'Strengthening the incentive to save: a consultation on pensions tax relief' – a response from The Investment Association

30th September 2015

Introductory comments

1. The Investment Association[1] welcomes the government's decision to consider whether the current tax treatment and incentives for pension saving best support individuals to save for their retirement.

2. With Defined Contribution (DC) now established as the dominant form of pension provision in the private sector, it is a good time to ask how the system can be best set up to increase savings and to deliver best value to the taxpayer for a given level of tax incentivisation. While automatic enrolment is well on the way to solving the problem of years of declining workplace pension coverage, it will not, at legislated levels of contributions, be enough to deliver the standard of living in retirement to which most people aspire.

3. At the same time, we share the government's view that the shift from Defined Benefit (DB) to DC changes the context for the current system. Since the amount saved by individuals will now to a greater extent dictate their standard of living in retirement, the visibility and effectiveness of savings incentives becomes more important. So does the value for money and transparency of the products offered by the pensions and investment management sector.

4. Our response is underpinned by the following observations about the nature and role of savings incentives:

   - It is extremely difficult to find a solution that satisfies all of the government's ambitions. There is a clear and longstanding logic to the current system of tax relief, based on tax being paid at the point of income. However, with respect to the first of the principles (simplicity and transparency for savers), its inherent logic is not well understood. This is partly because the deferred taxation nature of the current incentive is not the same as a real cash incentive such as the tax free lump sum or a match provided on a net-of-pay contribution.

   - There is limited evidence about the effectiveness of fiscal incentives in increasing savings levels, particularly among middle and low income groups. However, there is evidence that the existence of incentives, particularly an employer matching contribution, can have a positive impact on scheme participation. This underscores the importance of the workplace as a highly successful conduit to pension saving.

   - Behavioural economics insight shows that individuals do not respond to economic incentives in the way that traditional economic theory suggests that they might. In the context of the tax relief debate, we are concerned about the behavioural implications of any move to back load fiscal incentives over a long period of pension savings. Behavioural testing is likely to indicate that savers will prefer an 'incentive' that appears to be 'upfront' and a larger initial account balance in exchange for locking away their contributions.

[1] The Investment Association represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of around £5.5 trillion of assets in the UK on behalf of domestic and overseas investors.

5. This leads to three main conclusions:

    - While simple conceptually, we do not propose a move to TEE for workplace pensions. It poses too many risks to individual behaviour, employer involvement and the automatic enrolment process more broadly. This should not detract from the inherent strength of the ISA regime as a vehicle for accessible savings. ISAs can encourage savers to invest for important life events, such as paying for higher education through JISAs, or buying a home through the new Help-to-Buy ISA. They are also used by many individuals to provide a pool of capital from which they can draw to supplement their income as they get older.

    - A reformed EET, maintaining national insurance exemptions for employer contributions, reduces the risk of significant disruption to automatic enrolment. Avoiding this disruption should be the near term priority. A number of reform options are available to target incentives on those seen by the government as most in need of support. Options include a single flat-rate of relief, cash matching of contributions, or a restructuring of the tax free lump sum. Government should test alternative designs with pension savers to determine what might be the most effective incentive. Other measures to be considered should include removal of the Lifetime Allowance (LTA) for DC schemes. An LTA dependent on the impact of investment returns creates uncertainty for those individuals close to it and reduces or removes their incentive to save in a pension.

    - While we do not have a strong recommendation on the shape of EET reform, we would encourage government to minimise both the complexity that might arise in some combinations of reform (for example, different treatment of employer and employee contributions in the DC system), and the potential for perceived favourable treatment of DB over DC (for example, different treatment of employee DB and DC contributions).

6. Whatever the final shape of reform, it is absolutely essential that a long-term commitment to durability is made. The current system has been subject to near constant change in recent years, with measures becoming increasingly complex. From an individual saver’s perspective, constant change to the shape of the system can have an impact on investment decisions and therefore, outcomes. If a new reform merely contributes to the impression that a central driver is fiscal economies with further measures to follow, it will fail to instil confidence in the ability of government to plan long term for its citizens' long-term needs.

7. At a broader level, it is clear that a range of factors beyond fiscal incentives require attention in order to ensure that consumers can maintain confidence in their long-term retirement saving. These include ensuring that charges and costs within pension and investment products are transparent at every level; that the right set of products are available for the new retirement landscape; and that individuals receive appropriate support throughout both the accumulation and decumulation stages in navigating their options for turning their pension savings into an income in retirement.

8. More fundamentally, there is scope to examine how both pensions and ISAs can encourage savers to invest to a greater extent in assets that have a much better

chance of delivering them good outcomes over the longer term than cash. By aiding the flow of capital to productive uses in the economy, this can also help strengthen the link between individual outcomes and broader economic growth.

9. In this regard, we note the imbalance within the economy between the asset base of residential non-occupier property investment (buy-to-let) and other forms of long-term investment, including pensions and stocks and shares ISAs[2]. This imbalance reinforces the need, in our view, for a broader plan to demonstrate the value of long-term productive investment for returns both to individuals and the broader economy.

10. Our response is in two main sections:

   - Section One comments on the government's principles.
   - Section Two answers the specific questions in the consultation document.
   - Annex One considers the evidence to support the effectiveness of tax incentives in encouraging pension saving.
   - Annex Two presents some more detailed work on the nature of EET and TEE systems.

[2] The Council for Mortgage Lenders estimates that there is currently around £990 billion of wealth in the private rented ('buy-to-let') housing market. In comparison, HMRC estimates that there is currently around £245 billion held in stocks and shares ISAs, while the DC workplace pensions market was estimated to have assets of around £277 billion at the start of the year. Data sources are as follows: for data on the 'buy-to-let' market see Council of Mortgage Lenders, '*Housing Wealth grew 8% in 2014';* for data on ISAs, see HMRC, 'Individual Savings Account (ISA) Statistics', August 2014, table 9.6; for estimated size of DC workplace pensions market, see Spence Johnson, '*Deeper Perspectives: 2014 – the year of the mastertrust'* number 24, January 2015.

