Association of British Insurers

Strengthening the incentive to save: a consultation on pensions tax relief

CONSULTATION RESPONSE FROM THE ASSOCIATION OF BRITISH INSURERS

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Strengthening the incentive to save: Consultation response from the ABI

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Executive summary

The ABI is pleased to contribute to the consultation on strengthening the incentive to save, particularly as we have been calling for a review of pension tax relief since 2013. We strongly believe that reforms are necessary, and that such reforms must combine incentivising savings with simplicity and transparency, allowing individuals to take personal responsibility, and improving fiscal sustainability, while at the same time building on the success of automatic enrolment (AE).

Out of the four possible scenarios (status quo, TEE, single rate, and meaningful reform of the current system) we do not support the status quo. Making no changes would not improve fiscal forecasts, especially as the roll-out of AE continues to small and micro employers and higher contribution rates are phased in during 2018, all of which will increase the cost of tax relief to the Exchequer in a period of fiscal constraint.

We believe that both a single rate of tax relief and meaningful reform of the current system are credible options that would deliver on the consultation's principles for successful, radical reform and fiscal sustainability, with a single rate our preferred option.

Conversely, taxing people's pension contributions in a TEE system risks putting off people from making provision for their retirement, and would undermine this Government's achievements in strengthening the incentive to save through AE and the introduction of the Pension Freedoms.

A TEE system

We do not consider TEE delivers on the consultation's principles. Firstly, it is highly questionable whether a TEE approach would incentivise savings. Accumulating pension savings pots is highly dependent on employers' contributions: around 75% of pension contributions that trigger tax relief are actually made by employers.[1] Just as importantly, many employers have matching arrangements in place where the employer will match a certain percentage being contributed by the employee. Research has repeatedly shown that this is very powerful in incentivising pension contributions.[2]

However, survey evidence shows that in a TEE system employers would expect their staff to value employer contributions less, and also expect staff to save less. Many would reconsider how much they contribute to employee pensions.[3] This would have a powerful detrimental impact on pension saving,

[1] HMRC Table PEN6 (2015) "Cost of Registered Pension Scheme Tax Relief"
[2] See Annex 4 - "Literature review: Behavioural economics and pensions tax policy"
[3] Aviva Employer Survey (2015) "Pension Tax Reform"

even assuming a government contribution.

Whilst a TEE system benefits from clarity and transparency in the sense that the pension would not be taxed at retirement, the transition to TEE would mean that simplicity is lost for retirees: Until all accrued savings have been withdrawn, retirees will still have to consider tax in retirement for their existing pots, and understand which tax regime applies where.

It is also highly questionable whether it would do much to allow individuals to take personal responsibility. First, our consumer survey shows only 19% of people trust future governments to leave their pension savings untouched. This lack of trust would undermine their incentive to save on the promise that there will not be tax when they access their pension. Second, the current system acts as a brake against people spending their entire pot early in retirement. This is because there is an incentive to spread income over multiple years to reduce the amount of tax payable. Without such a brake, people will be tempted to withdraw all their money as soon as they can, to keep it 'safe', risking poor investment decisions that will reduce the value of their pension and making them more reliant on state support in later life.

In addition, most of the hoped for savings under a TEE system are illusory. We cannot see how a TEE system could conceivably be applied to defined benefit (DB) pensions given the need to tax employer contributions, which is likely to reduce any potential savings by up to 75%. Furthermore, a substantial matching payment will be required to ensure that the incentive to save is not reduced for lower earners – particularly for those who pay little or no tax in retirement. Over half of those in receipt of state pensions pay no tax.[4] We believe such a contribution would reduce potential savings by a further 60%.

Whilst the government contribution could be targeted differently at different groups to limit costs, this would add complexity to a TEE system and undermine the simple messaging of the matching payment.

But most importantly, analysis shows that the negative macroeconomic consequences of moving to a TEE system would be significant. Independent modelling conducted by the National Institute of Economic and Social Research (NIESR) predicts that the consequences of a move to a TEE system would be a reduction in GDP, savings, productivity and real wages, while real interest rates would be expected to increase. This is because a TEE system shifts the tax burden away from pensioners and onto the working age population whose budget constraints are tightest, meaning they have fewer resources to split between consumption and saving, which lowers

[4] HMRC (2015) "Personal Income Statistics Table 3.6" & DWP (2015) "Outturn and Forecast: Autumn Statement 2014"

saving and affects the whole economy. Unsurprisingly then, EET systems are the norm in OECD countries, with only Hungary having a pure TEE system at present.

These concerns are heightened in an ageing society. The OBR has forecast that the proportion of GDP spent on health, state pensions and long term care costs will increase by 40% between 2019-20 and 2064-65, attributable to a large increase in the proportion of the UK's population aged 65-year and over.[5] Shifting the tax burden for these costs wholly to younger generations seems unfair.

According to NIESR "a shift from EET to TEE would affect the relative attractiveness of pension saving… there is a real risk that lower pension saving would be accompanied by greater demand for housing driving house prices higher. The switch in wealth could be considerable with a meaningful impact on house prices and even possibly financial stability. This would transfer wealth from the young to the old thereby deepening the pension challenges facing the country."[6]

Finally, TEE is both very costly and time consuming to implement. For pension providers alone, costs are likely to be in the hundreds of millions for the system changes needed to accommodate a move to TEE. The scale of the changes necessary for employers, payroll providers and the pensions industry are such that the implementation timeline would risk stretching over two parliaments. But perhaps even more concerning than the build cost is the creation of EET legacy systems which will need to be serviced for decades. For example, a 22-year-old who already has a workplace pension through AE would open an additional pension account under TEE, and both would run in parallel until their retirement.

A single rate of relief

A single rate of tax relief, coupled with a re-branding of tax relief as the "Savers' Bonus", will simplify pensions, incentivise savings and can save the government money. This would be a genuinely radical reform that could stand the test of time.

A single rate will be easier to communicate than the current system, ensuring people understand the tax benefit of saving into a pension. It is well established that matching contributions are the most effective incentive for increasing pension participation and contribution rates, as loss aversion means people save so as not to miss out on them.[7] Making the Savers'

[5] Office for Budget Responsibility (2015) "Fiscal Sustainability Report"
[6] NIESR (2015) "An Economic Analysis of the Existing Taxation of Pensions (EET) Versus An Alternative Regime (TEE)"
[7] See Annex 4 - "Literature review: Behavioural economics and pensions tax policy"

Bonus as visible as the employer's contribution will therefore have a powerful impact.

A single rate system supports personal responsibility by better targeting government spending towards the basic rate taxpayers, the audience that AE has been designed for. Recent government research has shown that almost 11 million people with incomes below £52,000 are undersaving, with almost 60% of this group on incomes below £32,500.[8] Despite the fact that basic rate taxpayers also account for the vast majority of taxpayers, they currently receive less than 30% of government spending on tax incentives for pensions. A single rate system is redistributive, and will increase the amount of tax relief received by basic rate taxpayers to nearly 50%.[9]

Personal responsibility in retirement is also encouraged in a single rate system, as compared with a TEE system, tax on withdrawals deters people from taking their pension too quickly, reducing the risk of state dependence.

A single rate will be less generous to higher earners. However this is arguably a product of the system being too generous for these savers already, as six out of seven will only pay basic rate tax in retirement.[10] Crucially, a single rate will maintain the incentive to save for all but a very few who expect to have savings in retirement well in excess of the current Lifetime Allowance.

It has also been argued that reducing the generosity for higher earners will have knock on effects for their employees. However, AE imposes a legal obligation on employers to set up and pay into pension schemes for their employees. Furthermore, decisions about executive remuneration do not always apply to other staff; research from the TUC shows that senior executives frequently have different pension arrangements from the majority of staff.[11] We have also seen no evidence to suggest that repeated cuts to pension tax relief in recent years have weakened employers' commitment to workplace pension savings.

A disadvantage of a single rate is that there would be a need to recover excess tax relief for those with a higher marginal rate than the chosen single rate, insofar as it applies to employer contributions. We believe this could be achieved through payroll but acknowledge that it makes it less straightforward to apply the single rate to DB.

In terms of fiscal sustainability, our modelling shows that a flat rate of anywhere between 25 and 33% applied to defined contribution (DC) alone could yield sustainable savings of around £1.3bn per annum when coupled with adjustments to the Annual Allowance. Even greater savings could be

[8] DWP (2014) "Scenario analysis of future pension incomes"
[9] PPI (2015) "Comparison of pension outcomes under EET and TEE tax treatment"
[10] CPS (2014) "Retirement Saving Incentives: The End of Tax Relief and a New Beginning"
[11] TUC (2015) "PensionsWatch 2015: A TUC report on director's pensions in the UK's top companies"

made by adjusting the multiplier and allowances for DB pensions. While we do not advocate applying a single rate to DB schemes, it is essential that equivalent changes are made to DB schemes to ensure that DB schemes do not receive more generous treatment than DC schemes.

Also, by ensuring pensioners remain as taxpayers, the macroeconomic consequences of a TEE system that come with shifting the burden of funding an ageing society onto the working age population will be avoided.

There will still be implementation costs for employers and pension companies. However, with total costs for providers measured in tens, rather than hundreds, of millions, they will be much reduced compared to a TEE system, and without the creation of legacy systems. More importantly, a single rate could be implemented much more quickly than would be possible for a switch to TEE, with radical reform delivered safely within one parliament.

A reformed system of marginal rate relief

Finally, meaningful reform of the current system can deliver on the consultation principles. The most important component would again be re-framing tax relief as the Savers' Bonus to make the incentive visible to people. This simple change will simplify the perception of pensions and make the system more transparent. Removing the Lifetime Allowance for DC pensions but keeping an Annual Allowance would further simplify the system and bring it closer to the current regime for ISAs. Doing the opposite for DB pensions would also make DB pensions much simpler.

As with a single rate, retaining taxation of pension income at retirement will help people take personal responsibility for having an income throughout retirement by encouraging them to spread their income.

The greatest strength of reforming the current system is that AE has already been proved to be effective within this framework, and we can be certain it will not undermine it.

While the system is costly for the Exchequer at present, we believe that reducing the Annual Allowance for DC pensions and the Lifetime Allowance for DB pensions will make the system sustainable over the long term. These allowances also provide a lever to control fiscal cost in future that is simple, transparent and only affects those with substantial incomes.

Finally, implementation costs will be the lowest of the options we have considered, meaning reform could be delivered quickly and with minimal risk.

Conclusion

There is a clear need to reform pensions tax relief, both to improve upon what we have and to find a stable and long term solution that gives people the confidence to save for their retirement. In reforming the system, it must be remembered that pensions tax relief does represent good value for money, as

the capital accumulation in the economy is high compared to the amount of tax revenue foregone.

To achieve the principles of the consultation, a TEE system is the worst option we have considered. It would be reckless and highly risky for the government to try and implement such a system.

In contrast, we believe both a single rate of pension tax relief and a reformed current system can deliver on the consultation principles, and we consider a single rate to be the better of these two options. As we show in the following chapters, international experience, evidence and common sense all point to these two reform options being the best ways to introduce workable but radical reform.

1 Introduction

1.1 The Government has identified four principles against which reforms of the pension tax relief system should be measured. The guiding principles are that any reforms should:

- be simple and transparent.
- allow individuals to take personal responsibility for ensuring they have adequate savings for retirement.
- build on the early success of AE in encouraging people to save more.
- be sustainable, by being consistent with the government's long term fiscal strategy.

The ABI supports these principles as the overarching framework for evaluating reform.

1.2 **Simplicity and transparency** is needed to ensure savers understand the value of saving into a pension, but also so they can interact with their pension easily, both while saving and in retirement.

1.3 A system that **supports personal responsibility** will give people a strong incentive to save while working and encourage them to continue being responsible throughout their retirement. An ideal system will target incentives at those most in need of support, and also be perceived as fair to all sections of society.

1.4 Building on the success of **automatic enrolment** (AE) is critical, given the importance of the workplace in encouraging people to save. An effective system will continue encouraging employer contributions over and above the statutory minimum, and avoid giving people another prompt which could lead them to opt out. Success depends on changes being feasible to implement for employers, the pensions industry and the government, who have worked together make AE a success.

1.5 A **sustainable** system that enjoys wide political support will provide the stability that is necessary to build public trust in long term savings. When measuring sustainability, macroeconomic consequences beyond the short term fiscal impacts need to be taken into account, as do long term demographic trends.

1.6 The Government is right to recognise that there will be both synergies and tensions between these principles. There is no reform option that will be superior to the others in every way, so the aim must be to find the package that works best when considered as a whole, and that can be implemented without undue risk.

Structure of our response

1.7 Our response evaluates the three broad options for pensions tax relief against the Government's guiding principles over the next three chapters: chapter two considers a "TEE" system; a flat-rate relief system is considered in chapter three; and, a marginal rate relief system, within the context of the current EET framework, is considered in chapter four. We discuss some of the implementation issues in chapter five. Our conclusions are presented in chapter six.

1.8 The questions posed in the Government's consultation document are answered in the first annex of the document, while summaries of the research we have commissioned to reach our conclusions is included in the subsequent annexes. The full research documents from NIESR and the PPI are included separately alongside this document, and are available on the ABI's website.

2 A TEE system

Key points

2.1 We do not support a TEE system for pensions tax relief as it will not meet the Government's principles for reform. This is because:

- There is considerable risk that a TEE system will **undermine the incentive to save** for both employees and employers.
- The **macroeconomic and demographic effects are significant** and **fiscal savings will be limited**.
- There are significant implementation risks moving to a TEE system and **reform could not happen quickly or easily**.

2.2 While there are some simplicity benefits under TEE, many would be lost in what would be a long, complex and risky transition from the existing EET system which would threaten AE. More importantly, the overall effect will likely be a reduction in savings, investment and GDP, which are costs that cannot be justified by the short to medium term fiscal benefits of shifting to a TEE system.

What would a TEE system look like?

2.3 We have considered various approaches for designing and implementing a TEE regime. Our evaluation of the TEE system is based on what we consider to be the best possible design of a TEE system, as set out below:

2.4 For defined contribution (DC) pensions:

- Pension contributions are made out of net pay after tax.
- Savings are tax free when accessed at the point of retirement.
- A matching payment from the government is made for both employer and employee contributions. The rate of the payment is between 20% and 30% with payments made monthly by HMRC.
- Pension contributions by employers remain exempt from employer National Insurance Contributions (NICs).
- Treatment of employee NICs is unchanged.
- Savings cannot be accessed until the age of 55.
- There is an annual limit on contributions to control fiscal cost.
- The TEE system applies only to new contributions, existing savings remain subject to tax upon withdrawal.

2.5 A TEE system is unworkable for defined benefit (DB) pensions (refer to paragraphs 5.4 - 5.13). Rather than applying TEE to DB pensions, we expect the government would reform the current system of tax relief for DB by:

- removing the Annual Allowance; and
- reducing the DB multipliers and/or the Lifetime Allowance to ensure that those saving into DB schemes do not receive favourable treatment compared to the benefits someone might realistically be expected to receive in a DC scheme.

Evaluating a TEE system

Simplicity and transparency

2.6 The apparent simplicity of a TEE system is its major strength. Its proponents argue that, combined with matching payments from the government, a TEE system would make it simple for the public to understand how the pension system works for new savings and, more importantly, the value of saving incentives.

2.7 A TEE system also offers scope to reduce the number of interactions people have with the tax system. Most obviously, people withdrawing savings in retirement will not be required to pay tax. In addition, higher and additional rate payers will not be required to file a tax return or have their tax codes amended to ensure they receive the right level of tax relief, as is the case now under a relief at source (RAS) model.

2.8 However, this simplicity cannot be fully realised for decades. People accessing funds in retirement will continue to pay tax until they have exhausted the pension assets they accumulated under the existing system. This process would take decades. Further, the differing tax treatments of new and old savings will undermine simplicity as people will need to understand how two different tax regimes apply to two different savings pots. This complexity would be further exacerbated by the different treatment of DB pensions.

2.9 Another result of introducing a TEE system would be a proliferation of pension pots: all existing pots would be closed to future accruals with new savings being channelled into new pots. This problem would be even more acute if a switch to TEE occurred after the staging of employers for AE is complete, as there would be an even larger number of small pots that would be closed to future accruals. In addition to being less efficient, having a multitude of pots will make it more difficult for people to track their pensions, while the differential tax treatment means it would not be possible to consolidate pots.

2.10 Both of these problems could be addressed by transfer rules allowing transfers from EET to TEE pots, however such rules would drive arbitrage between the systems and increase the complexity of TEE. The difficulty associated with transfers between EET and TEE is discussed in more detail in paragraphs 2.41-2.43 below.

