unrealistic charges, but actuaries would be quick to raise some potential (technical) points, including:
    - o if *all* assumptions were GAD-specified, then slightly artificial tax charges could result (relative to the reality of the underlying scheme);
    - o the valuation process could reveal disparities between the value of accruals and prevailing contributions rates…. which could prompt some adjustments to accrual rates and / or contribution rates; and
    - o should the strength of employer covenants be taken into account within a standardised assumptions framework for valuations? (*Suggestion*: benchmark against the PPF levy mechanism).

None of these concerns is insurmountable but, alternatively, would it be better to allow scheme actuaries to accommodate individual scheme nuances, perhaps permitting the discount rate to take into account the asset mix and membership age profile? If so, then actuaries could have a significant impact on the one-off charge received by the Treasury.

It should be noted that schemes with a D-Day deficit would lose proportionally more assets, further diminishing their ability to meet pensions-in-payment. A significant simplification would be to apply the haircut to 20% of *assets*, obviating the need for a liabilities valuation. This would, however, risk moral hazard because under-funded schemes would experience a smaller reduction in assets than otherwise.

**2.3 Conclusion: D-Day accruals**

Grandfathering is conceptually simple, but an alternative, a one-off reduction in D-Day accruals, accompanied by a matching charge to DB funds, would take the past EET world into the future world of TEE. It would avoid the need for two operationally cumbersome tax frameworks to co-exist for decades to come, and would also be more attractive from a Treasury perspective.

It should be noted that the *"what of DB?"* question is not specific to the introduction of an ISA-centric, TEE world. It arises if the Treasury were to make any further reductions to the annual and / or Lifetime allowances (AA and LTA, respectively). That said, determining any excess over the LTA, in particular, involves ridiculous complexity for a relatively small £ return to the Treasury.[2] Given that the LTA would be redundant in a TEE world, it should be scrapped for future accruals, but it should we leave it in place in respect of pre-D-Day

2 With DB schemes, a tax liability arises on any excess amount when the expected annual pension multiplied by 20, plus any tax-free cash lump sum if it is additional to the pension, is measured against the LTA.

accruals? Scrapping it entirely would certainly create "political capital" amongst high earners, as well as being a welcome simplification measure.

## 3. DB DEFICITS AS AT D-DAY

### 3.1 Deficits: two components

The legacy of deficit recovery in respect of D-Day accruals has two components:

(i) the deficit as at D-Day; and

(ii) any subsequent (i.e. post-D-Day) deficit development in respect of pre-D-Day accruals.

Given that D-Day deficits would have arisen within the EET framework, then post-D-Day contributions made to recover them should be eligible for tax relief. Or should they? Why should taxpayers be exposed to poor asset selection (subsequently producing deficits), or actuarial assumptions that, with hindsight, proved to be too low? In addition, post-D-Day, would providing tax relief on deficit recovery contributions risk moral hazard (for example, an incentive to maintain a deficit)?

For now, let us assume that tax relief would be provided on D-Day deficit recovery contributions, accompanied by mechanisms to mitigate moral hazard. Corporate scheme sponsors would, of course, also encourage tax relief on contributions to arrest any subsequent (i.e. post-D-Day) deficit development in respect of pre-D-Day accruals.

Note that in a TEE world, contributions towards deficit recovery in respect of post-D-Day accruals would no longer be subsidised by taxpayers.

### 3.2 Sizing the tax relief cost of deficit repair

The Treasury's saving from scrapping tax relief would be slower to emerge than may be expected, because a significant proportion of today's contributions are dedicated to deficit repair rather than in-year accruals. How much?

**(a) Income Tax**

We first have to estimate what proportion of employer contributions are in respect of deficit repair. Over the last eight years, the FTSE 100 employers contributed an average of £15.4 billion per year to their DB schemes, 54% of which was in respect of deficit repair: £8.6 billion per year (Table 1).

An alternative data source is Table 4.3 of the ONS's MQ5 dataset. This shows that over the last six years, an average of 89% of employer contributions were in respect of DB schemes, 37% of which were in respect of "special" contributions to DB schemes, i.e. for deficit repair. In 2014-15, employer contributions attracted £16.3 billion[3] in Income Tax relief, so £5.4 billion would have been in respect of deficit repair.[4]

[3] *Table PEN6;* HMRC. Another £3.2 billion was paid in respect of employer contributions to DC personal pensions.

[4] As £16.3 billion x 89% x 37%.