SECTION ONE: Principles for supporting retirement saving

11. The government has set out a number of principles in its consultation paper that any reform should meet:

    - "It should be **simple and transparent**. The government believes that greater simplicity and transparency may encourage greater engagement with pension saving and strengthen the incentive for individuals to save into a pension.
    - It should allow individuals to take **personal responsibility** for ensuring they have adequate savings for retirement. It should encourage people to save enough during their working lives to meet their aspirations for a sufficient standard of living in retirement.
    - It should **build on the early success of automatic enrolment** in encouraging new people to save more.
    - It should be **sustainable**. Any proposal for reform should also be in line with the government's long-term fiscal strategy."

12. We believe that as the government considers retirement issues (in a tax reform context or otherwise), its first priority should be to encourage individuals (and employers) to generate adequate retirement income. We therefore welcome the emphasis on individual engagement and personal responsibility within the automatic enrolment context.

13. These principles are therefore a strong starting point but we also welcome the recognition in the paper that there may be tensions between them. In particular, we believe there is a fundamental tension between the kind of rational expectations that would drive the first two principles (simplicity and personal responsibility) and the behavioural biases that have driven the need for automatic enrolment, and will likely drive the need for further intervention such as automatic escalation of contributions. This inclines us towards considerable caution in expecting that any change to tax incentives will on its own fundamentally change savings behaviour. It also explains our concern about abandoning the EET system.

14. We also believe that the early success of automatic enrolment has an implicit embedded assumption about the central role of the employer, which could be spelt out. With the shift of all risk in DC to the employee, the role of the employer becomes even more critical in ensuring that their employees end up with good outcomes. This can be best achieved through the selection of high-quality, well governed pension schemes, with high levels of contributions being paid in. Employers need to be incentivised to do this and anything that makes pensions more expensive and burdensome is likely to lead to them being seen as a compliance issue as opposed to an important part of the remuneration package.

15. In that context, while we recognise that the NI relief enjoyed by employers on the pension contributions they make is less publicised and expensive - £14 billion in 2013/14[3] – we do not believe it would be appropriate to remove the exemption. Since the available evidence suggests that tax incentives are relatively limited in their

[3] HMRC, Table PEN 6 'Cost of Registered Pension Scheme Tax Relief', updated February 2015.

success at the individual level, it would make more sense to look to control costs in relation to individual tax incentives. Essentially, reducing the generosity of individual tax incentives is likely to be far less damaging in the long run than reducing the employer's incentive to contribute more than the auto-enrolment minimum.

16. We would further encourage the government to consider adding the following two principles:

    - **Policy durability** – This is more than simply fiscal sustainability. It is the idea that any new settlement should be for the long term and not subject to constant change. In order to achieve this political consensus is vital. Durability may encourage greater engagement with pension saving and strengthen the incentive for individuals to save into a pension.

    - **Long-term investment should be rewarded** – Individuals need to earn a premium for locking up their savings for the long term. Without this there may not be a strong enough incentive to tie money up for decades. An illiquidity premium aligns the investment horizon of the individual saver with the demands of the economy for long term financing.

Creating a long-term savings culture

17. This second additional principle is linked to the need to create a stronger long-term savings culture. Automatic enrolment (AE) into DC pensions represents for many in the AE 'target-market' their first direct exposure to capital markets as a way of generating a future pension income. For many savers the concept of investing in market instruments to generate income and increase savings is an alien and disquieting concept[4] and persuading individuals to take risk over extended periods of time is a challenging task.

18. Much is made of the greater popularity of ISAs compared to pensions. However, this may be a better indicator of attitudes to investment risk than a reliable comparator between the ISA and the pension. Data from HMRC shows that ISAs are largely a cash brand for some segments of the market – with cash ISAs dominant both in terms of the number of accounts subscribed to annually and the amounts contributed.[5] This is particularly the case for the less affluent groups in society – the same HMRC data shows, for example, that around 60% of cash ISA holders earned less than £20,000 per annum, but the same group held around 45% of all stocks and shares ISAs. For those earning over £30,000 per annum, stocks and shares ISAs were more popular than cash. The comparison with pensions is therefore not correct because it is not like-for-like; these are very different products. Left to their own devices it would appear that there are some segments of the market that prefer the certainty and perceived lower risk of saving in cash deposits.

19. Of course, the architecture of automatic enrolment to a great extent ensures that individuals saving in pension plans do not simply put their holdings in cash, thus protecting them against the risk of undersaving and inflation reducing the real value of their savings. The reliance on default investment strategies is crucial in mitigating

[4] See for example, *'Attitudes to Pensions'*, DWP, 2009 or *'Attitudes towards investment choice and risk within the personal accounts scheme: Report of a qualitative study'* DWP, 2009.
[5] 'Individual Savings Account Statistics', HMRC. Available to download at https://www.gov.uk/government/collections/individual-savings-accounts-isa-statistics

inherent investment risk aversion. The critical question here, however, is how to persuade individuals to make the contributions commensurate with the level of retirement income that many expect.

20. The need to invest to generate long term savings is not just an issue for the individual. At the heart of economic growth and strong returns to savers lies efficient allocation of capital. For both individuals and companies, long-term investment not cash accounts represents the route to such efficiency. The long-term savings and pensions regime should be designed to recognise this, providing savers with a form of illiquidity premium to reward those who lock away money for future retirement needs. More generally, any reform to tax incentives should strengthen the link between pensions and long term investment, not weaken it. Any change that makes short term investment or cash holdings more attractive would be to the detriment of both individuals and the economy.