Supporting personal responsibility

2.11 The economic literature judges that TEE systems are inferior to EET systems, all else being equal, as there will be lower pension saving in a TEE system. EET is also superior to TEE in terms of sharing risk across generations and between retirees and the government.[12] For these reasons, it is unsurprising that EET systems are the norm in OECD countries, with only Hungary having a pure TEE system at present. TEE systems are intellectually coherent though, as they avoid double taxation and are theoretically pure. Even so, TEE systems present some significant faults that can be expected to undermine savings and hence personal responsibility:

- The up-front tax charge reduces the benefits to saving as only post-tax, rather than pre-tax, saving is available for accumulation and investment. Importantly any reduction in up-front funding will be magnified due to compounding – for example an initial reduction of £100 will grow into a loss of over £430 after 30 years assuming a return of 5%.
- Because tax relief occurs in the future there is a risk that future governments will renege and the system will become "TET". If consumers perceive such a risk exists, pension saving becomes much less attractive. Consumer research we have conducted has found only 19% of people trust the government to leave alone money they have saved, suggesting a lack of trust in future governments could have a significant bearing on savings rates in a TEE system. The inability to bind future governments means this risk cannot be fully mitigated.[13]

2.12 TEE systems also challenge a fundamental principle of society, which is that tax should be levied according to one's ability to pay. Under TEE, the tax rate on savings is determined by the individual's income while they are saving, rather than the individual's income when the savings are accessed, as is the case in an EET system. The result is that in a TEE system an individual with a very modest income in retirement could be living on income that has been taxed at a much higher rate. This feature of TEE systems is particularly damaging to the self-employed and other groups with variable income.

2.13 Positively though, there is a significant body of literature to support the argument that the presence of matching contributions will effectively encourage savings. We strongly support rebranding tax relief as a matching contribution from government for precisely this reason. A TEE system could also allow matching payments to vary. For example, payments could be more

[12] See literature review from: NIESR (2015) "An Economic Analysis of the Existing Taxation of Pensions (EET) Versus An Alternative Regime (TEE)"

[13] This risk has been considered by NIESR, who state that "[g]iven that it is well understood that there are pension challenges in the future, the possibility around contingent risks (such as the financial sector) and the time lapse between current and future taxation policy, there is no commitment device to overcome this dynamic inconsistency problem." (NIESR 2015)

generous for initial contributions up to a certain cap, and less generous thereafter, ensuring government expenditure is better targeted, although this comes at a cost of added complexity.

2.14 However, to help people reach an adequate level of savings for their retirement, any pension tax relief system not only needs to improve the incentive to save, but it must also be sufficiently generous to assist those with binding budget constraints.

2.15 For the system to be politically palatable, it therefore has to be generous enough relative to the current system. Given that over 50% of people claiming the state pension do not pay tax, the existing system is effectively "EEE" for many already.[14] The government would therefore need to set a matching contribution of at least 25% if it is to prevent the most vulnerable in society from being disadvantaged by a move to a TEE system.

2.16 To maintain the current level of support to the two million people who move from higher rate to basic rate would be even more difficult. If this were seen as necessary, the matching payment would need to be in excess of 40%. Given that tax on withdrawals is foregone in a TEE model, matching payments to this extent would make a TEE system less sustainable in the long term. The full implications of this trade-off are discussed in paragraphs 2.29 – 2.40.

Table 1: Taxed fund value of 25 year olds under a TEE system as a result of a £1,000 contribution

Tax Position (pre/post)	*Current*	*TEE*	*TEE 10% match*	*TEE 20% match*	*TEE 30% match*	*TEE 40% match*	*TEE 50% match*
Non/Non	£1,680	£1,344	£1,479	£1,613	£1,748	£1,882	£2,016
Basic/Non	£1,680	£1,344	£1,479	£1,613	£1,748	£1,882	£2,016
Basic/Basic	£1,428	£1,344	£1,479	£1,613	£1,748	£1,882	£2,016
Hghr/Basic	£1,904	£1,344	£1,479	£1,613	£1,748	£1,882	£2,016
Hghr/Hghr	£1,568	£1,344	£1,479	£1,613	£1,748	£1,882	£2,016
Adnl/Hghr	£1,711	£1,344	£1,479	£1,613	£1,748	£1,882	£2,016
Adnl/Adnl	£1,619	£1,344	£1,479	£1,613	£1,748	£1,882	£2,016
Key	< 95% of current		Between 95% and 105% of current			> 105% of current	

Source: PPI (2015) "Comparison of pension outcomes under EET and TEE tax treatment"

[14] HMRC (2015) "Personal Income Statistics Table 3.6" & DWP (2015) "Outturn and Forecast: Autumn Statement 2014"

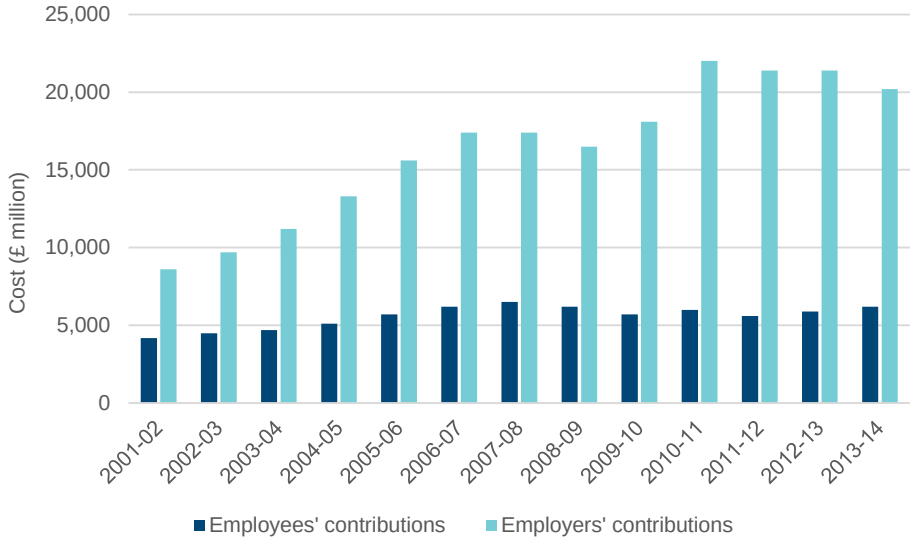
2.17 A TEE system also has implications for personal responsibility during retirement, as there is no incentive to spread income to reduce the amount of tax payable. Given the lack of trust in government, the opposite will become true. Many people will withdraw all of their savings from pensions at the age of 55 so that they can be kept 'safe', resulting in poor investment decisions. Overall, the likely effect is an increase in the number of people relying solely on the state in later life.

2.18 This problem could be mitigated to an extent by giving payments in the decumulation stage that encourage people to keep their savings invested. However, this would increase the complexity of the system, and the cost of any bonuses would reduce funds available for up-front matching payments, reducing the initial incentive to save.

Building on the success of automatic enrolment

2.19 AE has been extremely successful to date as very low numbers of workers have opted out of pension saving. However, employers in the aggregate contribute much more than the AE minima, as three quarters of pension contributions come from employers not employees. To build on the success of workplace saving, it is critical that employees continue not to opt-out of pension saving and that employers continue to contribute at a level above the statutory minimum.

Figure 1: Cost of tax relief on employees' and employers' contributions, 2001 - 2014



Source: HMRC Table PEN6 – "Cost of Registered Pension Scheme Tax Relief"

2.20 Any substantial change to the pensions system presents a risk for AE as it is unclear how employees and employers will respond to change. With a switch to a TEE system, we believe two design criteria would be critical.

- Relief from both employer and employee NICs must remain.
- Matching payments from government must apply equally to both employer and employee contributions.

2.21 Without these two incentives, the likely response from employers will be to reduce contributions to the minimum allowed under AE and offer salary instead, allowing the individual to choose how much to save. It is unlikely the consumer response to such a change would be an equal increase in pension contributions, and so the outcome would likely be a significant reduction in net saving and an increase in consumption.

2.22 Even if these incentives for employers were retained there is a significant risk that a TEE system will damage the incentive to save in the workplace. This is because taxing employer contributions will either result in a reduction of take-home pay or lower total pension contributions. We expect people will favour maintaining take-home pay. However, the consequent drop in pension contributions will not go unnoticed and may disincentivise some from saving. For employers paying the AE minimum, it will not be possible to reduce pension contributions, and therefore maintaining take-home pay will come at a cost. Given that employers already face increased employment costs from introducing the living wage and implementing AE, more costs as a result of moving to a TEE system seriously risks undermining employer support for pensions.

2.23 The willingness of employers to contribute above AE minima will also depend on the extent to which employees value pension contributions. If employees place a lower value on pension contributions, there is a real risk that employers will prefer to increase the proportion of salary paid in cash relative to pension contributions. This concern is supported by a survey of employers conducted by Aviva, which found that over 60% of employers surveyed believed employees would value the employer's pension contribution less in a TEE system.[15]

2.24 The same survey also showed that without tax at the point of withdrawal, employers would be concerned that employees would be increasingly likely to spend a large part of their fund prematurely and be unable to afford to retire. By reducing the value of pensions as a tool for employers to manage an ageing workforce, pension contributions would become less appealing to employers also.

2.25 The upheaval associated with a transition to a TEE system will be substantial for both employers and the pensions industry, and will come at a significant cost. Given that AE is a tripartite system that depends on employers, pension

[15] Aviva Employer Survey (2015) "Pension Tax Reform"

providers and individuals, the implementation challenges for employers and providers must be taken into account.

2.26 For providers alone, the costs would be in the hundreds of millions of pounds, and will typically require new systems to be built from scratch. The scale of the changes necessary for employers, payroll providers and the pensions industry are such that the implementation timeline would risk stretching over two parliaments. Even this timeline comes with significant risk - the only comparable change is AE, which will take six years to implement and did not commence until four years after legislation. Such a drawn out implementation period is likely to have knock-on effects on saving through increased uncertainty and instability.

2.27 A shift to a TEE system would require existing platforms to be run in parallel with new systems for decades. As competition for new savings will be restricted to TEE platforms, we would expect less investment in existing platforms and fewer customer service improvements. While a consolidation market will likely emerge, this is a sub-optimal outcome. Running dual systems would also make the cost and lead time for any future changes much greater. Some closed book providers would also be expected to close to all future contributions rather than modifying their systems to accept more payments. This would mean that some employers would need to find new providers to meet their AE obligations.

Sustainability

2.28 Introducing a TEE system will present the government with an immediate tax windfall that will support its efforts to reduce the deficit. This is because tax receipts on the existing stock of pension assets in decumulation will continue to come in as planned, while tax receipts on future contributions will come in immediately, rather than being delayed until the point of retirement, as would be the case in an EET system.

2.29 However, many of these savings are illusory. Because DB pensions receive around three quarters of tax relief, most of this potential tax windfall cannot be realised. A large portion of the remaining savings will then be offset by the increase in matching payments necessary to incentivise saving and make reform politically palatable. For example, a matching payment of 30% would limit first year savings to less than £2bn.

2.30 The fiscal gain is also only temporary, and would be improving today's fiscal accounts at the expense of tomorrow's. This is because as the existing stock of pensions assets are withdrawn they will not be replaced by new savings; eventually the government will only be receiving revenue from contributions, which will be offset by any matching contributions. PPI state that, "moving to a TEE system would start to reduce the tax revenues from pensioner income, up to a point where all pensions accrued under the current EET system have been paid and the TEE pensions would produce no tax revenue. … as the pension tax revenue falls each year, there could come a point ... where the

net cost of matching payments and pension tax revenue is a higher cost to the government than under the current system."[16] Modelling by the NAPF has found that the net present value of all future revenues under a TEE system would actually be 15% less than under the current system.[17]

2.31 The rate of matching payments is therefore of critical importance in determining the long term sustainability of a TEE system – if they are set at the wrong rate, short term savings will become long term costs, increasing the perceived risk of the system becoming TET, and further undermining savings incentives.

Table 2: Single year cost to exchequer of tax relief on pension contributions for TEE systems (£billons)

Tax Treatment scenario	*Cost on employer contributions*	*Cost on employee contributions*	*Total cost to exchequer*
Current system	21.3	5.9	27.2
TEE with no matching payment	0	0	0
TEE with 10% matching payment	5.7	1.5	7.2
TEE with 20% matching payment	10.7	2.8	13.5
TEE with 30% matching payment	15.3	4	19.3
TEE with 40% matching payment	19.4	5.1	24.5
TEE with 50% matching payment	23.2	6.2	29.4

Source: PPI (2015) "Comparison of pension outcomes under EET and TEE tax treatment"

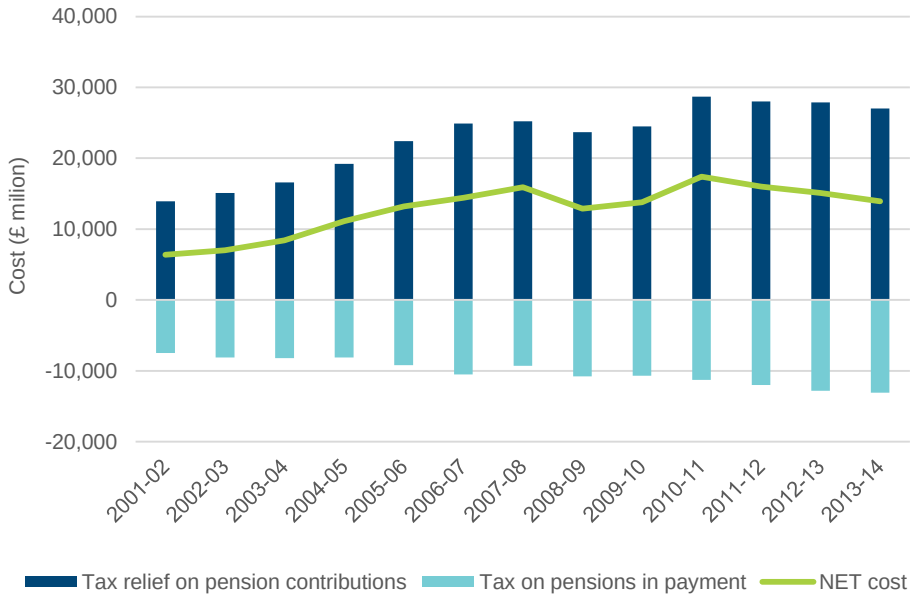
Note: These exchequer costs include cost of tax relief for both DB *and* DC pension schemes, and exclude the tax receipts from pensions in payment that arise in the current system, which totalled £13.1b in 2013/14. Our estimates for fiscal savings assume a 1:3 split of costs between DC and DB.

2.32 On a static accounting basis, the total cost of the current system is around £14bn per annum, when measuring the difference between tax foregone on contributions and tax receipts from withdrawals. This is comparable in cost to a TEE system with matching payments of roughly 20%. Alternatively, if sustainability is measured by fiscal neutrality over the 50 year forecast period used by the OBR, then a 30% rate is probably affordable.[18] However in this

[16] PPI (2015) "Comparison of pension outcomes under EET and TEE tax treatment"
[17] NAPF (2015) Pension taxation myth buster from NAPF
[18] We note that a matching payment of 20% in a TEE system equates to a flat rate of relief of 16.67%. A matching payment of 30% in a TEE system equates to a flat rate of relief of 23%.

case, the system would cost significantly more than it does now by the end of the forecast period.

Figure 2: Net cost of income tax relief on pension contributions, 2001-2014



Source: HMRC Table PEN6 – "Cost of Registered Pension Scheme Tax Relief"

2.33 Based solely on static costings, a government matching payment somewhere between 20 and 30% appears reasonable. A choice at the lower end of the range is more sustainable over time. At this level of matching payment though, many would be worse off, especially those who pay little or no tax in retirement. This would be politically difficult to implement and sustain and will significantly reduce the benefits of saving. Conversely, a choice at the upper end of the range is more generous and therefore easier politically, but is more difficult to characterise as sustainable over the long term, which is necessary to build trust in a TEE system.