**Table 1: FTSE 100: employer contributions to DB pensions, £ billion**

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | Average |
|---|---|---|---|---|---|---|---|---|---|
| DB scheme deficit repair | £5.0 | £4.0 | £12.0 | £12.0 | £12.0 | £10.5 | £8.0 | £5.4 | £8.6 |
| DB accruals that year | £8.5 | £8.5 | £6.0 | £5.6 | £5.5 | £6.5 | £6.7 | £7.1 | £6.8 |
| **Total DB contributions** | £13.5 | £12.5 | £18.0 | £17.6 | £17.5 | £17.0 | £14.7 | £12.5 | £15.4 |
| **% deficit repair** | 37% | 32% | 67% | 68% | 69% | 62% | 54% | 43% | 54% |

*Source: LCP's Accounting for pensions 2015. See also the Purple Book 2015's Figure 12.2.*

However, the MQ5 dataset does not include all pension schemes: it is based on a sample of 350 large pension schemes, automatically including all those with more than 20,000 members. Consequently, the aforementioned £5.4 billion should be considered as a low estimate, albeit that given the MQ5's focus on larger schemes, it will capture the significant majority of deficit repair contributions.

Let us settle on a figure of £7 billion as the on-going annual Income Tax relief cost of deficit repair. This is a bit more that the Association of Consulting Actuaries' (ACA) estimate of "perhaps £5 billion" for tax relief is in respect of employers' deficit repair contributions.

**(b) Relief on employers' National Insurance contributions (NICs)**

We should also consider the £13.8 billion of NICs relief provided on c.£69 billion of employer contributions (2014-15).[5] The question is, how much of the £13.8 billion relates to deficit repairing contributions? HMRC data is accompanied by a footnote:

> *This (the £13.8 billion) is a combination of National Insurance relief for employers, on the pension contributions they make, as well as the saving for individuals from the employers' contributions not being treated as part of their gross income and subject to employee NICs (in accordance with how individuals' own pension contributions are treated).*

This does not reveal how the £13.8 billion is divided between employers and employees. Elsewhere, however, HMRC gives a figure of £9.5 billion for the cost of NIC relief on employer contributions, with a footnote stating that the figure *excludes* any consequential change for employee NI charges (which must therefore be £4.3 billion).[6] Of the £9.5 billion, £8.1 billion is in respect of employer contributions to DB schemes[7] so, applying the aforementioned 37%, we arrive at £3 billion as the attributable cost of NI relief in respect of deficit repair contributions.

**3.3 Summary: cost of tax reliefs in respect of deficit repair**

If TEE were to become universal, the Chancellor would come under pressure to retain reliefs on contributions related to addressing D-Day deficits. The combined cost of tax reliefs on employer contributions in respect of deficit repair is roughly £10 billion per annum, based upon evidence from recent years, comprising £7 billion in Income Tax relief and £3 billion in NICs relief. Consequently, the annual saving to the Treasury from ending upfront Income Tax and NICs reliefs would *initially* be reduced to £30.3 billion, offset by the loss of Income Tax from future pensioners (pensioners paid £13 billion last year).[8] This figure would (hopefully) rise over time, as D-Day deficits diminished.

Note: none of the aforementioned figures take into account any funding "circularity" in respect of employer contributions for deficit repair made to funded public service schemes.[9] If today's tax

5 *Table PEN6;* HMRC, February 2016.

6 Footnote 14, *Estimated costs of the principal tax expenditure and structural reliefs;* HMRC, December 2015. Note that £69 billion x 13.8% NICs rate = £9.5 billion.

7 85% of employer contributions were to occupational schemes, the other 15% to personal pensions (which will be DC); PEN6, HMRC.

8 As £26.5 billion in Income Tax relief plus £13.8 billion in NICs relief, less the total of £10 billion estimated to be associated with employer contributions for deficit repair.

9 Notably the Local Government Pension Scheme (LGPS). Most public service pension schemes are unfunded (NHS, the teachers, etc.), so there are no contributions specific to closing deficits.

relief cash flows were to cease, they may have to be made up from other public sector funds, for no net saving.

## 4. TAXING POST-D-DAY ACCRUALS AS A BENEFIT IN KIND

In a post-D-Day TEE world, individuals' DB scheme accruals arising from employer contributions would have to be converted into a single monetary amount ("benefit in kind") for the purpose of assessing Income Tax liability. Few would dispute that the current annual allowance-based methodology is increasingly unfit for purpose, particularly given the much both it and the LTA have been reduced in recent years.[10] The ACA describe it as overly simplistic and riddled with anomalies.[11]

Outlined below are three alternative approaches to determining DB schemes' benefits in kind, arising through employer contributions.