Sustainability and measuring the cost of tax relief

21. One of the arguments cited for reforming the system is its growing cost – estimated at close to £50 billion in 2013/14 by HMRC, a figure mentioned by the government in its consultation document. The government recognises that this may not represent an accurate cost of the system but nonetheless, estimates produced using this methodology do appear to be the basis for decision-making on the reform of the system, as witnessed by the reductions in relief for those earning £150,000 or more. Some of these changes have not yet shown up in the data but on the government's own methodology, we would expect the cost of the system to be lower today as a result.

22. We would argue that that the uncertainty around the true cost of the system underscores the point that cost should not be the key driver for decision-making on the future shape of pensions tax relief.

23. The Institute for Fiscal Studies[6] has articulated why the current methodology for estimating the cost of pensions tax relief is highly likely to be an overstatement. Briefly, the expenditure on tax relief is measured on annual 'cash flow' basis that considers in any given year only the foregone income tax on pension contributions net of the income tax paid by today's pensioners. This methodology is a misleading measure of the true value of the tax treatment of retirement savings because it fails to account for future revenue outside the annual measurement window; and this future revenue is likely to be higher for two reasons. First, real growth in per-capita national income means that today's working-age individuals are very likely, on average, to have higher pension incomes than today's retirees. Second, demographic change means that the current working-age population will, when they reach retirement, be more numerous at each age than the current retiree population.

24. The corollary of this measurement error is that any reduction in retirement savings today, while raising revenue in the short term, will mean the government actually collects less revenue in future, because retirees will have less taxable retirement income.

[6] *Taxation of Private Pensions'* , 2014 Green Budget, Institute for Fiscal Studies.

25. This discussion emphasises our earlier point that in considering the pension system, the government's first priority should be to encourage individuals and employers to generate adequate retirement income; and that the cost of the system has to be considered in this broader context.

SECTION TWO: ANSWERS TO SPECIFIC QUESTIONS

Q1: To what extent does the complexity of the current system undermine the incentive for individuals to save into a pension?

Q2: Do respondents believe that a simpler system is likely to result in greater engagement with pension saving? If so, how could the system be simplified to strengthen the incentive for individuals to save into a pension?

26. At a general level, the complexity of the current system is undoubtedly undermining the incentive for some income groups, but not those that the government is most concerned about with respect to broader retirement saving. Arguably, the broader risk is the negative message that frequent announcements of change send about the durability of the system.

27. However, there is a broader problem here in discussing incentives. The evidence around the effectiveness of tax incentives in encouraging pension saving is limited. Further detail can be found in Annex One of this response, but to summarise, the key findings from this literature are that:

    - Understanding of the tax incentives around pensions is low and this is likely to dilute their effectiveness. For lower income groups, tax relief is not an important determinant of the decision to save. In contrast, employer contributions do have an impact on the decisions of individuals as to whether to be members of pension schemes.

    - Tax incentives for pensions have not led to significant levels of additional savings overall; money that would have been saved in other vehicles has instead been diverted to pensions.

    - Individuals with higher incomes, who may be more likely to save, are more likely to respond to incentives. Evidence from the UK and US suggests that it is those on higher incomes that are more likely to save into pensions, but that much of this saving is diverted from other savings vehicles. Those on lower and middle incomes are less likely to be saving in a pension or any other savings vehicle; and therefore any successful attempt to incentivise this group may lead to additional saving.

28. Furthermore, there is a significant tension between classical economic theory, which suggests that consumers should react rationally to incentives, and behavioural economics, which suggests – with some justification – that they often do not. This creates a considerable challenge for policymakers given the lack of compelling evidence about the effectiveness of fiscal incentives in raising overall savings levels, even if they are sometimes successful in channelling existing savings, or new money that would be saved anyway, in particular directions.

29. This challenge is magnified by the true nature of the current fiscal treatment of pensions in the UK, and indeed in many other parts of the world. Broadly speaking, the dominant paradigm (EET) sees contributions exempt from marginal rates of income tax (E), investment returns exempt from capital gains tax (E) and retirement income subject to marginal rates of tax (T).

30. The logic behind the EET paradigm is poorly understood, particularly by savers. Contrary to widespread belief, there is no inherent incentive in this structure beyond the ability to smooth rates of income tax over the individual's lifetime. All things being equal, the outcome under EET is no different to TEE (ISA-type regime), with the exception of one group: those who pay higher rates of income tax during their working life than they do in retirement. The true incentives in the UK system are the 25% tax free lump sum (TFLS) and the considerable fiscal support for employer contributions using exemption from National Insurance contributions.

31. If these points are taken together, the pros and cons for government in dismantling the current system become clearer but not necessarily easier to resolve. We believe that a reformed EET system (e.g. limited to basic rate relief or some form of additional flat-rate match), while making the system cheaper to operate, will not necessarily meet the government's simplicity principle. If simplicity was the central criterion and an idealised pensions system was being constructed, the model that would arguably most credibly satisfy the simplicity criterion is TEE with a matching contribution. In other words, savings are made out of post-tax earnings, and exempt from any further tax. However, we are not constructing a brand new system and that is a critical point emphasised in other principles, notably the success of automatic enrolment.

32. While decoupling incentives from marginal rates of tax would allow greater targeting of incentives, any move away from marginal rates will likely create more complexities in payroll and large variations in effective marginal rates of tax for individuals. For that reason alone, it should not be undertaken lightly. This is as true for a reformed EET structure with a match offered up front as it is for a TEE system. Both effectively move to net pay as a starting point for individual contributions, blurring the lines between TEE and EET.

33. A behavioural economics experiment might also add a further degree of challenge for policymakers. A simplified calculation shows that the final pot for a basic rate tax payer would return roughly the same net lump sum on retirement under *TEE with a 10p/£1 match* as under *EET where the front-end relief was 30p/£1 and the tax free lump sum was maintained*. Would 30p up front be more persuasive than 10p? Would 10p persuade people to put money into a locked box rather than an accessible ISA?

34. There are, of course, many ways in which incentives could be structured and presented, which might make a match look more attractive – for example, 100% matching up to the first £500 contributed annually; or 50% matching up to the first £1000 or 25% up to the first £2,000 etc. Ideally, a number of different presentations should be tested on consumers.