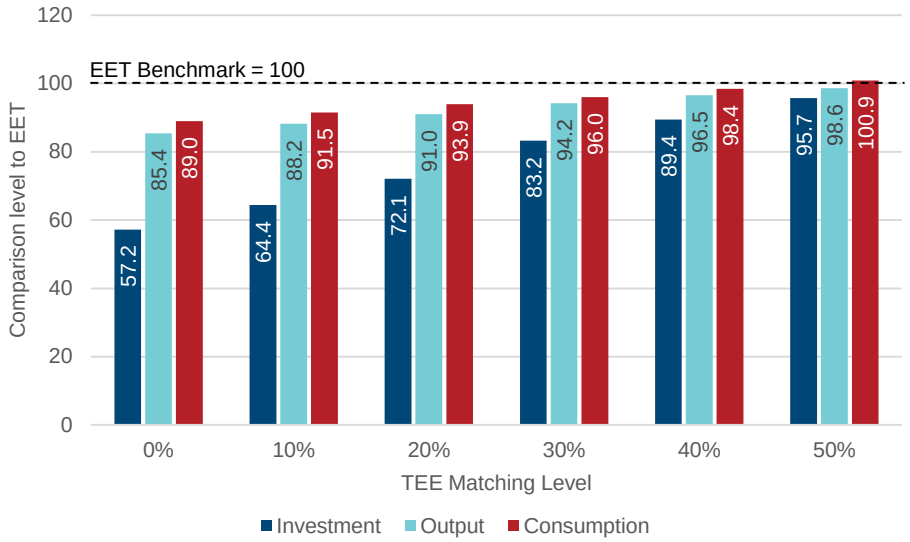
2.34 It is worth noting that these static costings do not factor in the fiscal risks associated with a TEE system. For example, there would be an incentive to withdraw savings and then immediately reinvest them into the system to benefit a second time from government matching payments. As we have seen with the introduction of the Pension Freedoms, controls on these types of behaviours are difficult to implement and will increase complexity in the system.

2.35 Even if we ignore these fiscal risks, when considered in a dynamic rather than static way, a TEE system is inferior to EET when judged against sustainability. There are three broad reasons for this.

2.36 The first reason is because of the macroeconomic effects. Independent modelling by the National Institute of Economic and Social Research has

found that moving "from EET to TEE leads to declines in aggregate GDP, investment (savings), productivity and real wages, and to an increase in the real interest rate up to a pension subsidy of 50%. Aggregate consumption also falls, except for the most generous pension tax subsidy of 50%."[19] These findings are consistent with most of the economic literature.

Figure 3: Macroeconomic impact of various TEE match levels on investment, output and consumption

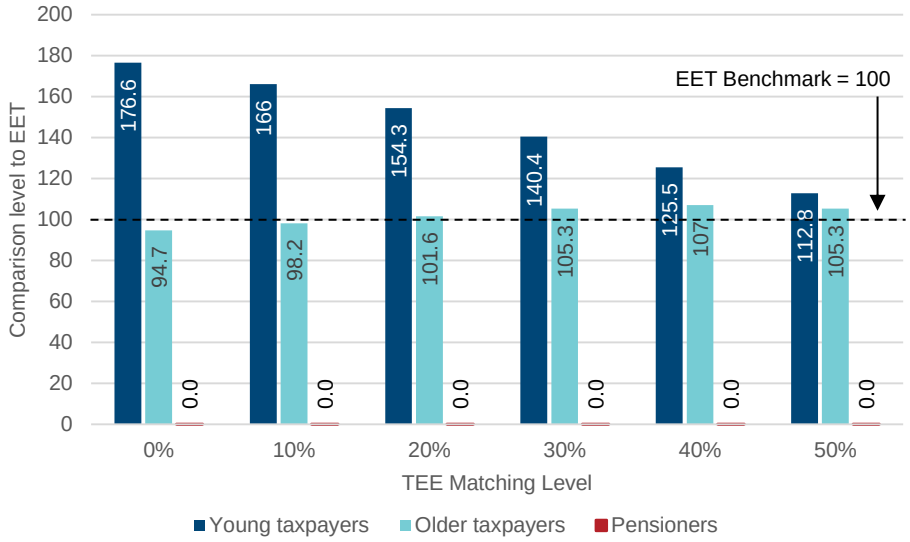


Source: NIESR (2015) "Comparison of EET and TEE Pension Tax Regimes"

2.37 The reason for these results is that "the shift from EET to TEE shifts the tax burden to working-aged agents, reducing the after-tax income that they can allocate between consumption and savings… The lower savings reduces the amount of investment and a smaller steady state capital stock. The fall in the capital to labour ratio implies a higher real interest rate, lower labour productivity and a lower real wage rate."[20]

[19] NIESR (2015) "An Economic Analysis of the Existing Taxation of Pensions (EET) Versus An Alternative Regime (TEE)"
[20] NIESR (2015) "An Economic Analysis of the Existing Taxation of Pensions (EET) Versus An Alternative Regime (TEE)"

Figure 4: Tax burden comparison of various TEE matching levels by age cohort



Source: NIESR (2015) "Comparison of EET and TEE Pension Tax Regimes"

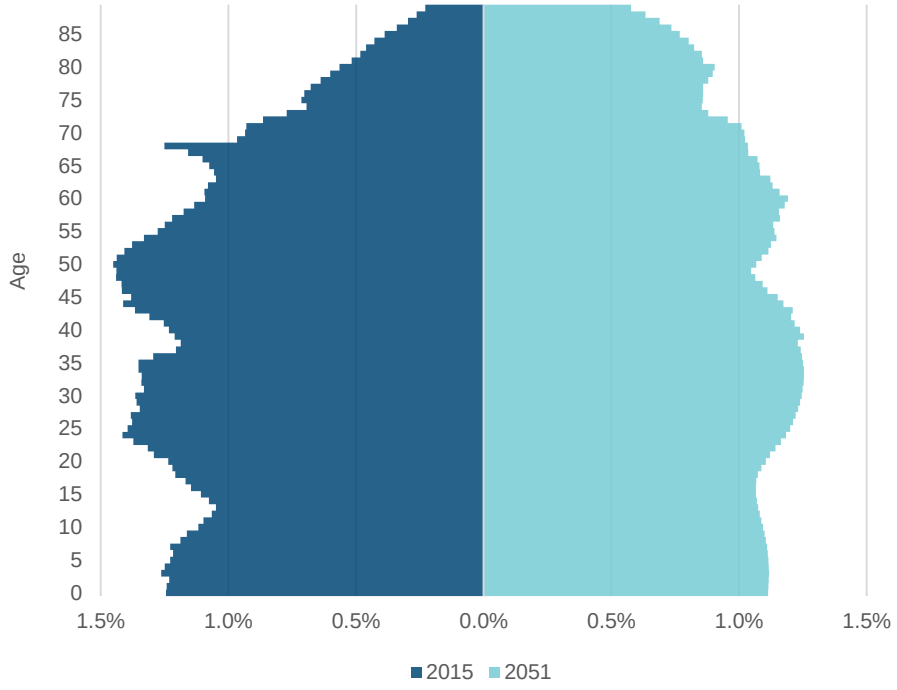
Note: Under a TEE system pensioners do not pay income tax, therefore all categories are zero.

2.38 Of the different levels of matching payment modelled, NIESR found that "the only scenario where output (almost) and consumption return to the levels under the current EET system are with a 50% government pension subsidy which would likely be detrimental on a Whole Government Accounts basis."[21]

2.39 The second, and related, reason is that when demographic trends are factored in, the consequence of moving to a TEE system will be to remove pensioners from paying tax at the same time as society ages and care costs increase. This would put a disproportionate burden on the working age population, and make the social and economic consequences above even more acute.

[21] NIESR (2015) "An Economic Analysis of the Existing Taxation of Pensions (EET) Versus An Alternative Regime (TEE)"

Figure 5: UK population proportion by age, 2015 & 2051



Source: ONS 2012-based National Population Projections – principal projection

Note: Proportions for those aged 90+ have been excluded due to grouping in ONS data.

2.40 A third reason is the impact on housing. According to NIESR "a shift from EET to TEE would affect the relative attractiveness of pension saving… there is a real risk that lower pension saving would be accompanied by greater demand for housing driving house prices higher. The switch in wealth could be considerable with a meaningful impact on house prices and even possibly financial stability. This would transfer wealth from the young to the old thereby deepening the pension challenges facing the country."[22] We believe this would complicate the challenges facing the Bank of England, not only due to concerns about lender's stability due to the rapid growth of the buy-to-let sector (40% since 2008), but also because households become more exposed to house price risk.[23]

[22] NIESR (2015) "An Economic Analysis of the Existing Taxation of Pensions (EET) Versus An Alternative Regime (TEE)"

[23] Bank of England (2015) "News Release – Financial Policy Committee statement from its policy meeting, 23 September 2015"

Transfers from EET to TEE

2.41 We have assumed in our design of the TEE system that it would only apply to future contributions; existing accruals would remain subject to tax upon withdrawal. However, given the large windfall gain that would accrue to the government by immediately taxing existing pension wealth, and the complexities associated with operating parallel pension regimes for the next 50 years, transferring current EET savings into a TEE account may hold some theoretical attraction for government. Therefore, whilst we would not expect this approach to be considered, for completeness we have briefly recorded below the reasons why this would not be a viable option:

2.42 We believe there would be major legal obstacles to making people transfer existing pension wealth out of the current EET system and into a TEE account. Additionally, such an approach would undermine public trust that future governments would not tax pension assets again, which is critical if a TEE system is going to incentivise saving. It would also lead to a sharp fall in the UK markets, as assets would need to be liquidated so that an immediate tax bill could be paid. This would significantly reduce the value of people's pensions and their incomes in retirement.

2.43 Allowing people to transfer on a voluntary basis would lessen some of these problems, but would still be problematic. As it would be impossible to identify the appropriate rate of tax for people in advance of their retirement, an arbitrary rate of 15% or less would need to be chosen. A rate of 15% would be appropriate for people expecting to pay the basic rate of tax in retirement, given that 25% of withdrawals are tax free. However, a rate this low would give people expecting to pay higher and additional rates in retirement a substantial benefit at the expense of the Exchequer. In contrast, people who pay no tax in retirement would be considerably worse off. Given that over 50% of people claiming the state pension pay no tax, such a rate would hurt a significant number of individuals with small pension pots.[24]

[24] HMRC (2015) "Personal Income Statistics Table 3.6" & DWP (2015) "Outturn and Forecast: Autumn Statement 2014"

3 A single rate of relief

Key points

3.1 We believe that a single rate of tax relief, framed as the "Savers' Bonus", best meets the Government's principles for reforming the pensions tax relief system. This is because:

- the system **is simple and transparent**, making it easy for savers to understand the system and the benefits of saving into a pension
- it supports personal responsibility as it **improves the incentive to save and the targeting of incentives**; and
- it is **sustainable over the long term** and is a radical reform that can be **implemented quickly to deliver savings in the short term**.

3.2 A single rate system as we have proposed meets all of the Government's guiding principles for a good pensions tax relief system. The simplicity benefits are significant, as are the fiscal benefits and the improvements in incentives and targeting. Overall, a single rate offers a radical reform option that can be achieved within this Parliament and without undue risk or a damaging transitional period. We strongly support its implementation as the best option available to the Government.

What would a single rate system look like?

3.3 There are various ways to implement a single rate system. Our evaluation of the single rate system is based on what we consider to be the best possible design of a single rate system, as set out below:

3.4 For defined contribution (DC) pensions:

- tax relief is renamed as Savers' Bonus, which is set at a single rate for all between 25 and 33% of contributions
- tax is levied at the individual's marginal rate when savings are accessed, with 25% remaining tax free
- The Savers' Bonus applies to both employer and employee contributions
- there are no changes to the treatment of either employer or employee NICs
- the Lifetime Allowance is removed and fiscal cost is controlled by adjusting the Annual Allowance
- changes only apply prospectively; and
- for employee contributions, the single rate is implemented via relief at source (RAS). Employer contributions are adjusted through payroll.

3.5 As with TEE, a single rate system applying to employer contributions is impractical for defined benefit (DB) pensions (see paragraphs 5.4 - 5.13).

Rather than applying a single rate, we expect the government would reform the current system of tax relief for DB by:

- removing the Annual Allowance; and
- increasing the DB multipliers and/or reducing the Lifetime Allowance to ensure that those saving into DB schemes do not receive favourable treatment compared to the benefits someone might realistically be expected to receive in a DC scheme.

Evaluating a single rate of relief

Simplicity and transparency

3.6 A key benefit of a single rate, expressed as Savers' Bonus, is how simple it is for consumers to understand. At a rate of 33%, it could be presented as £1 from the government for every £2 they contribute, making the benefits of saving into a pension much more visible than they are at present.

3.7 The single rate system we propose will also simplify the administration of pension saving:

- By using a RAS system, all savers will receive the correct amount of tax relief when contributions are made, meaning higher and additional rate taxpayers will no longer need to file tax returns or have their tax codes amended to receive the right amount of pensions tax relief.
- Removing the Lifetime Allowance means savers no longer need to estimate future investment returns when deciding whether to make additional contributions.
- Because the single rate distributes tax relief more evenly, it would be possible to remove the Annual Allowance taper, which has been introduced to reduce the tax relief accruing to additional rate taxpayers but adds unwelcome complexity to the system, particularly for employers.

3.8 In contrast to a TEE system, tax will remain payable at the point of withdrawal. However, all pension income will be treated the same way, meaning people accessing different types of pensions (for example DB, DC and the state pension) only need to understand a single tax regime.

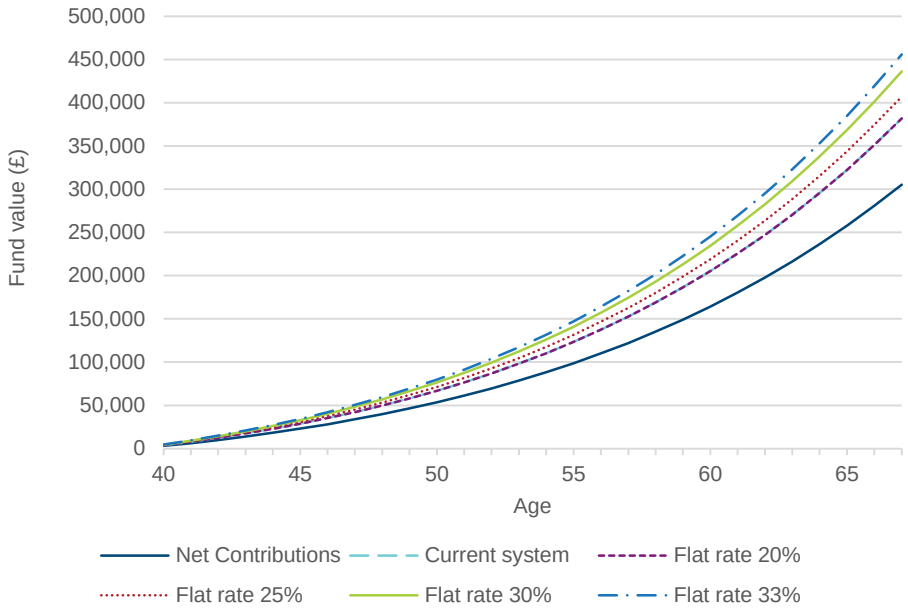
Supporting personal responsibility

3.9 The economic and behavioural literature suggests that matching contributions are one of the most effective means of encouraging savings. This is why we propose reframing tax relief as the Savers' Bonus. Such a change will have strong positive effects on people's propensity to save as evidenced by the

international literature which consistently finds that matching contributions provide the strongest incentive to save.[25]

3.10 While we should of course take the opportunity to improve incentives, we must not lose sight of the fact that the most important determinant of an individual's ability to take personal responsibility during retirement will be the size of the individual's pension pot.

Figure 6: Growth of pension fund for a 40-year-old earning £40,000 in 2015 under various EET tax systems (nominal terms)



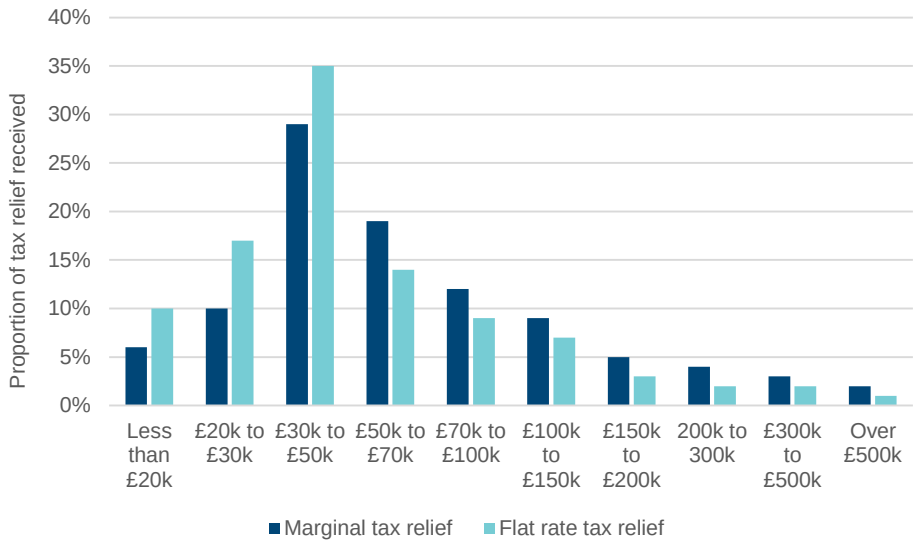
Source: PPI (2015) "Comparison of pension outcomes under EET and TEE tax treatment"

Note: For a basic rate taxpayer a flat rate of 20% and the current system are identical.