### 4.1 Option A: tax employer contributions

Taxing employer contributions would be by far the most simple method to adopt, because they are readily quantifiable and unambiguous. The scale of a scheme's benefits is ultimately related to the periodic valuations that drive contribution rates. And while a single year's contributions may be out of synch with the long-term requirement to sustain the scheme, over time they serve as a reasonable proxy for the value being received by employees.

Such an approach would, however, favour employees with relatively high annual accrual rates (perhaps high earners or those with long service) because many employer contribution rates are scheme-wide (representing the average of scheme accrual "values"). That said, many scheme members' contribution rates are tiered by salary, with high earners paying more, which helps to redress any imbalance between accrual rate and contribution.[12] In addition, if contributions were set cautiously high, valuations could be overestimated, resulting in accusations of the Treasury taxing prudence. Such criticism should be ignored, not least because in other years there would likely be "low" contributions: over time they would probably balance out.

Some may claim that taxing employer contributions would be unfair, but they should remember that DB schemes are collective structures in which risks are socialised across the membership. As such, they are already inherently "unfair" to many individuals. For example, valuations (which influence contribution rates) are usually based upon membership-wide data for life expectancy, whereas in reality there is a wide disparity amongst individuals.

10 Today, if the pension input amount (PIA) exceeds the AA at the end of the pension input period (PIP), tax is due on the excess at the marginal rate. Calculating the PIA: **DC schemes**: the sum of (tax-relieved) contributions (employee and employer) made during the PIP. **DB schemes**: the value of benefits ("pension savings") accrued over the PIP. This is related to salary, accrual rate and length of service (and is very sensitive to large pay rises combined with long service). The AA is compared with the PIA using a flat annuity rate of £16 per £1 of annual pension. Thus, if the PIA exceeds £2,500, tax is due.

11 For example, due to the use of the flat £16 per £1 annuity rate, in event of a rise in pay or accrual rate, the risk of breaching the AA rises with length of service. It also gives rise to significant valuation anomalies, depending upon how DB is drawn, and also between DC and DB.

12 The NHS's DB scheme, for example, has a flat employer contribution rate of 14.3%, but employee contributions range from 5% (salaries up to £15,432) to 14.5% (salaries over £111,377) of Pensionable Pay, divided into seven salary bands.

In addition:

- there is *already* considerable variance in the current valuations process; it is riddled with unfair flaws and imperfections;[13]
- smaller schemes probably only review their financial status every three years, using approximation in the interim;
- larger schemes do not value every nuance accurately (partly because it would raise unfairness issue if the process were to be broken down to an individual level); and
- different actuaries and firms use different assumptions, resulting in value variations of 10%-15% between similar schemes.

Furthermore, taxation based on employer contributions would probably make much more sense to scheme members than something linked to benefits in kind (i.e. accruals). Membership communication could remind employees that they are participating in a communal structure that (already) entails participation in a form of lottery related to how long they live relative to underlying scheme assumptions.

### 4.2 Option B: tax accruals

Quantifying the value of annual DB accruals is complicated and operationally expensive, particularly if done on a highly granular (i.e. individual) basis. An alternative would be to adopt a scheme-wide average accrual rate for all active members. While operationally simpler, this would be less fair at an individual level, giving rise to "winners" and "losers".

In addition, irrespective of methodology, some form of "certification of fairness" would be required (mostly likely from the Government Actuary's Department, GAD). Interested parties would include employees and their unions, ministers, the media and the public at large, leaving considerable scope for disagreements.

### 4.3 Option C: banding, as a compromise

An ACA-proposed compromise would be to establish a number of bands (akin to Council tax) based upon criteria such as scheme "quality", i.e. generosity of benefits / deemed salary, and the age profile of the membership. Individual schemes would then fall into a given band (or more than one if there were multiple sections), to be taxed accordingly.

Banding could also work at an individual level; e.g. based upon a DB scheme member's age, he would be deemed to have received a benefit worth X% of salary. Not scientific, but it would be relatively simple to operate.

### 4.4 Conclusion: determining the benefit in kind

The methodology for determining the value of DB scheme accruals is essentially a choice between simplicity, fairness, or a mid-range compromise. Given that DB schemes are already inherently "unfair" to many individuals, simplicity should trump fairness: employer contributions should be used as a readily-quantifiable proxy for the annual accrual.