35. This illustrates the need for a more thorough behavioural analysis to understand the impact of how a "matching" or "tax relief" presentation will impact saver behaviour, and whether savers respond better to incentives that are offered on a net basis (such as a 'buy-two-get-one-free' offer) or as tax relief.

Q3: Would an alternative system allow individuals to take greater personal responsibility for saving an adequate amount for retirement, particularly in the context of the shift to defined contribution pensions?

36. We believe the fundamental way of allowing individuals to take greater responsibility within the context of the shift to DC is to remove the Lifetime Allowance (LTA) for DC pensions and use the Annual Allowance as the main cost control lever, lowering it as appropriate. This would make it clear that individuals saving in a DC pension would be unambiguously better off – more money going in would result in a higher income in retirement. From the government's perspective, maintaining the EET structure would also mean the State retains a claim on this increased pension wealth.

37. A Lifetime Allowance that is subject to inherently unpredictable long-term investment returns is particularly problematic since it means that market movements could push individuals' pension pots above or pull them below the LTA, possibly on multiple occasions, with associated tax consequences. Furthermore, a pension is a long term investment and with the benefit of time, should be invested in asset classes that generate growth in the economy and strong returns for the investor. Because of the need to avoid breaching the LTA, it risks diverting the investments of those close to it into less volatile assets such as cash and government bonds that may be less productive for the economy and less profitable for the investor, in turn reducing the potential for a better outcome in retirement.

Q4: Would an alternative system allow individuals to plan better for how they use their savings in retirement?

38. The central planning challenges in a DC and Freedom and Choice world are likely to be dominated by the question of how to secure a sustainable income in later life, overlaid by considerations about how to plan for expenditure shocks such as ill health and care needs. With respect to tax treatment specifically, the simplification offered by TEE would remove one layer from the planning process for individuals. However, for reasons that we set out, we do not see this as a compelling argument for a move to TEE. Perhaps the most important issue regarding tax treatment is likely to be predictability, which relates to the durability point we raise as a guiding principle.

Q5: Should the government consider differential treatment for defined benefit and defined contribution pensions? If so, how should each be treated?

39. Our response has deliberately focused on the tax structure for DC pensions. When thinking about tax incentives there is a need to make a distinction between DB schemes and DC schemes. The former are largely a legacy issue in the private sector, with the majority of contributions being paid by employers, often to close deficits. The issue of individual incentives simply does not arise in these cases and anything that increases the funding costs of these schemes simply risks further undermining the sustainability of funded DB schemes. Furthermore in the context of employer budgets and the hard nature of the DB promise, any increase in the costs of DB funding is likely to feed through to a levelling down of DC contributions, putting at risk the early success of automatic enrolment and further highlighting the differences between contributions in DB and DC schemes. In unfunded public sector

DB schemes, the issues are once again different given the Pay-As-You-Go nature of these schemes.

40. On balance, given the risks and complexity of change, we would favour a solution that minimises the costs and disruption of any change for DB schemes. DC is very much the future of the pension system and it makes sense to think about a future system of tax incentives that is shaped around DC provision. The important point will be to ensure that however tax incentives are granted to DC pensions, they should not be any less generous than tax incentives for DB schemes. Individuals contributing an identical amount to their pension should receive the same value of tax incentive regardless of the type of scheme they are in.

Q6: What administrative barriers exist to reforming the system of pensions tax, particularly in the context of automatic enrolment? How could these best be overcome?

41. One major practical consideration in the context of automatic enrolment is whether it is necessary to interrupt a process that has already seen five million people automatically enrolled into pensions, and put in a place a new system of pensions tax (as would be the case in any move away from a pure EET system that provides relief at the marginal rate). It is not clear to us that the upheaval would be justified, particularly given the wider behavioural elements we outline in our answers above.

42. In addition, a major change in the treatment of pensions tax could require pension providers to run parallel accounting and administration systems in order to cater for the two models, old and new. This would come with material development costs. Again, these considerations suggest that a major reform presents a real risk to automatic enrolment.

Q7: How should employer pension contributions be treated under any reform of pensions tax relief?

43. As previously discussed, we believe that the hugely important role of employers in pension provision must be recognised and that they are incentivised to go beyond the minimum requirements of their duties under automatic enrolment. To this end, we recommend that the NI exemption on employer pension contributions is maintained. Any change to this exemption risks turning pensions into little more than a compliance issue for some employers.

Q8: How can the government make sure that any reform of pensions tax relief is sustainable for the future?

44. As well as sustainability, we have argued that durability of a new pensions tax settlement is important. In order to achieve this, government should ensure that it has just one or at most two levers to control costs, which do not undermine individual incentives to save in a pension, in the way that piecemeal changes have distorted incentives and created further complexity in the current system. As discussed above we believe that an approach for DC schemes that involves a lower AA and no LTA is the best way to achieve this.

ANNEX ONE: The efficacy of tax incentives in encouraging pension saving

1. The evidence around the effectiveness of tax incentives in encouraging pension saving is limited. A 2013 report published by the Pensions Policy Institute[7] provides an excellent overview of the literature on the effectiveness of tax incentives in encouraging retirement saving.

2. To summarise, the key findings from this literature are that:

    - Understanding of the tax incentives around pensions is low and this is likely to dilute their effectiveness. For lower income groups, tax relief is not an important determinant of the decision to save.

    - Tax incentives for pensions have not led to significant levels of additional savings overall; money that would have been saved in other vehicles has instead been diverted to pensions.

    - Individuals with higher incomes, who may be more likely to save, are more likely to respond to incentives. Evidence from the UK and US suggests that it is those on higher incomes that are more likely to save into pensions, but that much of this saving is diverted from other savings vehicles. Those on lower and middle incomes are less likely to be saving in a pension or any other savings vehicle; and therefore any successful attempt to incentivise this group may lead to additional saving.