3.11 A single rate will support low and middle income earners to accumulate larger pots by better targeting government incentives towards them. Government research has shown that there are 10.9 million people with annual incomes below £52,000 that are undersaving, and almost 60% of this group have annual incomes below £32,500.[26]

[25] See Annex 4 - "Literature review: Behavioural economics and pensions tax policy"
[26] DWP (2014) "Scenario analysis of future pension incomes"

Figure 7: Distribution of tax relief by salary band in 2012/13 under the current marginal rate system compared with a flat rate system



Source: PPI (2015) "Comparison of pension outcomes under EET and TEE tax treatment"

3.12 This also makes for a much more radical reform, sending a powerful message to blue collar and clerical/administrative workers that the government is supporting their retirement saving.

3.13 For higher and additional rate taxpayers, the benefit to saving will reduce under a single rate system. However, this is arguably a product of the system being too generous for these savers already, given that six out of seven will only pay basic rate tax in retirement.[27] For those fortunate enough to pay higher or additional rate tax in retirement, there is a far weaker case for government support for saving.

3.14 It is often proposed that a single rate system will result in double taxation, and that this will discourage people from saving. While this risk exists, the level of retirement income required for it to be a serious concern means it is irrelevant for the overwhelming majority of people. This is because even someone who is a higher rate taxpayer in retirement is very unlikely to have an average tax charge on their pension at a rate as high as the relief they receive while saving. For instance, even someone with the maximum pension pot of £1,000,000 will only pay an average tax rate of under 19% on their pension.[28]

[27] CPS (2014) "Retirement Saving Incentives: The End of Tax Relief and a New Beginning"

[28] Assume the person concerned takes £250,000 as a tax free lump sum and with the remainder buys an annuity at 5.5% (£41,250 per annum). With a personal allowance of £10,600 and a basic rate band of £31,785, assuming no other taxable income, they would pay tax of £10,143 (£31,785 at 20% and £9,465 at 40%) – an average rate on their pension of 24.6% - or when their tax free lump sum is taken into account, 18.5%.

Even if they had other savings income of £20,000 per annum, their average tax rate on their pension would still be under 26%.[29]

3.15 Reducing tax relief for higher and additional rate taxpayers could reduce the incentive for these groups save at the margin. However, customer research by Hargreaves Lansdown has found that their customers, who are typically higher and additional rate taxpayers, favour a single rate system with relief at 33%, and expect they will save more, rather than less, in a single rate system.[30]

3.16 Finally, a single rate will continue to encourage personal responsibility in retirement, by virtue of pension income being taxed, which guards against the instinct to withdraw pensions early. Since the introduction of the Pension Freedoms, there has been a large increase in the number of lump-sum payments, mostly of smaller pots.[31] However, tax has acted as a brake on people's instinct to take all funds as cash in one payment, which supports the goal of pensions being used to provide a steady income throughout retirement without the need for state support. It is entirely compatible with personal responsibility to understand this instinct and guard against it.

Building on the success of automatic enrolment

3.17 As was noted in the previous chapter, any substantial change to the pensions system carries a risk for AE. However, a single rate system minimises the risk of disruption to AE by retaining the current treatment for NICs, and by applying Savers' Bonus equally to employer and employee contributions.

3.18 Because a single rate system will be beneficial for basic rate taxpayers, AE will be strengthened for this group and their employers. Indeed, reframing tax relief as the Savers' Bonus, and the increased generosity of those payments for basic rate taxpayers, could well see the already low rate of AE opt-outs fall further. For their employees, the true value of the employer contribution is likely to be more obvious, making this a more valued portion of an employee's remuneration package.

3.19 In contrast, reducing the value of tax relief for higher and additional rate taxpayers risks reducing the value of AE to these cohorts. While it is a natural consequence of a flat system of tax relief that higher earners will receive fewer benefits, it is important to carefully consider the consequences of such a change.

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[29] If they had additional income of £20,000 per annum, a greater proportion of their pension would be taxed at the higher rate, giving an average rate of 34.3%, or 25.7% when the tax free lump sum is taken into account.

[30] Hargreaves Lansdown Research (2015) "ISA-style pensions versus tax relief"

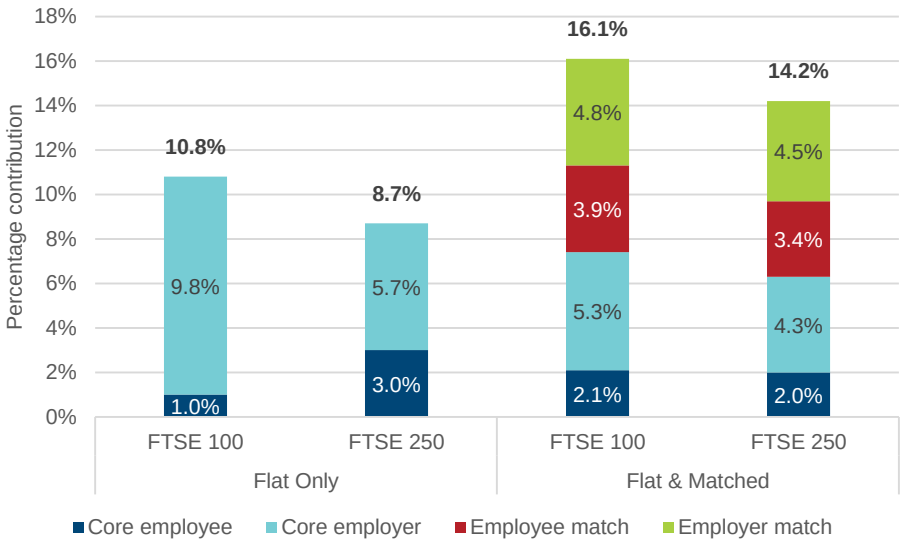
[31] ABI (2015) "Payments made to savers since the pension reforms reach nearly £2.5 billion, ABI stats show"

3.20 The first and most obvious change is that any pension contribution by higher earners will be less valuable, all else being equal. While this risks a marginal fall in the level of contributions from this group, pension contributions will still be tax efficient for almost everyone (as set out in paragraph 3.14), which will mitigate this impact.

3.21 The second, and bigger, concern is that employer contributions will need to be taxed at a rate equal to the difference between the single rate and the individual's marginal tax rate. As a result, employer contributions will reduce take-home pay.

3.22 Again, while this reduces the value of pension contributions relative to salary for higher earners, pension contributions will remain tax advantaged for all but a very tiny minority. This reduces the risk that people will opt-out of AE. Furthermore, we know that employer contributions are a major driver of employee participation in pension savings, so contribution rates for higher earners will be sustained by matching employer contributions, as people will not readily forego pension contributions from employers. This fact is supported by the much higher rate of employee contributions where matching contributions are present, as illustrated in Figure 8 below.

Figure 8: Impact of employer matching on employee contributions



Source: Towers Watson "FTSE 350 DC pension scheme survey 2015"

3.23 It is sometimes argued that reducing the benefit of pension saving for senior executives will also reduce their support for pensions for their workforce. In considering this argument, it is important to distinguish between a relative and absolute loss of benefits. This proposal is an example of the former case; while senior executives may receive fewer benefits, they still receive a tax benefit from pension saving and so any reduction in their support for pensions would be marginal. An absolute loss of benefits would mean there is no benefit to those executives from saving into a pension, and as such it would

be more likely to see firms step away from pension provision entirely. Given that a single rate would only present another relative reduction in benefits, we do not expect that the employer reaction would be significant. This expectation is consistent with the experiences of recent years, where we have seen no evidence of reduced employer support for workplace pensions, despite repeated cuts to pension tax relief, particularly for higher earners. Furthermore, decisions about executive remuneration do not always apply to other staff; research from TUC shows that senior executives frequently have different pension arrangements from the majority of staff.[32]

3.24 It is worth noting that these impacts on higher earners can be mitigated by setting a higher single rate of relief.

3.25 Like any major reform, implementing a single rate of relief will be challenging. But relative to implementing a TEE system, implementation will be low risk. As noted above, it could be implemented through the RAS system, relying on the development of existing payroll systems and provider platforms, rather than requiring new IT infrastructure.[33] As a result, providers estimate that the development costs would be just 10 to 20% of the cost of implementing a TEE system.

3.26 The transition to a single rate system could be made relatively quickly. We think a realistic timeframe is 18 months to two years, with the benefits realised within this parliamentary term.

3.27 The analysis above suggests that a single rate is the radical reform option most likely to support AE. While it is more risky than retaining or modifying the existing system, it is unambiguously less risky than a TEE option. This is because basic rate taxpayers, who represent the vast majority of savers and are the target audience of AE, would gain substantially under a single rate system. This additional incentive will also reduce the risk of opt-outs from basic rate taxpayers as AE contribution rates go up between now and 2018. The fact that implementing a single rate is faster, cheaper and easier than implementing a TEE system only confirms the superiority of the former.

3.28 In judging whether the risk of undermining AE justifies the benefits of shifting to a single rate system, it should be remembered that in a world of constrained budgets, it will never be possible to improve the incentive to save for lower and middle income earners without reducing it for higher earners. If the government is worried about the effect on higher earners, the answer lies in minimising that effect by setting the Savers' Bonus at a higher level overall, and reducing the Annual Allowance to control the total cost.

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[32] TUC (2015) "PensionsWatch 2015: A TUC report on director's pensions in the UK's top companies"

[33] This includes the need to levy a benefit in kind tax on employer contributions for higher earners. There is already a precendent for taxing benefits through payroll without the need for inclusion on a P11D. If this were applied to employer pension contributions through payroll, the correct result could then be achieved without employees needing to file tax returns.

Sustainability

3.29 From a fiscal perspective, a single rate will enable the Exchequer to make fiscal savings quickly that are sustainable over the long term. With the Savers' Bonus set at 25%, sustainable savings of roughly £1.3bn per annum could be expected from DC pensions alone, when measured on a static basis.[34]

Table 3: Single year cost to exchequer of tax relief on pension contributions for EET systems (£billions)

Tax Treatment scenario	*Cost on employer contributions*	*Cost on employee contributions*	*Total cost to exchequer*
Current system	21.3	5.9	27.2
Flat rate – 20% relief	13.0	3.4	16.4
Flat rate – 25% relief	16.7	4.4	21.1
Flat rate – 30% relief	20.5	5.5	26.0
Flat rate – 33% relief	22.9	6.1	29.0

Source: PPI (2015) "Comparison of pension outcomes under EET and TEE tax treatment"

Note: These exchequer costs include cost of tax relief for both DB *and* DC pension schemes , and exclude the tax receipts from pensions in payment that arise in the current system, which totalled £13.1b in 2013/14. Our estimates for fiscal savings assume a 1:3 split of costs between DC and DB and allow for likely changes arising from the roll out of AE..

3.30 We believe the same level of savings would be achievable at rates up to 33% by reducing the Annual Allowance. Significantly more savings could be made by amending the multipliers for DB pensions to ensure savers in DC pensions are treated fairly relative to those in DB schemes.

3.31 It is important to recognise that, unlike in a TEE system, these savings do not rely on bringing tax receipts forward. This means the savings will be sustainable over the long term and do not increase long term liabilities for future governments.

3.32 All else being equal, any significant fiscal savings made by reducing tax relief for pensions will by definition reduce the amount of money saved into pensions and subsequently invested back into the economy. However, retaining what is essentially an EET framework means that the macroeconomic cost of government making savings should be lower because the tax burden will be shared more evenly between the working age and

[34] This is the level of saving possible from 2019, once automatic enrolment applies to all employers and statutory contribution rates are 8%. Savings in the years before 2019 would be even greater.

retired populations. Accordingly, in a single rate system we would not expect the same negative macroeconomic impacts on GDP, investment, wages or productivity, as we would in a TEE system.

3.33 Finally, a single rate is sustainable when considered from a demographic perspective, given that it ensures retirees will remain as taxpayers. This is important in the context of an ageing society where the ratio of dependents relative to the working age population is increasing, and so is the cost of those dependents.

An alternative approach to implementing a single rate

3.34 The ABI has proposed a flat rate system which applies both to employer and employee contributions (described in more detail in paragraphs 3.3-3.5 above). Overall we think that this package provides the optimal balance of advantages and disadvantages, given the Government's stated objectives for reform.

3.35 However, there are two disadvantages arising from this approach:

- Due to the difference between employee National Insurance rates for basic and higher rate taxpayers (12% and 2% respectively), applying a single rate to employer contributions will create a disparity in favour of basic rate taxpayers. For example, at a flat rate of 30% on employer contributions, a basic rate taxpayer will receive relief totalling 42% (tax relief of 30% and NIC relief of 12%), whereas a higher rate taxpayer will receive total relief of 32% (tax relief of 30% and NIC relief of 2%). In other words, rather than removing the existing bias in favour of higher rate taxpayers, the position would be reversed, creating a bias in favour of basic rate taxpayers.[35]
- As discussed in paragraphs 3.21-3.22, the application of a single rate to employer contributions also means that excess tax relief on employer contributions will have to be recovered for higher and additional rate taxpayers (assuming a flat rate of 33%, tax of 7% (40% - 33%) will have to be recovered from a higher rate taxpayer). Although this can be managed through payroll systems, it has implications for take home pay and creates added complexity. This additional complexity would be particularly problematic for DB pensions, which is one of the reasons why our proposal relates only to DC pensions.

3.36 Both of these issues could be addressed or at least mitigated if a flat rate were applied to employee contributions only, with marginal rate relief retained for employer contributions. Although it could be argued that it is conceptually

[35] Note that although there is an incentive to use salary sacrifice arrangements to minimise employee NICs, this incentive is present in the current system. Therefore, not addressing this risk does not add fiscal cost or risk to the system when compared with the status quo.

inconsistent to adopt a different approach to employee and employer contributions, this approach has the following advantages:

- It would not favour basic rate taxpayers in relation to employer contributions. Instead a higher rate taxpayer would receive total relief of 42% (40% tax and 2% NIC) and a basic rate taxpayer would receive relief of 32% (20% tax and 12% NIC) in respect of employer contributions.
- There would be no need to recover excess tax relief from higher and additional rate taxpayers, avoiding considerable administrative complexity and potentially allowing the single rate to be applied to both DB and DC pensions.
- It could potentially yield even greater savings for the Exchequer than applying a single rate to both employer and employee contributions.

3.37 However, application of a flat rate to employee contributions but not to employer contributions would create a tax incentive for higher rate taxpayers to convert employee contributions to employer contributions through salary sacrifice. Doing so would enable them to obtain a marginal rate of relief instead of the flat rate (i.e. 40% tax relief instead of the lower flat rate).

3.38 Critically, therefore, this approach relies on devising a mechanism for preventing salary sacrifice. Although this may well be possible and we have considered some different approaches, this is likely to be difficult and there is a risk of catching innocent employer contributions. Therefore the effectiveness of such a mechanism would need to be confirmed before we could recommend this as a sustainable alternative.[36]

[36] We note that the government announced in the 2015 summer Budget that is was monitoring the loss of tax receipts through salary sacrifice arrangements, which implies the government is considering how the fiscal risk could be addressed.

4 A marginal rate relief system

Key points

4.1 The status quo is ineffective at incentivising savings as savers do not fully understand the benefits due to its complexity, and it is becoming fiscally unsustainable. On this basis, we do not believe that retaining the status quo is a credible option.

4.2 However, there are ways to meaningfully reform the system while maintaining marginal rate relief. We do not believe the gains offered by reforming the current system match those from moving to a single rate system, but it is also true that the risks of the reforms we propose in this chapter are significantly less than the alternative reform options, especially for AE:

- it is proven to be **compatible with automatic enrolment**
- it is possible to reform the system to reduce the fiscal cost and make it **sustainable over the long term**; and
- **reform could happen quickly and with minimal risk** and cost, and apply to both DB and DC pensions.

4.3 For these reasons, we consider that a reformed system of marginal rate relief, as outlined below, offers definite improvements and represents a credible, viable and very low risk alternative to our preferred option for reform.

What would a reformed marginal rate relief system look like?

4.4 We think a system of marginal rate relief will best meet the Government's principles for reform if designed as set out below.