**Proposal 1:** In a post-D-Day TEE world, the employer contribution should be used, for Income Tax assessment purposes, as the proxy for an individual's annual DB scheme accrual ("benefit in kind").

[13] For example, when assessing "pots" against the LTA, the "deemed value" is irrespective of retirement age. Thus, someone with an annual DB pension of £50,000 x factor of 20 = £1 million, yet the pot is clearly worth far more to someone retiring at 55 than someone else retiring at 67.

One benefit of using employer contributions to assess DB scheme benefits in kind would be consistency with the approach used for assessing DC schemes' tax liabilities.

### 4.5 Paying Income Tax on employer contributions

A key objective would be to introduce a mechanism for paying Income Tax that avoids cutting take-home pay. Most employees are more sensitive to this than changes to pension benefits: better to reduce the annual accrual to reflect the tax due.[14] The emerging pension would then be smaller but, in a TEE world, exempt from Income Tax.

#### (a) Scheme Pays, by default

Perhaps the most simple approach would be to develop the existing Scheme Pays framework, which allows schemes to pay any members' tax charges on their behalf (arising from a breach of the annual allowance, for example), with subsequent pension entitlement being reduced. Scheme members could, however, be offered the choice of paying any tax due with their own cash, to avoid a reduction in accrual, the default being that the scheme pays.

#### (b) Integrate any incentive with the tax payment

To the extent that a Treasury-funded bonus were to be payable on employer contributions (as proposed by the author in respect of a Workplace ISA, mirroring the Lifetime ISA's 25% bonus), then it should be integrated with the Income Tax payment mechanism.[15] Consequently, only one net payment would be required, paid by the scheme (or possibly a paternalistic employer).[16] Such an approach would avoid "dry" taxation, i.e. scheme members having to pay tax without having received any cash from the benefit in kind, leading to a potential cashflow management issue.

> **Proposal 2**: As the default, Income Tax on DB accruals arising from employer contributions should be paid by the pension scheme, net of any HMRC incentive due on those contributions. The scheme should be reimbursed by a *pro rata* reduction in the annual accruals. Members should have the right to opt out of this arrangement to pay the tax themselves: there would then be no reduction in their annual accrual.

In a TEE framework, if the bonus were to be set at 20% then, for a basic rate taxpayer, it would cancel out any tax due from the employer contribution. The adjustment to each individual's annual accrual could only be made once the marginal rate of Income Tax had been confirmed, i.e. in the following year (ideally also taking into account any breach of the AA or LTA). The multiplication factor to be applied to the annual accrual could be the subject of debate (currently 16 in respect of comparison against the annual allowance). The payment mechanism should replace today's confusing duopoly of "net pay" and "relief at source".

### 4.6 A sense of perspective: DB in decline

We should retain a sense of perspective. The private sector is increasingly a DB desert (in terms of open schemes): 62% of all private sector DB schemes (by membership) are closed to new members, 16% are closed to future accrual and 22% remain open.[17] Amongst the FTSE 100 com,

[14] Any changes to accruals would have to be accompanied by the necessary legal power to do so, at scheme or employer level.

[15] See *The Workplace ISA; reinforcing auto-enrolment*; Michael Johnson, CPS, April 2016.

[16] The tax liability would be (the employer contribution x marginal rate of tax) - any £ incentive amount.

[17] *The Purple Book; DB pensions universe risk profile 2015, Figure 3.5*; TPR and PPF.

only three companies now providing *any* form of DB pension provision as standard to new recruits: Diageo, Johnson Matthey and Morrisons, each of which offers a cash balance scheme.[18] Table 2 summarises the DB scheme status of the FTSE 100 companies.

Mounting deficits are hastening the private sector's retreat from DB, and the end of contracting out (April 2016, resulting in the loss of NICs rebates) is likely to accelerate the trend.[19] Consequently, whenever the "*what of DB?*" question is posed, it focuses attention on the elephant in the DB room: public service pensions. Indeed, the question is becoming synonymous with the public sector.

## 5. PUBLIC SERVICE PENSIONS IN A TEE WORLD

### 5.1 The issues: inflexible benefits and unfunded schemes

If the TEE framework were to become omnipresent, the Scheme Pays route could be adopted for the public service funded schemes, notably the Local Government Pension Scheme (LGPS), but some 85% of public service employees' pensions are unfunded. Consequently, while there are employer contributions to use as a proxy for quantifying accruals, these schemes have no assets from which to raise the necessary cash. So, what to do?