Table 1: Income tax payers in 2012/13: income distribution of all income tax payers and pension contributions attracting tax relief

Range of gross income (£)		Number of income tax payers		Tax paid		Contributions to occupational and personal pensions attracting tax relief		Tax relief received*	
From	To	'000s	% of total	£ billion	% of total	£ billion	% of total	£ billion	% of total
0	19,999	14,350	47%	14.5	9%	1.9	9%	2.1	8%
20,000	29,999	7,210	24%	21.9	14%	3.2	15%	3.5	13%
30,000	49,999	6,080	20%	34.0	22%	6.7	30%	7.2	27%
50,000	69,999	1,500	5%	7.7	5%	3.2	15%	3.6	13%
70,000	99,999	746	2%	15.5	10%	2.2	10%	2.5	9%
100,000	149,999	394	1%	14.3	9%	1.9	9%	2.2	8%
150,000	And over	304	1%	39.3	25%	3	14%	5.5	21%
Total		**30,600**		**157**		**22**		**26.7**	

- *Includes non-pensions related reliefs accounting for just under 20% of total value of reliefs.
- Source: HMRC Personal Income Statistics 2012/13, Tables 3.3 and 3.8

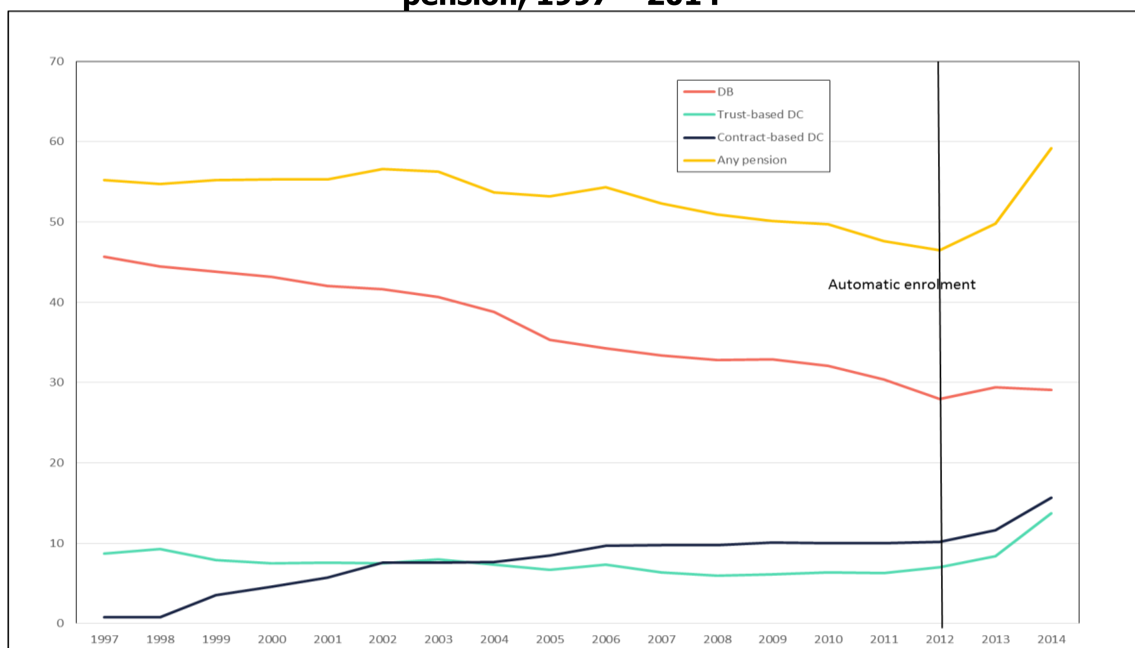
3. This final point can be seen in the distributional data on pensions tax relief in the UK (see Table 1 above) where the progressivity of the tax system is reflected in a greater proportion of pensions tax relief going to those individuals paying more tax (precisely because they are making the bulk of pension contributions). This group of

[7] *'Tax relief for pension saving in the UK'*, Pensions Policy Institute, July 2013.

people may well be more likely to save in the first place, in which case it could be legitimate to ask, in the context of the UK system, if the incentive of the tax-free lump sum is well-targeted – on the assumption that tax incentives should be targeted at those who otherwise may not save.

4. Taking all this together with the general decline in pension saving (see Chart 1) that has only recently been reversed under automatic enrolment it is hard to argue that tax incentives on pension saving have been particularly effective in the UK, if the objective of such incentives is to boost saving. Of course we cannot observe the counterfactual and it may be that coverage would have been even lower in the absence of tax incentives, but whether or not this is true, it is irrelevant in the context of workplace pension coverage that has been falling until relatively recently.

Chart 1: Proportion of employees with workplace pensions: by type of pension, 1997 – 2014



Source: ONS, Annual Survey of Hours and Earnings

5. None of this implies that tax incentives to save for retirement should be removed. Indeed, in the absence of any incentive, it is highly unlikely that individuals would be prepared to lock money away for the future, especially when there are alternative savings products available that allow individuals to access their savings when they wish.

6. The issue is then to consider how the design of tax incentives could be improved. In this regard, there is a related literature[8] – on the effects of employer matching of individual contributions to pension plans – that may provide some insights into the kind of incentives that could work to increase savings.

7. A key lesson is that the visibility of the incentive is important – multiple studies show that employer matching of individual contributions is demonstrably effective in

[8] See for example Papke (1995), Even and Macpherson (1996), Kusko, Poterba, and Wilcox (1994), Basset, Fleming and Rodrigues (1998), Engelhardt and Kumar (2004), and Even and Macpherson (2004) for evidence on the effects of employer matching and its level on participation rates, as well as the effects of plan design on contributions.

achieving high levels of participation. However, there is also significant evidence that it is the existence of a match, rather than its level that is what matters – providing a match raises saving, but an increase in the level of the match rate (conditional on providing a match) does not.