4.5 For both DB and DC pensions:

- employee pension contributions continue to be subject to tax relief at the individual's marginal rate
- up to 25% of savings can be taken as a tax free amount at the point of retirement
- the remaining 75% of savings is taxed at the individual's marginal rate when accessed in retirement
- employer contributions are not taxed nor subject to Employee NIC; and
- pension contributions by employers continue to attract employer NIC relief.

4.6 For DC pensions, the Annual Allowance would be retained, but the Annual Allowance taper and the Lifetime Allowance would be abolished. The Annual Allowance would be the primary lever for controlling fiscal cost.

4.7 For DB pensions:

- the Annual Allowance is abolished, but the Lifetime Allowance is retained

- the existing DB multiplier is corrected to align the size of notional funds commensurate with benefit levels to those achievable for DC pensions; and
- the Lifetime Allowance is then set by reference to Annual Allowance levels for DC pensions.

4.8 Alongside these changes we would recommend a government-sponsored communication and education program, perhaps tied to AE, to improve public understanding of the benefit of pension saving.

Evaluating a marginal rate relief system

Simplicity and transparency

4.9 The difficulty of communicating the deferral value of marginal rate relief to savers is a limitation for any system of this type. While this can be overcome through increased financial literacy, it is equally true that savers should not need to have a detailed understanding of the tax system before concluding that it is in their interests to save. A concerted effort to communicate the benefits of pension saving more clearly should increase understanding, and the success of marketing the benefits of AE suggests this approach could be successful.

4.10 Although the current system is complex, much of the complexity stems from measures introduced to control costs. These include the Lifetime Allowance, the Annual Allowance and the Annual Allowance taper. The plethora of transitional regimes and benefit crystallisation events associated with these allowances complicate matters further. Abolishing these restrictions as we propose would simplify the system, enabling better customer understanding and engagement, while making it faster to implement changes in future.

4.11 For example, responsibility for keeping track of the proportion of Lifetime Allowance used lies with the customer, with different rules for DB and DC pensions. Although the Lifetime Allowance is irrelevant to the vast majority of customers, anyone seeking to take out a retirement product or a cash lump sum must sign a Lifetime Allowance declaration and state the proportion of Lifetime Allowance they have already used. In addition, providers issue an annual statement, which includes information on the amount of Lifetime Allowance used, to those who have pensions in payment. Furthermore, there are anomalies in the amount of pension that can be accumulated, as beneficiaries can inherit uncrystallised pension funds or unused drawdown pension without contributing to their own Lifetime Allowance.

4.12 As with the single rate system we have considered, tax will remain payable at the point of withdrawal. While this is a burden in some respects, the absence of change would at least prevent further confusion during the transitional period.

Supporting personal responsibility

4.13 Whilst the current system is poorly understood by many, this does not mean that the basic premise is flawed. Indeed the EET system is commonly used across the world. Rather, this is a failure of communication, which could be addressed in part by the simplifications we have proposed above alongside a renewed effort to educate the public about the benefits of saving. The current system has a lot of positive features. These include:

- Generosity – taken together the incentives in the current system are generous and can support people to build adequate savings to support their retirement.
- Coherence – the pure EET system avoids double taxation, which means that all taxpayers are positively incentivised to save.
- People are taxed according to their income – as tax is levied according to an individual's income in retirement, the tax rate payable is set relative to that individual's means during the period the income is accessed. The opposite is true of a TEE system.
- Responsibility in retirement – like with the single rate, by levying tax in retirement, the system acts as a brake to slow the rate at which people access their pension, limiting the risk that people run out of money in retirement.

All of these factors contribute to a system that helps people to take personal responsibility in retirement.

4.14 Conversely, the system has inherent weaknesses. These include:

- Targeting – tax relief is poorly targeted with a significant proportion of incentives accruing to higher and additional rate taxpayers.
- Incentives – the incentives have relatively weak behavioural benefits in comparison to matching payments, because most people don't understand the concept of tax relief.

4.15 The changes we propose to the current system will ensure improvements over the status quo by building on the existing strengths and addressing some, but not all of its weaknesses.

4.16 First, abolishing the Annual Allowance taper removes a barrier that discourages higher earners from pension saving. Whilst the Annual Allowance taper may limit fiscal cost, we believe it is a crude tool that reduces the overall coherence of the system. We instead propose to limit the fiscal cost of the system by simply adjusting the Annual Allowance.

4.17 Using the Annual Allowance to manage cost also works to reduce the amount of tax relief captured by higher earners, without disincentivising saving up to the allowance. While a flat rate would be more effective in ensuring a greater proportion of tax relief went to people on lower incomes, amending the

marginal rate system via the Annual Allowance would have a comparable effect because higher earners would be most affected by a lower allowance.

Building on the success of automatic enrolment

4.18 The great strength of the marginal rate relief system is that AE has been designed to work within this framework. For this reason, a marginal rate relief system is the only option we can be certain will not undermine AE.

4.19 Despite the initial success of AE within the current framework for pensions tax relief, we believe the changes we propose would build on the success of AE by improving, extending and embedding the communication of benefits of pension saving.

4.20 With regards to implementation simplicity, a marginal rate system does have one drawback relative to the other systems we have considered. With the introduction of the Scottish Rate of Income Tax, delivering marginal rate tax relief will become more difficult due to the need to apply differential rates in different parts of the UK. In contrast, matching payments that apply equally across the country should not be affected.

Sustainability

4.21 As stated above, we do not believe the current system of marginal rate relief is sustainable in the current fiscal environment, especially given the increasing cost of tax relief as AE rolls out to small and micro employers and contribution rates increase.

4.22 However, reforming the system as we have set out above gives ample opportunity to sustainably and quickly reduce costs to the Exchequer of both DC and DB pensions. It is extremely difficult to determine the levels at which the allowances and DB multipliers should be set to make the system sustainable due to a lack of data.

4.23 Once the DB multipliers are corrected, the level of the Annual Allowance can be meaningfully translated to the DB Lifetime Allowance – for instance based on contributions at the Annual Allowance for a set number of years of service. This provides a mechanism for controlling fiscal costs across both DB and DC pensions while creating and sustaining fairness between the two systems.

4.24 Reforming marginal rate relief can be achieved without substantial systems changes. Consequently implementation times are likely to be shorter than for the other reform options we have discussed. We therefore expect that savings could be realised within a year of any announcement.

5 Implementation considerations

5.1 While a TEE system would be much harder to implement than the other options for reform we have considered, there will be a degree of difficulty implementing any of the options. Regardless of which option the Government pursues, employers and the pensions industry must be given enough time to ensure any changes are delivered successfully, with a sufficient period of consultation on detailed proposals to avoid any unintended consequences.

5.2 This chapter sets out some of the issues that will need to be considered in more detail.

National insurance

5.3 We have not recommended any changes to the treatment of NICs in the options we have considered. However, we note that the Office for Tax Simplification is considering closer alignment of tax and National Insurance. As any changes to National Insurance could have significant implications for workplace pensions, the system of pensions tax relief must be consistent with both the short term and the long term treatment of National Insurance.

Treatment of defined benefit pensions

5.4 We have assumed a different treatment for DB pensions relative to DC pensions in the TEE system we postulated and have also recommended different treatment for our preferred EET single rate option (which applies the single rate to both employee and employer contributions). While there are multiple challenges associated with applying either system to DB pensions, the main reason it is necessary to treat them differently is because of the difficulty of taxing employer contributions, as set out below.

5.5 The first challenge with taxing employer contributions is simply valuing the benefit. In DB schemes, employer contributions reflect the cost of new accruals for all scheme members rather than representing contributions for individuals. To value these contributions, a formula would be needed to determine how much accrued to each individual. While one exists for calculating whether the Annual Allowance is reached, it is a crude calculation that does not adequately account for the individual's retirement age or their age at the time the contribution is made, both of which are material for determining the actual value of a benefit. Given that tax would need to be paid by the individual, such faults could not realistically go unaddressed. This would lead to a much more complex actuarial formula, and considerably increased administration costs.

5.6 The second challenge is that after valuing the contribution, the employee would need to pay tax on it. Given that employers will in some cases be contributing 25% on top of salary, basic rate taxpayers would face a pay cut of almost 1% in a TEE system with a 20% matching contribution. For higher rate taxpayers the pay cut would be almost 6%. In the single rate system we

propose there would be no impact for basic rate taxpayers and the impact for higher and additional rate taxpayers would be less. However, the drop in take home pay for higher rate taxpayers would still be at least 1.75%. It may be possible to avoid this drop in take home pay by reducing the value of the pension, but given that the employer has promised a defined benefit to the employer, it is not clear whether this would be possible.[37]

5.7 Finally, simply levying the tax would be difficult even if there was an appropriate formula to use. The accrual would be calculated at year-end, meaning tax paid in one period would relate to the previous period. Where the individual leaves employment, it would not be possible to pay tax via payroll adjustments, so would require the individual to pay tax on the employer contribution by submitting a tax return.

5.8 While there are numerous other issues associated with applying either a TEE system or a single rate system for both employer and employee contributions to DB pensions, we believe these challenges alone are sufficient to make these systems unworkable. As we noted in chapter 3, a single rate system that applied to employee contributions only would avoid a lot of these challenges, making it possible to apply the single rate to both DB and DC pensions. However, such an approach relies on a mechanism to prevent salary sacrifice arrangements, which we acknowledge is difficult.

5.9 Although we are strongly of the view that the tax relief regime must be equitable for DB and DC savers, we do not consider it essential for DB and DC pensions to operate the same tax relief regime because the two regimes are fundamentally different. The Pension Freedoms have already widened the legislative differences between DB and DC, for example through the Money Purchase Annual Allowance. We also do not think the rationale for changes to tax relief is as strong for DB pension schemes as for DC schemes. This is because there is little concern about savings adequacy for members of DB pension schemes, and an individual's incentive to save into a DB pension is not typically dependent on tax relief.

5.10 As set out in chapter three, we propose to achieve equitable treatment for both DB and DC savers by removing the Annual Allowance and adjusting the multipliers and/or Lifetime Allowance for DB pensions. We believe that the DB multipliers are already overly favourable towards DB pensions, and that even

[37] The size of the pay cut in these examples is determined by multiplying the employer's contribution and the differential between the individual's tax rate and the matching payment. For example, a matching contribution of 20% is equivalent to tax relief at 16.67%. This means that for a basic rate taxpayer a 3.33% tax needs to be applied to employer contributions. For an additional rate taxpayer, a 28.33% tax needs to be applied to employer contributions. For employer contributions of 25%, this means a basic rate taxpayer would face a reduction in after tax income of 0.833% while an additional rate taxpayer would face a reduction in after tax income of 5.833%. The reduction in take home pay for higher rate taxpayers in our single rate proposal is calculated the same way, with the outcome dependent on the single rate. With a 25% single rate, the reduction for higher rate taxpayers would be 3.75%, and at a 33% rate the reduction would be 1.75%.

if the current system remains unchanged, the DB multipliers should be increased to ensure equitable treatment for different groups. However, in the context of different tax regimes for DB and DC pensions, relying on the multipliers to deliver equivalence will not be perfect, and there are several implications that should be noted.

5.11 First, as most DB pensions are public sector schemes, there is a chance that the public may judge that government employees and Members of Parliament have been given favourable treatment to private sector workers.

5.12 Second, retaining a marginal rate system for DB schemes would mean that higher earners in those schemes would continue to receive proportionately more tax relief than basic rate taxpayers, making DB schemes more attractive for higher earners and less attractive for lower earners when compared with DC schemes on pure tax grounds. This creates a risk that basic rate taxpayers transfer from DB to DC pensions to benefit from increased tax relief, even if it is not in their best interests to transfer due to other guarantees.

5.13 While we do not believe there will be much appetite for employers to set up or reopen DB schemes for the purpose of taking advantage of this differential for higher earners, there is a risk that employers will offer the minimum DB promise allowable for AE, or a small element of guarantee with the DC pension to ensure that under tax legislation it is deemed a DB pension. Rules addressing these risks, along with the treatment of hybrid schemes and additional voluntary contributions would need to be put in place, as would a means of capping tax relief for people with a mixture of DB and DC accruals.

5.14 Third, if DB and DC pensions have different tax regimes, it will be more complex to transfer from DB to DC pensions to take advantage of the Pension Freedoms. This problem would be particularly acute if TEE were applied to DC pensions, or reduced for transfers for immediate access of benefits in an EET-only system.

Impact on protection insurance

5.15 The Government also needs to be cautious about the impact of pension tax reforms on the provision of death in service benefits provided through pension arrangements. Group death benefits offered by employers can be registered as an ‘occupational pension scheme’ under the Finance Act 2004 and share the same tax reliefs available to retirement benefits.

5.16 At the end of 2014, approximately 8 million people were insured in registered occupational death in service arrangements. For many low to middle earners, employer-sponsored cover can be the sole life cover they hold. Cover can usually be provided for individuals and their families who might otherwise not be able to purchase an individual life assurance policy as a result of their state of health.

Pensions dashboard

5.17 While a secondary consideration, tax changes could also impact on the creation of a Pensions Dashboard, which has been recommended by the FCA to help customers see all of their pensions in one place to support consumer choice. A move to a TEE system, which would increase the number of pots and make comparison of them more difficult, would make the development of a pensions dashboard significantly more challenging.

6 Conclusion

6.1 Having thoroughly considered the different options for reform with independent inputs from NIESR, the PPI and Populus, the ABI has a clear preference for a single rate relief system, as set out in chapter three. This system would command the support, goodwill and enthusiasm of the key providers in the market, who will be critical to implementing change.

6.2 We consider the single rate option to be clearly superior to the alternatives we have considered as it meets all of the Government's principles for reform:

- It is simple and transparent, making it easy for savers to understand the system and the benefits of saving into a pension.
- It improves both the incentive to save and the targeting of incentives. This redistributive effect will allow individuals to take greater personal responsibility for saving an adequate amount for retirement.
- It increases the benefit of being automatically enrolled into a workplace pension for basic rate taxpayers, who are the target demographic for AE.
- It is sustainable over the long term, and is a radical reform that can be implemented relatively quickly to deliver fiscal savings to the government in the short term.

6.3 Despite its strengths, the system is not perfect. Applying the single rate to employer contributions requires a tax on those contributions, which reduces take home pay for higher and additional rate taxpayers.

6.4 While this could have some implications for AE, we believe that this problem (along with some other, more minor, problems) is heavily outweighed by the benefits of a single rate. Overall, the single rate system we propose provides a radical option for reform that delivers on the objectives of the consultation without taking any undue risks.

6.5 Reforming the existing marginal rate relief system by simplifying it dramatically also offers an improvement on the status quo, albeit a much more modest improvement when compared with the single rate option. However, this option has by far the lowest risk, especially for AE, which means we consider it a viable alternative to our preferred option of a single rate.

6.6 The worst system we have considered is a TEE option. While a TEE system has some attractive features in theory, as a whole package it is inferior to all of the alternatives we have considered, including the status quo. This is because there are significant macroeconomic consequences and the savings are largely illusory, while it threatens to undermine the incentive to save for both employees and employers. Considering the significant implementation risks that also come with a TEE system, we believe that it would be reckless and highly risky for the government to try and implement it.

Annex 1: Answers to consultation questions

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

1.1 The current system is not in principle particularly complex. However, the central concept of tax relief is not well understood. Most of the complexity of the current system derives from measures added to control fiscal costs: the frequent changes to the Lifetime Allowance with its associated transitional regimes and the Annual Allowance taper for high earners are two of the most egregious examples.

1.2 If this extraneous complexity can be reduced, then reframing the key principle – that government makes a contribution when you pay money into your pension – would increase the incentive to save.

1.3 We comment further on this aspect in chapter four of our response.

2 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?

2.1 Inevitably a simpler system makes communication of the available incentives easier. However any simplification at the savings stage should not be at the expense of further complication for those in retirement. In this context we are particularly concerned that a TEE system would involve different systems for different pensions in payment for the foreseeable future.

2.2 We therefore advocate applying an EET single rate approach to DC pensions. This would make pension saving easier to understand without introducing further complexity for those drawing their pension. To further improve the simplicity of DC pensions, we advocate retaining the Annual Allowance for DC pensions but dispensing with both the Lifetime Allowance and the Annual Allowance taper.

2.3 We comment further on this in chapters two and three of our response.

3 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?

3.1 Yes, the current system allocates over two thirds of tax relief to higher and additional rate taxpayers. However a single rate system would ensure that relief is better targeted towards those whose pension saving it is most important to increase – i.e. those in lower and middle income bands. Furthermore, a flat rate makes the government contribution easy to communicate and will increase the visibility of tax relief, so incentivising pension savings.