**(a) Leave unfunded public service pension schemes as EET**

"Do nothing" in respect of the unfunded schemes would perhaps be the most simple solution, but it would leave the Treasury operating two tax frameworks on an on-going basis.

**(b) Move to TEE and reduce the accruals, but forego collecting tax**

Collecting tax from an unfunded public service scheme would, of course, be a circular exercise, a case of the Government paying itself: pointless. Accruals could, however, be reduced by 20%, with pensions subsequently being paid with a 20% tax credit, i.e. tax-free for most people. Self-assessment could be used to capture higher and additional rate taxpaying retirees, with non-taxpayers being reimbursed via an income top-up. Thus, employees would not experience a reduction in take-home pay, although their pensions would be smaller than otherwise, but tax-exempt.

Other "technical accommodations" could, no doubt, be conjured up, but perhaps we should face up to reality, and finally confront the elephant in the room: in their current form, public service pensions are unsustainable.

[18] *Accounting for pensions 2015; LCP's 22nd annual survey of FTSE 100 companies' pension disclosures*, 2015. Tesco is currently closing its career average revalued earnings ("CARE") scheme to new entrants and future accrual.

[19] March 2016's update of the 5,945 schemes in the PPF 7800 Index reports an estimated aggregate deficit of £302.1 billion. The overall funding ratio was 81%, with 82% of schemes in deficit (4,891).

**Table 2: FTSE 100 companies' DB pension scheme status**

| | |
|---|---|
| No DB scheme in UK | 14 |
| DB scheme closed to accrual | 23 |
| DB scheme - final salary, with cap on salary increases | 14 |
| DB scheme - final salary, no cap on salary increases | 36 |
| DB scheme - non final salary | 13 |
| | 100 |

### 5.2 Going to TEE: an opportunity for fundamental reform

#### (a) An escalating cashflow deficit

Unfunded (pay-as-you-go, PAYG) pensions schemes represent a classic case of kicking the (ever-growing) fiscal can down the road and, in so doing, perpetrating intergenerational injustice. Ten years ago, pensions in payment from the unfunded public service schemes were almost entirely met by contributions (from employers and employees), but an £11.2 billion shortfall is expected this year, rising to £14.7 billion in four years' time (Table 3). This cashflow gap has to be plugged by the Treasury, i.e. taxpayers.

In addition, in the 2016 Budget the public service pension schemes discount rate was reduced from CPI + 3% to CPI + 2.8%, adding £2 billion per year to employer contributions (from 2019-20 onwards).[20]

#### (b) A Workplace ISA for all

Propagation of a TEE-based savings framework could serve as a catalyst for replacing all DB public service pension schemes with funded DC arrangements. A Workplace ISA could hold employer contributions, ideally incorporating default collective decumulation via annuitisation (with an opt-out, consistent with "freedom and choice"); employee contributions could go into Lifetime ISAs.

In parallel, the Treasury would have to confront the "pay twice" problem, and continue to meet past DB pension commitments on a PAYG basis.[21] Given the scale of unfunded pension payments (some £35.5 billion last year, £11 billion more than received contributions), transition could take a generation to complete.[22] But, sooner or later, we will most likely have to confront this issue: better to "reef early" (albeit that it is pretty late already).

From an implementation perspective, an interim decade of cash balance schemes (a form of DB) may be politically expedient.[23]

20 *Budget 2016, Table 2.1: Budget 2016 policy decisions;* HM Treasury, March 2016.

21 The "pay twice" problem: today, employer contributions in respect of today's accruals are used to pay pensions. Moving to funded DC schemes would mean that employer contributions would, in future, go into the current generation of employees' own DC pots, i.e. they would be unavailable to pay today's pensioners.

22 *Public Expenditure Statistical Analyses 2015, Table D.1 Pay as you go public service pensions schemes in AME and in TME;* HM Treasury, 2015.

23 Cash balance schemes promise a funded pot size at retirement, not a specific, ongoing, income in retirement. Contributions are accumulated in members' retirement accounts, the employer providing an assured minimum rate of return on the account (such as CPI), thereby assuming the investment risk, up until retirement. At retirement, the "cash balance" is passed to the retiree who then assumes his own longevity risk.