8. Plan design is important. In a number of studies, contributions clustered at specific thresholds built in to the design of the plan, so called "kink points". These include contributing nothing, contributing at the level that obtains the highest level of employer match, or contributing at the maximum amount allowed under the rules of the plan. When the levels of such thresholds change, existing plan participants move very slowly to the new threshold-points (because of inertia) – but new entrants go straight to the new thresholds.

9. The implications of this literature for the design of tax incentives are interesting. Whilst the UK has reversed the decline in workplace pension coverage with auto-enrolment, it remains to be seen whether the opt-out rate will remain at around the current level of 12%[9] when employee contributions are phased up from the low initial rate of 1%. A system of tax incentives presented as matching contributions may help maintain the high level of participation currently enjoyed under auto-enrolment.

10. Plan design and "kink points" can be used to drive behaviour, and may need to be deliberately inserted into a tax incentive structure. The tax system for long term savings products in the UK does not incorporate kink points – simple annual savings limits for pensions and ISAs may not be enough to maximise savings. An incentive structure that provided different levels of match at different contribution levels could be effective if the goal was to raise contribution rates from the legislative minimum.

[9] '*Automatic enrolment opt out rates: Findings from qualitative research with employers staging in 2014'*, DWP, 2014

ANNEX TWO: The nature of EET and TEE systems

1. The existing system of pension taxation in the UK, in common with European systems and many around the world, operates on the following principles:

    - Pension contributions are exempt from income tax (E);
    - Once invested, returns on these contributions build up free of tax[10] (E);
    - Pension income in receipt is taxed at marginal rates of income tax (T).

2. We do not believe that an 'EET' system in and of itself constitutes tax relief – it is instead a way of taxing pension income as it arises. It is therefore more correctly characterised as income deferral or tax-rate smoothing.

3. Someone who is a basic rate payer in working life and retirement is merely deferring their income tax liability. An individual who pays higher or additional rate tax in their working life and basic rate in retirement can be said to be smoothing their tax liability – the EET system allows changes in the marginal tax rate to be evened out over the individual's lifetime. Though not a tax incentive in itself, it can be perceived by individuals to be advantageous.

4. The key point is that EET on its own does not inherently constitute an incentive structure for pension savings – it is merely a way of taxing pensions.

5. There are only two genuine tax incentives in the UK system designed to encourage pension saving – one for individuals and one for employers.

    - For individuals there is the option to take a Tax Free Lump Sum (TFLS) of up to 25% of the value of their benefits (subject to the Lifetime Allowance);

    - Employers are incentivised to remunerate their employees via pensions since contributions made by the former on behalf of the latter do not attract Employer National Insurance Contributions. This makes it more cost effective to remunerate employees through pensions rather than wages.

A comparison of 'EET' and 'TEE'

6. One of the ideas mentioned in the consultation document for a "fundamental" reform of the system is to alter the point at which pension savings are taxed to a 'TEE' system:

    - Pension contributions would be made from post-tax income tax (T);
    - Once invested, returns on these contributions build up free of tax[11] (E);
    - Pension income in receipt is not subject to tax (E).

7. As with EET, TEE is merely another way of taxing pensions, with the tax (effectively) levied on pension contributions (since by reducing income, the tax reduces the amount of money that goes into the pension, unless the individual chooses to

[10] Though returns credited to pension funds will have been reduced by corporation tax and transaction taxes where appropriate.
[11] See footnote 10.

maintain the level of pension contribution and accept a lower level of consumption today).

8. The difference between EET and TEE for the individual experience is less than is often imagined. In fact as Table 2 below demonstrates, for an individual who faces the same marginal tax rate throughout their lifetime, there is no difference between TEE and EET. Importantly, the benefit of compounding in tax relief in an EET system is offset by additional tax at the point that the income is received.

9. The figures also illustrate the incentive provided by a tax free lump sum within an EET framework (as is currently the case for UK pensions).

Table 2: Comparing TEE and EET

	Pre-tax contribution	Post-tax contribution	After 10 years*	Final available
Constant marginal tax rate (20%)				
		T	E	E
TEE system	**£5,000**	**£4,000**	**£6,516**	**£6,516**
		E	E	T
Pure EET system	**£5,000**	**£5,000**	**£8,144**	**£6,516**
EET system with 25% TFLS	**£5,000**	**£5,000**	**£8,144**	**£6,923**
Changing marginal tax rate (40% → 20%)				
		T	E	E
TEE system	**£5,000**	**£3,000**	**£4,887**	**£4,887**
		E	E	T
Pure EET system	**£5,000**	**£5,000**	**£8,144**	**£6,516**
EET system with 25% TFLS	**£5,000**	**£5,000**	**£8,144**	**£6,923**

* Assumes 5% p.a. nominal rate of return on investment.

10. The situation is different for an individual facing a change (most likely a fall) in their marginal rate over time. The impact of tax-rate smoothing under EET can be clearly seen, relative to the effect of a pure TEE system (which does not allow for smoothing of tax rates) – the individual is clearly better off under the former.

11. This discussion makes clear that the only issue from a theoretical tax perspective that arises for an individual in a move from EET to TEE is the loss of the ability for those facing different marginal tax rates over their lifetimes to smooth those rates over time.

12. The issue of tax incentives is also distinct. The NICs relief on (pension) contributions could just as easily be applied to a TEE system. A TFLS under an EET system could be adopted under a TEE system, but as an up-front discretionary benefit.

13. However, what Table 2 does not convey is the behavioural and operational risks of a move to TEE. We examine these in more detail below. In addition, tax take is also

an important consideration. EET gives government a stake in investment growth over time through the scale of the final 'T'.

Options for the future tax treatment of pensions

14. We see two main options for the future tax treatment of pensions:

    - Maintaining the existing 'EET' structure but reforming certain elements of the system.
    - A move to a 'TEE' system with a simpler tax treatment and a clear up-front incentive to save.