3.2 We comment on this in chapter three of our response.

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

4.1 This depends on the alternative system adopted. Moving to a single rate within the existing EET framework would leave the existing position for pensions in payment unchanged. However, in contrast, moving to a TEE system could adversely affect people's planning. Not only would there be no tax 'brake' (which currently encourages people to smooth their pension withdrawals), but lack of trust that future governments will not renege on any promise not to tax pensions, will encourage people to withdraw their savings as soon as possible.

4.2 We discuss our concerns in chapter two of our response.

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

5.1 This should be considered. DC and DB pensions are fundamentally and conceptually different and it may not be feasible to force DB pensions to fit a model which makes sense for DC pensions. But by the same token it would be a missed opportunity if the position of DB pensions prevented savers benefitting from meaningful reform of DC pensions.

5.2 For DB Pensions, we believe it is important that the level of relief available is equitable with DC schemes. This is a very complex area and therefore further consultation is required on how to achieve this goal, although retaining a marginal rate system may ultimately be the final outcome.

5.3 Further detail of our proposed approach is included at the beginning of chapters three and five.

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

6.1 There are numerous barriers to reforming the system of pensions tax, the severity of which will depend on how the system is reformed. We strongly recommend introducing a single rate, on the basis that it offers radical reform without undue implementation risk. Even so, sufficient time must be given to those implementing any reforms before they come into force.

6.2 Our members have indicated that the overall costs of implementation of a TEE system would be an order of magnitude greater than those of moving to a flat rate within an EET framework, with a shift to a TEE system costing in the hundreds, rather than tens, of millions of pounds for providers alone. It would take up to twice as long to put a TEE system in place than it would a single rate, potentially stretching over two parliamentary terms. This is because new systems would have to be built from scratch. Furthermore, a move to a TEE system would require existing platforms to be in parallel with new systems for the next 50 years.

6.3 We are particularly concerned that moving to a TEE system would seriously undermine employer support for pensions and evidence suggests that employers would level down to the statutory minima for AE. In contrast, we believe that a single rate within the existing EET framework would build on the success of AE.

6.4 We comment on this in more detail in chapters two, three, four and five of our response.

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

7.1 It is essential to maintain the incentive for employers to make pension contributions for employees, given that direct employer contributions make up the majority of contributions, and are even more important once the effect of matching payments is factored in.

7.2 Although there are arguments that a single rate should be applied just to employee contributions, on balance we recommend that a single rate be applied to both employer and employee contributions.

7.3 We explore this further in chapter three of our response and also discuss the alternative approach of applying a single rate to employee contributions only.

7.4 We do not recommend any change to the treatment of NICs for either employers or employees.

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

8.1 We believe that in conjunction with an EET flat rate set at an appropriate level, the most effective 'lever' to control fiscal costs for DC pensions is the Annual Allowance. This is easy to understand, does not create the need for transitional provisions and whilst it limits contributions, does not distort incentives – in contrast with, for instance the Annual Allowance taper for the highest earners. For DB pensions we believe that the Lifetime Allowance is the more appropriate lever coupled with an appropriate re-valuation of the multiplier.

8.2 In contrast a TEE system is less sustainable fiscally, politically and in macroeconomic terms. Potential initial cost savings will be severely restricted by the need to retain the current framework for DB pensions and the requirement for a substantial matching payment to ensure that those on lower earnings in particular are not disadvantaged. And in time as the tax exemption of pension in payment becomes more relevant, these savings will be eroded.

8.3 Furthermore, under a TEE system pensions will increasingly fall out of tax whilst the elderly population increases with consequent increased social security, health and care costs. This will exacerbate intergenerational unfairness as the cost to younger generations of supporting the older generation increases disproportionately.

8.4 Finally, modelling by NIESR indicates that moving from an EET to a TEE system leads to declines in aggregate GDP, investment (savings), productivity and real wages, and to an increase in the real interest rate up to a pension subsidy of 50%. Aggregate consumption also falls in all the TEE cases, except for the most generous pension subsidy of 50%. NIESR describe these as 'strong results' and note that the results of their modelling are consistent with most of the economic literature.

Annex 2: NIESR: An economic analysis of the existing taxation of pensions (EET) versus and alternative regime (TEE)

The ABI commissioned the National Institute of Economic and Social Research to carry out an economic analysis of the existing taxation of pensions under an EET system versus an alternative TEE regime. We have reproduced the executive summary of their report below. The full report can be found on the ABI website.

EXECUTIVE SUMMARY

The Government set out four principles that a pension reform should meet, in addition to being mindful of the macroeconomic consequences. In this paper we assess the economic consequences of changing from the existing EET to a TEE pension taxation system from two approaches. First, we review the economic and empirical literature, and second we construct a general equilibrium OLG model parametrized to UK data and tax system. Both approaches show consistent outcomes.

In our view, personal savings will fall in all scenarios (i.e. of scenarios of varying pension subsidies under TEE) we considered. This will result in lower consumption, a lower capital stock and productivity and a higher real interest rate. Therefore, based on the principles and macroeconomic consequences set-out by the Government, our analysis suggests that the proposed policy change will deliver the opposite outcome. Personal savings are lower even where a pension subsidy of 50% is provided. Our modelling supports results reported in the academic literature.

Another principle is that the proposal ought to be consistent with the Government's fiscal framework. The TEE system would lead to an immediate tax revenue gain from removing the current tax relief. This would improve today's headline fiscal deficit. However, this will be at the expense of tomorrow's fiscal accounts. We note that the only scenario where output (almost) and consumption return to the levels comparable to the current EET system are with a 50% government pension subsidy which would likely be detrimental on a Whole Government Accounts basis.

We note that the EET system has superior risk sharing properties to TEE. By changing the taxation of pensions to TEE, the tax treatment will be similar to ISAs and housing wealth, but much less liquid. There is a risk of considerable substitution into other TEE savings, in particular housing.

There is a dynamic inconsistency problem inherent in TEE because a future government can always reverse policy and remove the subsidy, or re-introduce taxation on pension income. Given the pension challenges ahead, a

government cannot credibly commit not to exploit this time inconsistency. Given the inferior risk sharing and credible commitment problem, individuals are less, rather than more, able to take personal responsibility.

The final principle proposed by the Government is that the policy is simple and transparent. We note that the transition from EET to TEE would require earmarking different pension pots of savings as accumulated under different tax regimes. The transitional costs for defined benefit pensions could be considerable (assuming they would be forced to pay additional top-ups out of taxed income). We are unconvinced that having separate pension savings under different tax regimes would be beneficial in terms of transparency and simplicity.

We suggest that any further consideration of the merits of such a change in pension taxation is preceded by general equilibrium modelling analysis. This is the only framework which incorporates the full consequences of the behavioural changes. Published results would allow an open discussion of the possible consequences of such an important policy change, which is surely in the public interest. This analysis is a first stage. A full assessment would include life cycle incomes, more granular cohorts and uncertainty over income, future care costs and changes in future tax policy.

Annex 3: PPI: Comparison of pension outcomes under EET and TEE tax treatment

The ABI commissioned the Pensions Policy Institute to analyse the impact of a number of potential reforms to the tax relief system. Their report sets out the impact that the potential policy reforms might have on the level of money that people of different ages and in different tax positions could accrue by retirement and their resulting post-tax pension wealth. It also considers the impact of potential reforms on the cost of tax relief to the Exchequer. We have reproduced the executive summary of their report below. The full report can be found on the ABI website.

Executive Summary

In the Budget of 8 July 2015, the Chancellor, George Osborne, announced a consultation into the use of tax relief to "strengthen the incentive to save" for retirement. The ABI has asked the PPI to analyse the impact of a number of potential reforms to the tax relief system, ranging from adjustments to the current system, through to more fundamental changes in the way the pension tax relief works.

This report sets out the impact that the potential policy reforms might have on the level of money that people of different ages and in different tax positions could accrue by retirement and their resulting post-tax pension wealth. It also considers the impact of potential reforms on the cost of tax relief to the Exchequer

Chapter one: Impact of tax treatment on a single contribution

Chapter one sets out analysis of a £1,000 contribution made by individuals under the ABI's set of potential reform options. Using a single £1,000 contribution for individuals in different circumstances serves to set a level playing field for comparison. Under this approach the difference between outcomes for people of different marginal tax rates is not obscured by the variations in the amount of contributions that each type of taxpayer could afford to make.

Chapter one: Key points

- The current EET system is beneficial to all individuals. Under the current EET system some of the pension may be received with no tax at all being paid on it. This is because of:
    - the tax free lump sum,

    - and the fact that state pension does not use up all of the Personal Allowance in retirement, so some of the private pension income may not be pensionable.

- EET Tax Systems are beneficial to people who are subject to a tax rate in retirement which is lower than the rate on which they got tax relief.
- A flat rate EET system with a flat rate between 20% and 40% has a redistributive effect, improving the outcomes for basic rate taxpayers and worsening outcomes for higher and additional rate taxpayers.
- A pure TEE system without matching contributions is likely to reduce pension outcomes, because, with tax being paid up front, none of the pension is received tax free, and the tax paid is at the individual's marginal rate in work, rather than an average rate after retirement.
- Giving a matching contribution on a TEE system is similar to a flat rate EET system in the accumulation phase.
- A TEE system with significant matching contributions could increase the outcomes for individuals.

Chapter two: Impact of tax relief on saving through working life

Chapter two considers the whole working life impact of the various tax regimes on individuals and the extent to which their outcomes are affected by working patterns.

The results in chapter two are set out in a measure that is similar to the 'taxed fund value' defined in chapter one. It is a single figure that sets out the value of their pension saving that is available to them after retirement in terms of the total value of the net income they might achieve under the potential policy reforms.

Chapter two: Key Points

- Individuals who are basic rate taxpayers through their working life tend to do better under a single tier which offers tax relief at greater than 20%.
- Those who have significant periods as higher rate taxpayers, including those who may have started as basic rate taxpayers, do less well under TEE systems or the single tier EET system, requiring a high matching contribution or rate of tax relief rate to maintain the value under the current system.
- Individuals with salary growth that leads them to move from basic rate to higher rate tax, will experience a combination of the basic rate taxpayer and higher rate taxpayer impact. The particular impact on them will depend on the amount of time and level of contributions made while basic and higher rate taxpayers.

- Higher rate taxpayers derive a lot of value in their pension from the 40% tax relief. An EET system with a reduced level of tax relief will leave them worse off. Even a TEE system with a 50% matched contribution could leave them worse off compared with the current system, if they would likely be a basic rate taxpayer in retirement.
- For those who would be eligible for means tested benefits, those benefits may be able to offset some of the loss in a switch from the current system to a TEE system. However that would increase the cost on the government of providing means tested benefits.

Chapter three: Cost and distribution of reforms to tax relief

Chapter three sets out the first year static impact on the cost to the Exchequer of a number of alternative reform options. It goes on to consider how the distribution of tax relief by salary level and by age may change under a flat rate pension tax relief system.

Chapter three: Key Points

- Adjusting the tax relief on contributions changes the cost to the government of the tax relief.
- An EET system with a flat rate of slightly over 30% might be implemented for around the same initial cost of tax relief as the current system.
- A pure TEE system will lead to an initial reduction in cost as the tax relief on contributions falls to zero, however there will be a longer term cost when the resulting pensions are paid out with no tax payable.
- A TEE system with matching contributions introduces upfront costs to the Exchequer in addition to the loss of future tax revenue on pension payments.
- The distribution of tax relief under a flat rate system reflects the net contribution to pension schemes.
- The age distribution of tax relief is relatively unaffected by introducing a flat rate pension, however there is a slight redistribution from middle ages to younger, and to older pension savers.

Chapter four: Lifetime Allowance and Annual Allowance equivalence

Chapter four considers making an adjustment to the system of pension tax free allowances, the Annual Allowance and the Lifetime Allowance. The reform option considered is that DC schemes would be subject to the Annual Allowance but not the Lifetime Allowance, and that DB schemes would be subject to the Lifetime Allowance but not the Annual Allowance. The reasoning behind this is that DB schemes and DC schemes are each subject to a single element of the Allowance system, the one that is more suitable for

that type of scheme. It would be desirable for the DB and DC elements of the system to be consistent.

Chapter four: key points

- It may be possible to consider Allowances in terms of equivalence and thereby apply different types of allowances to different forms of pension savings.
- Changes to allowances which are designed to hit high earners can have impacts on more modest earners if they have been long term members of DB pension schemes.

Annex 4: Literature review: Behavioural economics and pensions tax policy

Executive summary

The vast majority of OECD countries use an EET system. Only Hungary uses a TEE model. Australia taxes up front contributions to pensions, but relies on compulsion and has the most expensive system of tax relief in the OECD.

Insights from behavioural economics, particularly Richard Thaler's work, show us that an upfront incentive is more likely to encourage people to save, as the actual value of the benefit is much easier for people to quantify.

Presenting incentives as matches makes them easier for savers to understand and engage with. Matching contributions, government and employer, have been shown to increase both participation and contribution levels in pension saving. This is particularly true for those with a low propensity to save such as younger and lower income savers.

Pensions tax relief represents good value for money. The capital accumulation achieved for the tax revenue foregone is very high, and this remains true even if one assumes that only small amounts of retirement saving represent new saving.

Introduction

Favourable tax arrangements for pension savings is one of a number of ways in which modern governments seek to ensure that their citizens have adequate financial provision for their retirement. Ensuring these arrangements achieve this aim, while delivering maximum value for the public purse is a crucial issue for policy makers, and one that has achieved even greater priority in the face of demographic changes. There is a broad range of literature on the various structures in place in different countries and their relative efficacy. This review will examine these in detail with particular focus on the effectiveness of incentives provided up front, relative to them being deferred, the role that can be played by matching contributions and the role that the flexibility of how pensions can be used plays in encouraging saving. The evidence from the tax regimes of the UK, USA, New Zealand, and Australia will be drawn on primarily.

The majority of OECD countries rely on an EET system for private pension savings (Yoo and De Serres, 2004). Ten countries, including the USA, have something close to a pure EET system, and a further twelve countries, including the UK, have one where withdrawals are taxed more favourably than normal income. In the UK, this preferential treatment takes the form of a tax free lump sum. The remaining countries, including Australia and New Zealand, have a system where contributions to pension funds are taxed. Only one of these, Hungary, uses a full TEE system (Yoo and De Serres, 2004).

Incentives for private pension saving differ widely in terms of both their design and generosity (Yoo and De Serres, 2004). This is due to a variety of factors. One of these is the relative emphasis placed on private pensions as a means of providing retirement income in different countries. In many countries pensioners rely on benefits from the state for most of their income and so encouraging private pension saving is not an established priority. In France for example, over 85% of the income of over 65s comes from public provision, whereas state benefits provide less than half of the total retirement incomes in the UK. Internationally, the general trend is towards greater reliance on private pensions. Total expenditure on private pensions in OECD countries rose 23% faster than national income between 1990 and 2007. Spending on public pensions grew 15% faster than national income over the same period (Whitehouse, 2012).

The UK is commonly referred to as an EET regime, but the system has a number of nuances that make it a far more complex picture. While individuals can make contributions to their pension pot out of their pre-tax income, these contributions are subject to an annual allowance, currently at £40,000. Employers can make optional matching contributions to their employees' pensions and are able to write this off as a business expense, carrying a tax advantage. Investment gains made on pension pots are largely tax free, but any dividends from equities are subject to corporation tax. Retirement income is taxed at a marginal rate, but all savers can take up to 25% of their pension pot tax free (PPI, 2013). The size of funds is also subject to a lifetime allowance. This system is supplemented by a basic state pension and a number of other universal and means tested pensioner benefits. In addition, there have been a number of attempts to supplement this system with further initiatives such as the Savings Gateway, which aimed to promote saving for those on low incomes (Kempson, et al., 2005).

There are two primary retirement savings instruments in the USA. These are the Individual Retirement Account, which is a vehicle for personal retirement saving, and the 401(K), an employer based scheme (Adams, et al., 2012). Since its creation in 1978, the 401(K) has become the most popular retirement savings vehicle, representing the vast majority of pension saving in the USA. As with the UK, these regimes are EET arrangements. Participants in these schemes also generally benefit from employer matching contributions (Even and Macpherson, 2004). Employers use these contributions to ensure their schemes are compliant with mandatory non-discrimination tests, which aim to ensure that these schemes provide coverage for lower income workers. As with the UK, additional attempts have been made to improve savings for lower income workers, including with individual development accounts (IDAs). The use of these for the purposes of retirement saving has been limited, but has been subject to some evaluation, which is discussed later in this review (Grinstein–Weiss, 2012).