**Table 3: Unfunded public service pension schemes: the cashflow deficit**

| *£ billion* | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Outturn** | £0.2 | £1.1 | £2.2 | £3.1 | £4.7 | £5.6 | £8.0 | £10.2 | £10.9 | £12.3 |

| | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 | 2020-21 |
|---|---|---|---|---|---|---|
| **OBR forecast** | £11.5 | £11.2 | £12.1 | £13.7 | £13.2 | £14.7 |

*Source: Economic and Fiscal Outlook, Table 4.15: Total managed expenditure; OBR, March 2016.*

### (c) Incentives

#### (i) Earlier access

Following the Hutton review, public service pensions are now tied to the State Pension age (SPA), 66 for both men and women, by October 2020, and 67 in 2028. In addition, John Cridland is currently conducting a review of the SPA. His report, due by May 2017, will exclude the existing SPA timetable to April 2028, but it could accelerate the timetable for increasing it to 68 (currently scheduled in 2046). Current forecasts for life expectancy suggests that the State Pension age (SPA) should rise to 68 in the mid-2030s and to 69 in the late 2040s.

For many public service workers, a workforce pension commencing so late could prove untenable. Consequently, the prospect of being able to access both Lifetime and Workplace ISAs at 60 could prove very appealing.

#### (ii) Perhaps a 50% bonus

The Lifetime ISA will be launched in April 2017 with a 25% bonus (i.e. 25p per post-tax £1 saved) on contributions up to £4,000 per year. It is envisaged that any Workplace ISA would benefit from the same bonus. However, as a *quid pro quo* for closing today's DB schemes, perhaps we could set the Lifetime and Workplace ISAs' bonuses at 50% for public service employees, capped at an amount to be determined by Treasury cost modelling? This would be *double* the 25p that basic rate taxpayers (i.e. most people) receive today through tax relief. Indeed, it would be *better* than EEE, a very good reason *not* to carve DB schemes out of a TEE regime.

### 5.3 An example

Table 4 compares pot sizes based upon 20% tax relief and the Workplace ISA's 50% bonus, for the LGPS's average annual contribution (£4,958) made over 40 years of service.[24]

Assuming a modest 2% annual real growth rate for investment (net of costs), the average LGPS member would, after 40 years, have a pot of over £458,000.[25] This would be sufficient to generate a lifetime pension of over £14,600 from the age of 65,[26] nearly two and half times the average LGPS pension paid last year, of £5,986.[27]

Cost modelling may determine that a 50% bonus rate would not be sustainable over the long term;

[24] Total LGPS contributions of £9.39 billion, as £7.32 billion from employers and £2.07 billion from 1.894 million contributing members (2014-15).

[25] Why "only" 2%? We should be mindful of the risk of long-term flat or negative real returns from fixed income, sclerotic investment returns elsewhere, and a developed world potentially on the cusp of going ex-growth.

[26] As £3,193 per £100,000 purchase price, for a single life, RPI-linked annuity with a five year guarantee. Paid monthly in advance, based on an average postcode and basic personal details, as at 10 March 2016. *Source*: HL website.

[27] As £7.13 billion in pension payments to retired employees and dependents divided by 1,489,175 pensioners (i.e. retired employees or dependents) *plus* another 25% to take into account lump sum payments on retirement.

**Table 4: DC pot size after 40 years of contributions**

| Investment real annual growth | Basic rate tax relief | 50p incentive per post-tax £1 | Pension from age 65 |
|---|---|---|---|
| 1% | £306,003 | £367,204 | £11,725 |
| 2% | £381,828 | £458,194 | £14,630 |
| 3% | £481,318 | £577,582 | £18,442 |

this would have to form part of any negotiations with the unions.

**Proposal 3**: The introduction of an omnipresent TEE framework could serve as a catalyst for replacing DB public service pension schemes with funded DC provision: a Lifetime ISA for employee contributions, and a Workplace ISA for employer contributions. The latter could incorporate default collective decumulation via annuitisation (with an opt-out, consistent with "freedom and choice"). Both ISAs could be accompanied by a 50% bonus, capped at an amount to be determined by Treasury cost modelling.

## 6. CONCLUSION

The *"What of DB in a TEE world"?* question can be resolved without triggering operational paralysis amongst industry providers: it is as much a question of will. Strong leadership from government may be required, but recall that other nations have successfully transitioned from an EET savings framework, including Australia (to ttE, since 2007) and New Zealand (to TTE).[28] Indeed New Zealand ceased all up-front tax incentives on pensions contributions overnight on 17 December 1987, i.e. without *any* warning. It can be done.[29]

[28] 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.

[29] For more detail, see Chapter 9 of *An ISA-centric savings world*; Michael Johnson, CPS, October 2015. Note that both Australia and New Zealand 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. 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.

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