    We begin with a discussion of the second option.

'TEE' model with tax incentives

15. We take the view that EET and TEE are both technically feasible tax treatments of pension saving. We have discussed above that there is less difference between these treatments than is often thought. Indeed, people facing the same marginal rate of tax throughout their lifetime are treated equivalently under the two.

16. People switching to a lower marginal rate later in life would clearly prefer an EET system because it allows them to smooth their tax rate. However, if desired, government could correct for this in a TEE system by giving these individuals a tax credit equal to the difference between the marginal rate faced during working life and that faced during retirement. This depends entirely on the government's view of where it wants the distribution of pensions tax relief to be.

17. While aspects of the current pensions tax system are unduly complicated, the actual tax incentives – the Tax Free Lump Sum (TFLS) and relief on NICs for employer contributions – are actually fairly straightforward to understand. This is particularly true of the TFLS which is the only pure tax incentive for individuals. The complexity in the system lies instead in the tax treatment. Unfortunately, there does appear to be a lack of understanding of how pensions are taxed and conflation between the incentives and the tax treatment.

18. The real benefit of a TEE model for pensions therefore lies in the potential to make the tax treatment of pension saving simpler to understand – once money has been paid into a pension, it will be entirely free of tax and individuals will not have to factor in tax when accessing their pension.

19. TEE for pensions also provides an opportunity to give an immediate and visible tax incentive instead of the current TFLS, which while visible and easy to understand, is not immediate. Additionally, if there is a desire to change the current distribution of pensions tax relief then a move away from relief based on marginal rates offers an opportunity to do this.

20. Using evidence from the literature on employer matching of pension contributions (discussed in Annex One), a possible TEE model with tax incentives could involve

individual and employer contributions being topped up with a government match. Such a match could:

- Be a simple flat rate regardless of amount contributed up to a cap; or
- Be different for different levels of contributions up to a cap;
- Have its value altered, thus allowing it to act as a cost control lever for government.

21. As with the current pension system, savings should be accessible only later in life; and as highlighted in our additional principles for reform discussed earlier, this illiquidity should be reflected in the value of the credit.

22. The existing contribution-based annual allowance could be retained as an additional cost lever for the government or the credit could be payable only up to a certain level of contribution, which would also be a way of capping the costs of the system to the taxpayer. The Lifetime Allowance could be removed as it has no relevance in a TEE system and only undermines the government's personal responsibility criterion.

23. This method of cost control would give at most one or two simple levers to the government while avoiding the complexity – both for HMRC to run and for individuals to understand – that current attempts to control the cost of tax relief bring.

24. The precise value and design of any credit system would depend on the government's choices in relation to overall cost, the targeting of incentives and the degree of progressivity required in the system.

25. We believe that such a system scores well against some of the government's principles for reform:

- **Simplicity and transparency** – the offer for individuals of no tax payable once money has been invested is attractive and easy to understand, avoiding the need for complicated tax planning in retirement. A carefully designed system of government matching can provide a simple and highly visible incentive to save.

- Clear in its message of **personal responsibility** – by removing the complicated tax considerations of the current system (including abolishing the LTA), a pure TEE approach makes clear that the more an individual saves, the greater the amount of resources they will have available to fund their retirement.

- **Sustainability** – the system outlined above has one or at most two, simple levers that allow government to control the costs of the system in a way that does not distort individual incentives to the extent that changes to the existing system have done.

26. In line with the additional principles that we outlined above, a pure TEE approach with a tax incentive could:

- Be designed in a way that **rewards the necessary illiquidity of pension saving**;

- Be more **durable** than the current approach – changes to the level of incentive and the value of contribution on which it is payable can control the cost of the system while still rewarding pension saving. The generosity of the system may change, but individuals will always be unambiguously rewarded for saving.

27. The precise design of a system will be dictated by government's decisions around what it wishes to spend on the system as a whole and how the incentive is distributed.

Limitations of TEE model: will automatic enrolment be affected?

28. Despite the attractiveness of TEE as a simple fiscal system with the scope for genuine and targeted incentives, we do not believe that it is appropriate for a workplace pension system operating under automatic enrolment. Beyond the obvious practical considerations of systems change and account modifications affecting millions of savers, lies a more fundamental behavioural dimension, for both individuals and employers.

29. From an individual saver's perspective, a stylised model shows the operation of a TEE 'match' as far more fiscally constraining than operating basic rate tax relief or enhanced basic rate tax relief presented as a 'match', but in fact constituting deferred tax. In such an approach, a 10p match under TEE is broadly equivalent to a 30p level of enhanced tax relief under EET with 25% TFLS. Whether individuals respond in the same way to each is an important question to explore. Behavioural evidence suggests that there might be a preference for 30p now, reinforced by the positive psychological effect of larger savings balances earlier in life.

30. From an employer perspective, while we believe that TEE could still be compatible with automatic enrolment and the maintenance of NIC exemptions, there is an obvious danger of administrative complexity and associated costs. The risk is that this causes employers to view pensions as a compliance issue and nothing more. As we have previously discussed, the role of the employer is important in pension provision and we fully support the need to ensure compatibility with automatic enrolment.

31. Beyond the behavioural impact lie a further set of considerations, which include the impact on government finances. There is an argument to be made for the fact that moving to TEE reduces 'fiscal diversity'. By taking future income streams out of the income tax system entirely, there could be an adverse impact on the public finances in future years; and this may well be exacerbated if ageing populations result in worsening dependency ratios.

32. Taking all of this together, while a TEE system may have much to commend it if designing a brand new regime, it is not right for the specificities of the UK pension system as it exists today and we therefore do not advocate its application to workplace pensions. Given the transitional issues and the lack of persuasive evidence around the efficacy of tax incentives, it is preferable to consider what can be done to reform the system within the existing EET architecture.

