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Securing the future of pensions

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

A response by the National Association of Pension Funds

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Contents

About the NAPF 3
Overview 4
  Introduction 4
  Our recommendations 5
  About our response 6
The purpose of pensions and their tax treatment 7
The current regime – strengths and weaknesses 8
  The 'cost' of pension tax relief 8
  A long and complex history 10
  Delivering incomes in retirement 12
  A complex system? 13
  An international perspective 14
Pension taxation systems – the options 15
Evaluating the options 18
  Treatment of employer and employee contributions 18
  NAPF member ranking of the options 19
  TEE taxation with a rebate 20
    TEE and funds in retirement 21
    TEE, tax revenues, sustainability and intergenerational tensions 23
    TEE, the pay packet and automatic enrolment 24
    TEE, employers and schemes 26
    TEE and DB schemes 29
    TEE and behavioural change among savers 30
  Single rate of tax relief 30
    Single rate - impact on pay packet, retirement funds and automatic enrolment 32
    Single rate and tax revenues 33
    Single rate, employers and schemes 34
  Modifying the current system by separating DB and DC 36
Pension tax and incentives 37
    Incentives and individuals 38
    Incentives and employers 39
    Building on automatic enrolment 39
Conclusions and recommendations 41
Appendix One – Consultation questions 43

NAPF
Securing the future of pensions

Table of figures

Figure 1: Income tax relief provided on pension contributions based on Pen6 data from HMRC/ONS ... 9
Figure 2: Tax and retirement income for different types of taxpayer from £1,000 invested from gross pay and taxed under the current system ... 13
Figure 3 : NAPF member views on complexity of current system ... 14
Figure 4: Pension tax options evaluated ... 16
Figure 5 : NAPF member ranking of current system (against other options evaluated below) ... 19
Figure 6: NAPF modelling of TEE with 10% rebate of gross contribution (basic rate and non-taxpayers) ... 22
Figure 7: NAPF modelling of TEE with 10% rebate of gross contribution (higher and additional rate taxpayers) ... 22
Figure 8 Summary of NAPF modelling of tax revenue under EET and TEE + rebate tax systems ... 23
Figure 9: Current payroll slip and TEE payroll slips ... 25
Figure 10: NAPF member ranking of TEE option. ... 26
Figure 11 NAPF modelling – single rate of tax relief (25%) for basic and non-taxpayers ... 33
Figure 12 NAPF modelling – single rate of tax relief (30%) for basic and non-taxpayers ... 33
Figure 13: Comparison of tax revenue between EET and single rate at 25% ... 34
Figure 14: NAPF member ranking of TEE option ... 34
Figure 15: The most important factors encouraging pension saving (NAPF member survey) ... 38
Figure 16: NAPF summary of the options evaluated ... 41

About the NAPF

The NAPF is the voice of workplace pensions in the UK. We speak for over 1,300 pension schemes that provide pensions for over 17 million people and have more than £900 billion of assets. We also have 400 members from businesses supporting the pensions sector.

We aim to help everyone get more out of their retirement savings. To do this we spread best practice among our members, challenge regulation where it adds more cost than benefit and promote policies that add value for savers.

The NAPF has called for a thorough evaluation of pension tax in the context of the role that pensions play in society and welcomes this consultation, which it is hoped will play an important role in that process.

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Overview

Introduction

"With increased longevity and the changing nature of pension provision, the government needs to make sure that the system incentivises more people to take responsibility for their pension saving so that they are able to meet their aspirations in retirement."1

The NAPF agrees wholeheartedly with the diagnosis and the outcome expressed in the foreword to the consultation document. As people live longer and fewer are able to depend on defined benefit pensions, the challenge of helping people move income from working life to income in later life is both more difficult and more necessary than ever before.

The evidence on adequacy of retirement saving is partial at present and needs to be improved. However, the available evidence[2] suggests that around 12 million people may be under-saving at present. Under-saving appears to be most prevalent among higher earners, particularly those on the cusp of moving into the higher tax band as well as those already above the band. It is very likely that people in different income/age segments will benefit most from different types of policy intervention, saving more may work for some while working longer or drawing on property wealth may be more appropriate for others.

We believe this makes for a challenge which needs to be addressed holistically across the many aspects of Government policy which affect people's ability to assess and meet their individual aspirations in retirement. Specifically, answers are bound up in the interaction between:

- state pensions and benefits – in ensuring pensioners avoid poverty in retirement;
- automatic enrolment – in providing a default route to pension saving for the majority of employees;
- employer contributions (mandated or voluntary) – as an addition to individual contributions and, through matching, as an incentive to individual contributions;
- employer attitudes to pensions – as a driver of the importance of pensions within individual workplace benefit packages;
- tax relief – and the incentives it gives to individuals to save;
- Pension Freedoms – in changing how people access and conceptualise the pension savings built up through all of the above;

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[1] HM Treasury, Strengthening the incentive to save: a consultation on pensions tax relief, foreword
[2] PPI (2013) What level of pension contribution is needed to obtain an adequate retirement income? and DWP (2014) Scenario analysis of future pension incomes

- work – and the availability of employment suitable for the millions of people who want to combine paid work with partial retirement;
- housing – both as a significant asset people could draw on in retirement and as a significant source of expenditure; and
- long-term care – as a significant in-retirement expenditure which many people will struggle to appreciate or plan for early in their retirement.