New Zealand has a complex history behind its tax regime. For some time from 1990 it was the only OECD country apart from Mexico to offer virtually

no preferential tax treatment on retirement savings relative to other savings. This was effectively a TTE system, however with some income from the fund taxed at a preferential rate. This system was supplemented by generous universal cash payments to pensioners from New Zealand's superannuation scheme (St John, 2007). However, this experiment came to an end in 2007 with the launch of KiwiSaver. The TTE system has remained in place, but with additional government matching contributions for savers as well. This project has been subject to a great deal of early evaluation, with researchers disagreeing strongly on the wisdom of pursuing KiwiSaver at this time, and the degree to which it offers value for money (Stephens, 2014; St John, 2007; CFLRI, 2014).

Since 1992 Australia has mandated individuals and their employers to make contributions to a private superannuation scheme. Savers are unable to opt out, but do have the ability to select the kind of fund they would like their money invested in. However, tax incentives still play a role. Contributions to, investment returns, and withdrawals from are taxed, albeit at a more favourable rate than other forms of saving (Guest, 2013). In fact, in terms of tax revenue foregone, Australia has the most expensive system of retirement tax incentives in the OECD (Yoo and De Serres, 2004). However, this is largely reflective of the fact that levels of tax on other forms of capital are very high (Disney, 2009).

Criticism of retirement savings incentives

Retirement savings incentives attract broad criticism from some who view them as an inefficient way of encouraging saving. There is some evidence that money that is saved in tax preferred schemes does not represent 'new saving', rather individuals have transferred into a particular account to take advantage of the preferential tax treatment. There is a substantial amount of evidence on this subject around IRAs and 401(k) schemes in the USA. This area of research has produced conflicting results, with researchers coming up with very different assessments about the extent to which savings in tax favoured retirement plans constitutes new saving.

Attanasio and Deleire (2002) look at data on the consumption levels of members of IRAs as well as any other savings and assets they have beside IRAs. They state that there is very little evidence that participants in IRAs reduce their consumption in order to fund their contributions, and estimate that only around 9% of saving in IRAs can be considered new saving. On the other hand, Venti and Wise (1991) find that the introduction of the IRA results in total household saving rising substantially, and go on to argue that the vast majority of IRA saving can be considered new saving. Wakefield et al. (2004) agree with Attanasio and Deleire's analysis and find similar results for ISAs and TESSAs in the UK.

Porterba, Venti, and Wise (1996) produced an analysis of saving in 401(k) plans, looking at those who saved in one and those were eligible but didn't save. They found substantially higher levels of saving for those with a 401(K),

arguing that this is evidence that these encourage new saving. Engen Gale and Scholz (1994) disagree, as in their view this doesn't take account of the fact that those with a higher propensity to save are more likely to take up a job with a 401(k).

Hubbard and Skinner (1996) argue that there is a middle ground between the extremes posed by studies such as these, and that the differences between the various analyses stem from a general lack of understanding among academics around what motivates people to save, as well as different methodologies and the fact that different groups of savers are often being studied. They build on the existing literature by using a cost benefit approach to look at the capital gains that are achieved relative to the initial revenue foregone by the government in the form of tax incentives, and how this is affected by the amount of retirement saving that can be considered 'new'. Hubbard and Skinner (1996) find that "Even for quite conservative measures of the saving effects of IRAs or 401(k)s, this approach estimates that the incremental gains in capital accumulation per dollar of lost revenue are generally large." As such, it cannot be said that pension tax incentives represent poor value for money on the basis that they only encourage modest amounts of new saving.

TEE vs EET

Whitehouse (1999) summarises the policy debate around an EET versus a TEE system. Formally each system offers the same level of incentive to its savers, but insights from behavioural economics suggest that savers prefer an upfront incentive to a deferred one. Thaler (1994) expands on this, saying that it is wrong to assume that the after tax return of a particular savings program is the key indicator of the extent to which it acts as an incentive. The actual size of the final benefit is very difficult for individuals to know due to the lack of information that they have, and their lack of ability to make predictions based on the evidence available. An upfront benefit is much easier to quantify and engage with (Thaler, 1994; Porterba, Venti, and Wise, 1996).

In addition, savers may not trust a future government to honour their commitment not to tax withdrawals from pensions. This will make them less willing to pay into a pension and in general to plan for retirement. Disney et al. (2006 p.2) state that: "If public retirement policies are themselves temporally inconsistent (and this fits in well with the central strand of macroeconomic theory which starts from the premise that governments have strong incentives to behave in an inconsistent manner), then the difficulties facing households that are attempting to adopt time-consistent retirement strategies are heightened".

One does not need to look far to find evidence that retirement saving incentives in Western countries are subject to frequent change, and the problems this can cause. St John (2007) wrote that New Zealand's transition from an EET to a TTE system in the early 1990s resulted in a number of distortionary effects. A number of people received tax concessions on both

their contributions and their withdrawals, effectively giving them an EEE system. The result was an effective windfall for higher rate taxpayers. In his analysis of changes to Australia's retirement income model, including restrictions and reductions of tax concessions for retirement saving, Guest (2013, p.25) notes that "Many of these changes have some merit individually, but the cumulative effect is to erode confidence in the ability to make durable lifetime saving plans".

While uncertainty is a feature of any retirement structure, the propensity to revise the beneficial treatment offered to money that has already been contributed to retirement savings is significantly increased under a TEE model.

Matching contributions

The role of matching contributions in encouraging pension saving has been subject to a great deal of evaluation. In many countries, matching contributions are used to encourage savings for retirement. Simplifying the process has long been thought of as a key way of increasing participation rates in retirement saving. Using matching is thought to help by communicating the incentive to save in way that people can clearly understand. Saez (2008) looked at the effect of retirement savings incentives on IRA saving, and found that individuals were more likely to take advantage of an incentive when it is presented as a match than when it as presented as a tax credit of an equivalent value.

A great deal of literature has found matches to be effective in the context of both government and employer contributions.

Employer matching contributions

Employer contributions are a key feature of 401(K) plans in the United States. In order for employers to receive the advantageous tax arrangements of these schemes they must pass a non-discrimination test. In order to satisfy the tests, the contribution rates of the highest paid must not be disproportionately higher than that of low paid employees (Even and Macpherson, 2004). Offering generous matching rates for low paid employees is one of the main ways in which employers achieve this (McGill, et al., 1996). While tax incentives are a primary reason for employers offering matching contributions, other motivators have been suggested, such as the need to attract and retain employees with particular characteristics (Ippolito, 1997).

When assessing how employer contributions act as an incentive for employees to save, there are two things to consider. Firstly, whether matching contributions help to promote employee participation in a pension plan, and secondly, whether matching can increase the level at which employees contribute.

With regard to the first issue there is strong consensus across the literature that employer contributions can increase participation rates in voluntary enrolment schemes (Papke and Poterba, 1995; Kusko, et al., 1998; Even and Macpherson, 2005). The effect on participation in auto enrolled 401(K) schemes is less clear. Beshears et al. (2007) found that removing the employer match had only a modest effect on the participation rate in a 401(K) scheme into which savers had been auto enrolled. In the UK, Lloyd et al. (2007) found that after controlling for all other factors such as age, education, earnings and gender, whether someone was offered an employer contribution was by far the most important factor in determining whether they saved into a pension scheme.

The literature is conflicted around the effect matching has on the level of contribution. Some researchers have found that matching has a negligible effect on the level of contribution. A study by Engelhardt and Kumar (2007) of older savers found that employer matching did not have much of an impact, and should not be considered an effective policy tool to encourage saving. Papke and Poterba (1995) found similar results, stating that the effect of matching was too small to detect.

Huberman, Iyengar, and Jiang's (2007) analysis of 926,104 participants of 647 401(K) plans found that matching can have a significant positive effect on the level of contribution, mainly for low income individuals. This research looks at potential explanations behind the levels at which employees contribute, including behavioural influences. They state: "It is possible that behavioural factors are also necessary to explain the match's influence on employees' choices. A substantial fraction of the contributions are at or near the point where they exhaust the employer's match: the contributions of about 18 (22%) of the participants whose employers offer a match are no more than $100 ($200) away from the upper limit of their employers' match" (Huberman, Iyengar, and Jiang's, 2007, p.25).

Huberman, Iyengar, and Jiang (2007) go on to state that government subsidies of employer matching would have a positive effect on improving the contributions of low income savers. VanDerhei and Copeland (2001) used a behavioural model to predict the effect that increasing the rate of employer match from a baseline of zero would have on increasing employee contributions. They found that there was a positive effect for those least likely to contribute initially, that is, low earning, younger workers who had not been with a company very long. This effect tails off as individuals begin to show less of these characteristics, until eventually it disappears.

While there is certainly a mixed picture, the evidence summarised here tells us two things. Firstly, that the non-discrimination test associated with the tax incentives behind 401(K) plans play a role in encouraging employers to introduce matching in order to increase the share of low income employees in their pension schemes. Secondly, that matching plays a positive role in increasing participation in pension schemes, as well as increasing the level at which savers contribute.

One fairly consistent finding is that the threshold at which the employer will match contributions is more important than the rate of match, and other evidence supports this. A review of the literature by Brigitte Madrian (2012) confirms this fact. In addition, statistical analysis by Towers Watson (2013) shows that contributions to Defined Contribution pensions in the UK tend to be either at the default level, or the maximum employer matching rate.

Government matching contributions

Government matching contributions have also been used to increase levels of retirement saving, their use within KiwiSaver being an important example. Unlike in most other retirement savings models, contributions to KiwiSaver are subject to taxation, in keeping with New Zealand's previous system in which retirement saving was effectively treated the same as all other saving. However, to encourage contributions KiwiSaver relies on a combination of generous matching, auto enrolment of savers, and compulsory matching contributions for employers (Rashbrooke, 2012). This design was strongly informed by behavioural economics (Toder and Khitatrakun, 2006; Rashbrooke, 2012; CFLRI, 2014).

Early evidence on the effectiveness of KiwiSaver is mixed. Many in New Zealand still strongly support the previous system of no tax incentives for retirement saving, supplemented by New Zealand superannuation, a generous public pension scheme (Rashbrooke, 2012). While this scheme has been historically effective at achieving low rates of poverty, its long term sustainability as the primary source of income for many retirees has been called into question. The Commission of Financial Literacy and Retirement Income (2014) found that:

> *"On current projections it is highly unlikely that the economy will grow by an amount sufficient to keep constant the proportion of GDP spent on NZS. A doubling of that proportion is much more likely. We can't be sure what the actual outcome will be, but if there is a sharp increase in the rate at which the costs of NZS go up, future generations may be less willing to meet that cost. In other words the sustainability of NZS will come into question. It makes sense to take steps now, to prevent that situation occurring."*

As such, despite the popularity of New Zealand superannuation, there was seen to be a need to move away from a public pay as you go model to a system of private saving due to demographic pressures. In addition, while this system was equitable, the average income of pensioners in New Zealand was much lower than the average for other OECD countries (Rashbrooke, 2012).

The financial incentives to join and contribute to KiwiSaver are substantial. The government offers a 'kick start' of $1,000 into the fund of anyone who joins the scheme. In addition to this, contributions up to a certain threshold are matched with a 50% contribution (CFLRI, 2014). KiwiSaver has been

successful in achieving a high level of coverage, particularly for those with a low marginal propensity to save. New Zealand now has one of the highest rates of voluntary retirement saving in the world, with half of the population below the age of 65 now members of the scheme. One of the most striking facts is the high number of savers who report no income or who are under the age of 18 (Rashbrooke, 2012).

There is substantial evidence that these financial incentives play a role in encouraging saving. A survey in 2012 found that 28% of those who had enrolled into KiwiSaver said that the financial incentive was their primary reason for joining. This was the second most popular answer after recognising the need to save for retirement (51%) (Matthews, 2012). In addition, of those who joined during the six years from 2007, only one third were auto enrolled, the majority having actively opted into the scheme (CFLRI, 2014). This suggests a high level of awareness of the financial benefits offered by the system. However, of those that have been auto enrolled, most simply contribute at the default rate (Rashbrooke, 2012). In addition, it's also worth noting that as the matching rate has fallen this has not resulted in more opt outs from auto enrolled savers (CFLRI, 2014).

Some have criticised KiwiSaver due to perceived macroeconomic inefficiency. There is concern that the overly generous matching contributions create distortionary effects with regard to individual's financial decisions. St John (2007) argues that "Subsidised KiwiSaver contributions overturn the old rule that reducing debt is the first main preparation for retirement. It now can make financial sense to either not reduce debt, especially student loan debt, or even to increase debt to join KiwiSaver" (St John, 2007, p.264). In addition, analysis of a sample of population income data by the New Zealand Treasury suggested that the accumulation of net wealth by participants of KiwiSaver was lower than that of the rest of the population (Law and Scobie, 2014). However, other evidence suggests that planned future increases in the default contribution rate to KiwiSaver will drive improvements to levels of saving and retirement outcomes (MacDonald, et al., 2012).

IDA and Savings Gateway

Government matching contributions have been used in a more targeted way to improve the savings levels of low income groups. The primary examples of this are the use of Individual Development Accounts (IDAs) in the USA and the Savings Gateway in the UK, the former having significantly influenced the development of the latter (Kempson, et al., 2005). These initiatives aimed to both help low income individuals build up adequate savings in the short term, often for a particular purpose, and to positively affect individual's long term savings behaviour. One of the main ways of achieving the latter goal was through tying financial education to participation in these programmes (Kempson, et al., 2005).

It is worth noting that retirement saving was not the primary focus of either of these instruments. The IDAs were primarily used to help low earners save up

to pay for investments such as a university education or setting up their own business. They were generally set up by charities or State and local governments. However, there were attempts to use the IDAs as a retirement savings vehicle. Grinstein-Weiss et al. (2012) conducted a study on the long term impact on retirement saving of an IDA programme in Tulsa. In this programme savers would receive a 100% match for any contributions that were later withdrawn for the purpose of retirement income. They could claim the same match if they wished to use the money for home repair, starting a business or paying for higher education, and would receive a 200% match if they used the money to buy a house. The study found that ten years on, those who has used the Tulsa IDA did not have higher levels of retirement savings than the control group.

The Savings Gateway was a project of the Labour government of 1997-2010 that was subject to two pilots, one from 2002-04 and one from 2005-07 (Harvey, et al., 2007; Kempson, et al., 2005). The scheme was set to be launched in July 2010 but was scrapped by the incoming Conservative-Liberal Democrat government. Unlike the IDAs, it was a centrally run government scheme rather than a series of smaller decentralised ones. The pilots involved offering matching contributions to those who paid into an account, coupled with financial education to improve immediate financial wellbeing as well as long term psychological and attitudinal attitudes to saving. Those on a range of means tested benefits were eligible for participation (Price, 2012).

The evaluation of the initial, smaller, pilot found that it had a number of positive effects. Participants in the Gateway had higher levels of personal saving overall than the control group after their participation in the scheme. In addition, there was evidence that the financial education linked to the Savings Gateway had a positive impact. Savers were more likely to have formalised their savings rather than store them in cash, less likely to borrow money from doorstep lenders compared to more formal kinds of borrowing, and were less likely to agree with the statement that “debt is inevitable” (Kempson, et al., 2005, p.75). Three months after the end of the pilot, savers were likely to still have most of the money they saved in a different account and only 9% had no money in a savings account (Kempson, et al., 2005).

The second pilot was broader, covering a much larger number of people and testing the effect of different sized matches. The evaluation found high levels of saving in the accounts across all match rates, with participants feeling that the optimum match rate was 50%. The median contribution rate was equivalent to the maximum match level in all but one of the pilot areas. In addition, levels of total saving were higher for Savings Gateway participants three months after their participation in the scheme; however in most areas the net wealth of participants had not increased. This indicates that participants may have been saving instead of buying other assets, or paying off debt (Harvey, et al., 2007).

The Savings Gateway was abolished two months before its planned implementation due to reasons of affordability. However, it was deemed by most to have had positive effects on saving and a number of lessons can be drawn from it. One of these is that savings into the scheme from those lower down the income scale were more likely to represent new saving, whereas wealthier savers were more likely to offset other forms of savings in order to take advantage of the higher match rate (Harvey, et al., 2007).

Pension savings and home ownership

One of the methods some have considered for encouraging participation in private pension saving is allowing other uses for savings besides a retirement income. The most prominent of these is the idea of allowing accrued savings to be used to pay for part of the cost of a first home.

The main experiment for this idea in the context of a country's primary savings vehicle is its introduction as part of KiwiSaver. Savers can use funds withdrawn from KiwiSaver as part of the deposit on their first house, but are unable to use any money from either the kickstart or member tax credits (CFRLI, 2014). This has proven to be a popular innovation with savers. Consumer research has suggested that many young savers gave the home deposit benefit as a primary reason for participating in KiwiSaver (Matthews, 2012). The benefit has also been used widely, with the proportion of home purchases financed in part by withdrawals from KiwiSaver having risen from 0.1% in 2010 to 5% in 2012 (CFRLI, 2014).