Maintaining the existing 'EET' architecture and reforming within that structure

33. Our preferred option is to retain the existing EET treatment of pensions and reform within that architecture. Pure EET has a coherent intellectual underpinning since it involves income being taxed as it is received, which is the most intuitive way of taxing income. It also comes with the inherent feature of providing tax relief at the marginal rate. As previously discussed, for people moving to a lower marginal rate of tax, this allows them to smooth their rate of tax over time in a way that a TEE system does not allow. A rational economics view[12] of this is that this is not a question of gaming the system, but simply a way of evening out the tax paid on 'lumpy' income streams over individual lifetimes.

34. An obvious point in favour of a reformed EET is that it would not involve the transitional costs that would arise under a move to TEE. For an industry that has seen the scale of change that the pensions industry has in the last year, this is a significant argument for retaining EET. In order to deliver good outcomes for consumers, the industry needs a period of stability in policy and regulation, while consumers themselves would benefit from having a settled system that they can navigate. A further argument here would be that more time should be taken to judge the effects both of automatic enrolment and the retirement income freedoms, and tailor incentives accordingly.

35. There are a number of changes that could be made to the current system that would allow it to fit well with the government's principles for reform:

- **Simplicity and transparency** – relief at the marginal rate appears to be a poorly understood concept and incremental changes to the system have complicated it further, though admittedly more so for groups that public policy is less concerned with; however, this seems to be more of a communication issue rather than an inherent feature of an EET system and it ought to be possible to improve the communication of how tax relief works. The TFLS remains a visible and (at least in a DC pension) transparent incentive.

- **Personal responsibility** – the Lifetime Allowance as well as restrictions on the value of tax relief for earners above £150,000 distort incentives over when and how much to save. The LTA in particular, which could be breached because of factors outside the individual's control, provides a significant disincentive to contribute further to those close to the limit. Removing the LTA for DC schemes will deal with much of this complexity and can be done without moving away from the EET architecture.

- **Compatible with automatic enrolment** – the current system is entirely compatible with automatic enrolment, a significant point in its favour.

- **Sustainability** – the current system has had its costs reduced through an increasingly complicated mechanism of limits and restrictions that distort incentives. However, none of this is inherent in an EET structure and there are simpler ways of controlling costs while working within the existing system– notably through changes in the level of the Annual Allowance.

36. There appear to us to be three main options for reform within an EET framework, which could be done separately or in combination. The first is to reduce or remove

[12] *'Taxation of Private Pensions'* , 2014 Green Budget, Institute for Fiscal Studies.

entirely the Tax Free Lump Sum (TFLS) that is currently available when the pension is accessed. At 25% of the final pot (so potentially up to £300,000 of the current LTA of £1.2 million) this is a potentially very generous benefit, which is arguably poorly targeted since the greatest benefit goes to those with the most money to save, who may not necessarily need such an incentive to save.

37. Capping the cash value of the TFLS or reducing the percentage available would be easy to do, would generate some savings for the government and could allow for better targeting of the incentive e.g. a higher percentage TFLS for pots below a certain threshold for example. However, on their own, these changes would do little to improve the coherence of the system and would, depending on how any change is structured, reduce the incentive for some individuals to save into a pension since the TFLS is the only pure tax incentive provided to the individual in the UK system.

38. A second option would be to keep relief at marginal rates, abolish the LTA for DC schemes and bring the AA down, with the latter henceforth being the main lever of cost control. As explained above, a pure EET system has a very neat logic to it and any move away from it brings significant complexity. Maintaining it, but with a lower AA is a way of controlling costs but still preserving incentives for all groups. Some of the money saved from a lower AA, possibly in combination with a reduced TFLS, could be used to incentivise those groups at greater risk of undersaving. This would be the least disruptive change and would score well against the government's principles for reform.

39. There is a strong case for removing the LTA for DC schemes; for DB schemes we have already stated our view that any reform should look to minimise funding costs and disruption. In DC schemes, an LTA dependent on the impact of investment returns creates uncertainty for those individuals close to it and may reduce or remove their incentive to save in a pension. While these individuals may be small in number today and less of a concern in public policy terms, it is not inconceivable that individuals saving for 40 years at the levels needed to maintain their standard of living in retirement could be at risk of breaching the LTA in future. Maintaining the LTA therefore conflicts with the government's personal responsibility criterion. The LTA is not needed to control the cost of the system as this can be effectively controlled through the Annual Allowance.

40. There is also an investment case for removing the LTA since it restricts the potential for investment growth. A pension is a long term investment and with the benefit of time, should be invested in asset classes that generate growth in the economy and strong returns for the investor. Because of the need to avoid breaching the LTA, it risks diverting the investments of those close to it into less volatile assets such as cash and government bonds that may be less productive for the economy and less profitable for the investor, in turn reducing the potential for a better outcome in retirement.

41. A third reform within the broad EET architecture would be to move to a single rate of tax relief available to all pension savers, regardless of their marginal rate of tax. Our starting assumption is that at a minimum, such a rate would be set at the basic rate, thus ensuring that no basic rate taxpayers were any worse off than under the current system. More realistically, a rate set between the basic and higher rate would bring a redistributive element into the system, with basic rate payers better off at the expense of higher and additional rate payers.

42. Relative to the existing EET system, a reformed structure on these lines could achieve three things:

    - A better targeting of incentives.

    - An alternative presentation to individuals in order to improve understanding and awareness of tax relief.

    - Depending on the rate chosen, meet the government's sustainability criterion, by reducing the cost of the system relative to the current arrangements.

43. However, as with any move to TEE, this is a major reform and we do not believe there is sufficient evidence to suggest that such a redistribution of pensions tax relief on its own will result in additional saving by basic rate payers. In addition, as we have explained above, improvements could be made to the current pure EET system in relation to presentation of the incentives and cost control.

44. Taking all this together, we do not have a firm recommendation about the precise shape of the reform, but would caution that any system that moves away from marginal tax rates as the basis for the treatment of pension savings (i.e. EET or TEE) risks introducing much greater complexity for individual savers.