Other countries have not replicated this experiment. Australia has examined the idea intermittently but has rejected it each time. After a discussion paper on the specific issue released in 1997, the idea was rejected on the basis that it was not an effective way of targeting support towards those who were likely to be unable to buy a home before they retired (Aus 1998 budget). The Australian Productivity Commission examined the idea in 2004 as part of its inquiry into first home ownership. The final report argued that the change would make superannuation merely a savings account for first time buyers (Productivity Commission, 2004).

Some countries have introduced accounts; separate to retirement savings, specifically for the purpose of buying a first home. As previously mentioned, saving for home ownership was one of the primary uses of individual development accounts in America (Sherraden, et al., 2003). In addition, the UK is set to launch the Help to Buy ISA in December 2015.

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Annex 5: ABI consumer survey responses

Populus surveyed 2,101 UK adults online on behalf of the ABI from 28th to 31st August 2015. Results were weighted and are representative of the UK population aged 18+. Note that commentary sections do not always highlight small sample bases, and interpretation should be treated with care. Percentages are relative to the stated sample size in each question, equivalent respondent counts are shown in parentheses.

Q1 "Have you ever saved into a private, personal, workplace, or other type of pension?"	
Full sample (2101)	
Yes - I currently save into a pension	31% (652)
Yes - I used to save into a pension, but not at the moment	31% (649)
No	36% (765)
Don't know	2% (34)

Commentary

Just over two thirds (62%) of our sample either currently save into a pension (31%) or have in the past (31%) – this constituted a 'Yes' response.

- This varies quite a lot with age – 18-24 year olds were least likely to say 'Yes' (30%), with the figure rising to 73% amongst 55-64 year olds – it declines again for 65+ year olds (to 69%).
- Regional variation was fairly small – the lowest 'Yes' proportion was in Wales at 51%, highest in the North West at 68%.
- Public sector workers were far more likely to respond 'Yes' - 84% - compared to 65% amongst private sector workers.

Q2 "What are the main reasons you save(d) into a pension? Please tick up to three main options for you"	
All respondents who have ever had a pension (1301, "Yes…" to Q1)	
The basic state pension will not provide enough for me in retirement	48% (630)
My employer set it up for me automatically / I was auto enrolled	37% (481)
My employer tops up and/or matches the amount I save	35% (450)
I want(ed) to be able to afford the same standard of living in retirement as I can afford now/could afford pre-retirement	33% (425)
I know/knew the government will not look after me if I run out of money in retirement	16% (210)
Saving into a pension reduces the tax I pay/reduced the tax I paid	11% (149)
I want(ed) to lock some of my money away so I'm not tempted to spend it	9% (113)
I want(ed) to be able to leave something behind for my family	6% (75)
My friends/family told me I should	5% (71)
Other	2% (28)
Don't know	2% (31)

Commentary

Nearly half (48%) of those that save into a pension chose inadequacy of the state pension as one of the main reasons they save; 37% were auto-enrolled or had their employer set up their pension for them, and 35% said an employer matching contribution was one of their three main options.

- These three options were the top three across the age groups until age 55 – at which point 'affording a similar standard of living…' overtakes the employer matching contribution in importance.
- Those that are currently retired with a private pension were more likely to rate state pension inadequacy and standard of living as one of their top three – 62% and 48% selected it respectively. Potentially interesting as a retrospective viewpoint.
- Those currently saving valued the employer match more than those that previously saved into a pension – with 41% of current savers selecting it, compared to 28% of those that used to save.
- Higher rate and additional rate taxpayers were far more likely to select 'saving into a pension reduces the tax I pay' – with 31% and 41% respectively choosing it. Just 12% of basic rate taxpayers chose this option. Note small sample sizes for higher tax bands (<100).

Q3 "What are the main reasons you have not saved into a pension? Please tick up to three main options for you"	
All respondents who have never had a pension (765, "No…" to Q1)	
I don't have enough spare money to save into a pension	50% (381)
I'd rather save money where I can access it quickly	17% (130)
I don't understand how pensions work	12% (90)
I don't trust the Government to leave my savings alone	10% (74)
My employer hasn't started auto enrolling employees into pensions yet	6% (44)
The Government will provide enough for me in retirement	4% (27)
My partner/other family members handle this instead of me	4% (27)
I worry about the tax implications in retirement	3% (26)
Other	18% (137)
Don't know	10% (75)

Commentary

The standout reason for not saving into a pension (as expected) was not having enough spare money – 50% selected this as one of their top three. The next-most popular was 'other' with 18% – suggesting a few missed choices here – followed by 'I'd rather save money where I can access it quickly' (17%). "I don't understand how pensions work" was fourth with 12%.

- Not having enough spare money rises in importance with age, from 36% amongst 18-24 year olds to 70% amongst those aged 45-54.
- Not understanding pensions is more relevant for respondents in their late 20's/early 30's; 22% of 25-34 year olds selected this option, dropping to 4% amongst those 65+.
- A large proportion of 'Other' responses related to filtering errors; many refer to not having enough money, some also say they are too young to begin saving. On reflection it appears that the only missing option is "I am too young to start saving".

Q4 "Before taking this survey, did you know that, when you retire and withdraw your pension, you are allowed to withdraw a quarter of your pension pot tax-free?"	
Full sample (2101)	
Yes	59% (1243)
No	34% (717)
Don't know	7% (141)

Commentary

Well over half (59%) of the sample said that they were aware of the tax free lump sum; 34% were not aware and the remaining 7% were not sure.

- Noticeable gender divide (66% male, 52% female), however part of this could be due to actually having a pension (similar gender breakdown to Q1).
- As expected awareness shoots up rapidly with age; from 27% amongst 18-24 year olds to 80% amongst those aged 65+. 64% of those approaching pension flexibility (age 45-54) were aware.
- Those with a pension saving history were more likely to be aware (70%) however this was still high for those without pension history (42%).
- Higher tax-payers were less likely to be aware – note small sample size however.
- Those with more sophisticated investments (stocks and shares ISA, stocks and shares) and homeowners were more likely to be aware.

Q5 "To what extent do you agree or disagree with the following statements?"	
Full sample (2101) – three statements were presented simultaneously	
a) "It is hard to plan for the future when the rules around pension saving keep changing"	
NET: Agree	61% (1291)
Strongly agree	22% (459)
Agree	40% (832)
Neither agree nor disagree	23% (494)
Disagree	5% (96)
Strongly disagree	2% (40)
NET: Disagree	6% (136)
No opinion	9% (180)
b) "I trust the Government to leave money I have already saved alone"	
NET: Agree	19% (399)
Strongly agree	6% (117)
Agree	13% (282)
Neither agree nor disagree	25% (533)
Disagree	26% (555)
Strongly disagree	23% (479)
NET: Disagree	49% (1034)
No opinion	6% (135)

c) "I like the changes the Government has made to how pension savings can be withdrawn"	
NET: Agree	31% (643)
Strongly agree	8% (161)
Agree	23% (482)
Neither agree nor disagree	41% (864)
Disagree	8% (175)
Strongly disagree	5% (109)
NET: Disagree	14% (284)
No opinion	15% (310)

Commentary

Nearly two thirds (61%) agree that it is hard to plan for the future when the Government keeps changing rules around pension saving; only 19% trust the Government to leave money they have saved alone; very mixed opinions on the pension flexibilities – 41% were on the fence, 31% favoured the flexibilities. Demographics are broken down by statement below:

(a)

- The proportion agreeing with this statement is far higher for public sector workers (73%) than private sector workers (56%).

(b)

- No particularly interesting demographic differences here – the agree % hovered around 20% for most subgroups.

(c)

- Current pension savers more likely to agree with this statement (43%, compared to 31% for the sample overall).
- No particularly large differences across age band – older respondents very slightly more likely to disagree with the statement.

Q6 "To what extent do you agree or disagree with the following statements?"	
Full sample (2101) – three statements were presented simultaneously	
a) "I am worried that the Government will continue to make changes to the way I save into pensions"	
NET: Agree	53% (1117)
Strongly agree	20% (417)
Agree	33% (700)
Neither agree nor disagree	26% (546)
Disagree	4% (74)
Strongly disagree	2% (35)
NET: Disagree	5% (109)
No opinion	16% (329)
b) "The risk of further changes to pension rules is deterring me from saving money/saving more money into a pension"	
NET: Agree	31% (643)
Strongly agree	9% (196)
Agree	21% (447)
Neither agree nor disagree	33% (688)
Disagree	15% (306)
Strongly disagree	4% (91)
NET: Disagree	19% (397)
No opinion	18% (373)

c) "I trust the Government to leave my pension savings untaxed until I am aged 55 or over"	
NET: Agree	19% (396)
Strongly agree	5% (95)
Agree	14% (300)
Neither agree nor disagree	30% (623)
Disagree	20% (418)
Strongly disagree	16% (339)
NET: Disagree	36% (757)
No opinion	16% (326)

Commentary

Just over half (53%) agreed that they were worried the government will continue to change pensions; 31% agreed that further changes would deter them from saving more (19% disagreed, 33% were on the fence); 19% trust the government to leave their savings untaxed until aged 55+, 36% disagree. Demographics are broken down by statement below:

(a)

- The proportion agreeing with this statement is far higher for public sector workers (73%, compared to 58% for private sector).
- Current pension savers are far more likely to agree (71%) – conversely non-savers with existing pension savings were the least likely to agree (43%).
- Higher and additional rate taxpayers were also more likely to agree (again, note small sample sizes).

(b)

- 25-34 year olds were more likely to be deterred (44% agree).

(c)

- 28% of current saver agree with this, 41% disagree.

Q7 "Please imagine for a moment that you are saving part of your income into a pension (if you are not already), and that the Government offers to top up your contribution. Which of the following would you prefer?"	
Full sample (2101)	
The government puts in £1 for every £2 you put into your pension	51% (1073)
The government tops up the money you put in by 33%	15% (307)
No preference	19% (393)
Neither	3% (54)
Don't know	13% (274)
Commentary By far the most-preferred option is £1 for every £2, versus the 33% uplift.	

Q8 "Imagine that your employer offers to match any money you save into a pension, up to 4%. This means that, if you saved 4% of your income, your employer would match it with a further 4%, however if you saved 6% of your income your employer would still only match 4%. How much of your income would you pay into the pension?"	
Full sample (2101)	
Nothing	4% (88)
Less than 4%	6% (124)
4%	43% (913)
More than 4%	3% (54)
Don't know	13% (274)

Commentary

The most-popular option is mirroring the level of the match, with '4%', chosen by 43%; 19% would contribute more than 4%, 28% don't know.

- Retirees with a private pension are more likely to have chosen more than 4% (33%).
- Higher income households also more likely to contribute above 4%.
- 24% of pension savers (current or otherwise) would contribute above 4%; 48% would contribute at 4%.

Q9 "Currently you are not allowed to withdraw money saved in your pension until you are aged 55 or over. Should people instead have the option to withdraw part of the money early to help buy their first home, or should they only have access when they reach the age of 55?"	
All respondents aged under 55 (1327)	
People should be able to withdraw money to help with their first home deposit	38% (501)
People should only have access to the money when they reach the age of 55	41% (548)
Don't know	21% (277)

Commentary

Mixed response – the overall winner is lock savings up (41%) by a small margin (38% chose access for deposit).

- 45% of 25-34 year olds chose early withdrawal flexibility.
- 42% of renters would like access early for home purchase.
- Current/past pension savers were more likely to opt for locking up savings (47%, compared to 35% amongst non-pension savers).
- Those that knew about the tax free lump sum were more likely to prefer the lock in (50%, compared to 35%).
- Respondents with cash ISAs or stocks and stocks and shares ISAs were more likely to prefer the lock in (47% and 61% respectively).

Q10 "Which, if any, of the following would be most likely to encourage you to save more for your retirement? Please tick up to three options."	
All respondents who are not retired (1598)	
Having more disposable income	41% (663)
Receiving a top up to my savings from the Government	29% (464)
Having my employer match the amount I save	26% (409)
Better investment returns / interest rates	25% (392)
Simplifying how the pension system works	21% (331)
Knowing how much to save now to have the same quality of life in retirement	18% (288)
Being able to take a quarter of my savings completely tax-free when I reach the age of 55	13% (203)
Knowing that the government would not look after me if I didn't have enough money in retirement	10% (168)
Better access to financial advice	9% (136)
More information about the costs of social care	5% (80)
Peer pressure / advice from my friends and family	2% (31)
Other	1% (22)
None of these	5% (81)
Don't know	9% (136)

Commentary

This mirrors Q3 to a certain extent – more disposable income (41% chose it in their top three) and contribution matching, either from Government (29%) or employer (26%), came out on top. Simplicity was fifth (21%), after better investment returns (25%).

- Broadly similar ranking across age groups.
- Government match was top for public sector workers (42%), disposable income highest for private sector (42%).
- Rankings similar regardless of current pension saving status.

Q11 "The Government taxes the money saved into pensions, but has a choice about when it does so. The tax could be paid when the money goes into your pension, or when the money is paid out after you reach the age of 55. Bearing in mind that money saved into a pension will grow over time, and that the more you save into your pension to begin with, the more it will grow, which of the following options would you prefer?"	
Full sample (2101)	
Have the money you save into your pension taxed when you pay it in, so there is less money going into your pension, but not have it taxed when you take out the money you have saved	32% (670)
Have the money you save into your pension be tax free, so there is more money going into your pension than in the option above, but have the money taxed when you take it out	26% (538)
No preference	20% (429)
Don't know	22% (464)

Commentary

The headline result here favours TEE - 32%, compared to 26% for EET. Worth noting that a lot of people had no preference (20%) or didn't know (22%).

- Males preferred EET (barely – 32% compared to 28% TEE), whilst females preferred TEE (36%, compared to 20% EET).
- Private sector workers prefer TEE (34% compared to 26% TEE).
- Retirees with a private pension prefer EET (36%, compared to 24% TEE).
- Basic rate tax payers were split evenly (32% apiece), higher rate taxpayers preferred EET (43% - note, small sample).
- Cash ISA holder preferred TEE (34% compared to 31% EET), whereas stocks and shares ISA holder prefer EET (41% compared to 25% TEE).

Q12 "In retirement most people have a lower income than when they are working. Many retirees will therefore pay tax at a lower rate than they did when they were working. This means if you pay tax at the point you save into your pension, you will pay more tax overall than if you pay tax when you take money out at retirement. Given this, which of the following options would you prefer?"	
All respondents who would prefer option 1 in Q11 (670)	
Have the money you save into your pension taxed when you pay it in, so there is less money going into your pension, but not have it taxed when you take out the money you have saved	45% (300)
Have the money you save into your pension be tax free, so there is more money going into your pension than in the option above, but have the money taxed when you take it out	41% (275)
No preference	6% (41)
Don't know	8% (55)

Commentary

When explaining one of the possible benefits of EET over TEE to those that had previously preferred TEE, just under half converted to TEE (41%; 45% stayed put).

- Recalculating the responses to question 11 based upon this suggests that 14% support TEE, 39% support EET, 22% have no preference and 25% don't know.
- Younger respondents were more likely to switch preference to EET than older respondents – subsample sizes are quite small however.

Q13 "What is the highest rate of income tax that you think you currently pay?"	
Full sample (2101)	
I don't pay income tax (my annual income is equal to or less than £10,600)	32% (666)
Basic rate (my annual income is up to and including £42,385)	54% (1143)
Higher rate (my annual income is higher than £42,385 but less than £150,000)	4% (79)
Additional rate (my annual income is more than £150,000)	<1% (7)
Don't know	10% (205)
Commentary This was included chiefly as a demographic question; 32% say they don't pay tax, 54% pay at the basic rate, 4% pay at higher rate or above.	

Q14 "Which, if any, of the following savings products / investments do you currently hold?"	
Full sample (2101)	
A savings account (separate to your main bank account)	46% (972)
Cash ISA	41% (870)
A private pension / workplace pension	38% (791)
Own (or part-own) my home outright	24% (502)
Premium bonds	23% (475)
Own (or part-own) my home with a mortgage	22% (455)
Stocks and shares	13% (280)
Stocks and shares ISA	10% (208)
Own additional home(s)/ property	4% (91)
Christmas savings club	4% (79)
Other savings product	10% (212)
Other investment	5% (95)
I don't have any savings or investments	16% (330)
Don't know	3% (53)
Commentary Also included chiefly as a demographic question. Most popular product is savings account (46%) followed by cash ISA (41%) and private/workplace pension (38%). 10% hold a stocks and shares ISA.	