Our recommendations

The NAPF shares the Government's desire to get more people saving more for their retirement but warns there are significant risks associated with a move to either TEE or a single rate. Instead, the NAPF urges the Government to focus its efforts on securing and building on the success of Automatic Enrolment as we reach the crucial point for millions of small employers starting to enrol their employees for the first time.

The NAPF argues that, over the long term, a move to a pensions tax regime of either 'taxed, exempt, exempt' (TEE) or a single rate jeopardises both pension saving and the tax revenues of future governments. Furthermore, separating DB from DC, while initially appealing, is impractical and will introduce more complexity over time. No change to the system is the most appropriate solution if we want to continue to: support automatic enrolment; sustain employer engagement in pensions; allow low earners to benefit from cross-subsidies from higher earners in schemes; deliver private incomes in later life; and protect future governments against increased dependency on the state.

While the Chancellor may raise more tax revenue in the short term by a change to pension tax but there is no evidence to show that savers would save more or take greater personal responsibility for their incomes in retirement as a result of further changes to the system.

Therefore, a review which seeks to address tax relief in isolation can only provide a partial answer. Worse, it risks being counterproductive if it overlooks the unintended consequences in other parts of the ecosystem which supports retirement income and planning. **We urge the Government quickly to follow this consultation with a thorough, independent review of pensions and retirement policy in the round so that we can seek sustainable solutions which continue the alignment of Government (both current and future), savers, employers, industry and broader society which has driven the success of automatic enrolment so far.**

About our response

The consultation poses some important questions that the NAPF has sought to answer in this response:

- What are the benefits of and problems created by the current system of taxation?
- How could the tax system for pensions be changed / simplified, what are the consequences of the changes considered and what does this mean for savers, employers, pension schemes and the Government?
- What behavioural effects might changes to the tax system bring about and how could changes be played out in the media?
- The importance of sustainability for Governments (both current and future), for individuals, for employers and for the providers of pension schemes and services that support pension schemes.
- What is it that drives people to save and what role (if any) does the tax system play? Does the tax system act as an encouragement or barrier to saving? Could it be changed to encourage more saving ? Is it necessary to design a system that individuals understand or is it better to design a system that benefits them and can be communicated simply as such?

The next two chapters of this response examine the purpose of pension tax relief and explore the current system of tax relief and its strengths and weaknesses and its implications for savers, schemes, employers and the state.

We then examine the different options for consideration, propose a framework for evaluation that includes those proposed in the consultation paper, and then evaluate these options against that framework.

This response then goes on to consider the broader question of incentives to save and personal responsibility and proposes some alternative approaches to achieving higher levels of retirement saving.

Finally, we draw together our conclusions and recommendations.

The purpose of pensions and their tax treatment

The primary purpose of pensions, whether provided by the state, employers or through savings is to alleviate poverty in later life, a period when generating an income through work may no longer be feasible. A further objective of private pensions is to alleviate pressure on the taxpayer in supporting those in later life who might otherwise need state support in retirement. The pension and related tax system must ensure that:

- people can plan for their retirement income with some certainty;
- savings put aside for retirement are just that and can be used efficiently to provide an income and emergency funding when needed in later life;
- employers can be confident that their funding will provide for a more comfortable retirement for older workers and can manage their workforce effectively; and
- Governments can plan for future state support and all taxpayers are seen to be contributing appropriately to the needs of the older population in both working life and retirement.

While the tax treatment of pensions does create some anomalies (explored below), the main objectives set out for the tax treatment of pensions[3] is that it provides for:

- support for the principle that saving for retirement (or put another way, smoothing consumption over a lifetime) is a good thing through deferral of tax collection or through some other incentive mechanism that favours long-term savings over other forms of saving;
- compensation for limited access before age 55 (or a later age) is available (through the delivery of tax free cash or some other device); and
- tax neutrality by ensuring that people are not taxed twice by the same tax on the same tranche of income.

Any changes to the pensions environment, whether tax or other structural changes, should be viewed through that lens, with account taken of the:

- impact that the changes could have on the propensity of individuals to save for their retirement and the amount saved (across different taxpayer cohorts);
- effect on employers in supporting pensions;
- cost of delivering pension provision; and
- willingness of industry to invest to provide the structures needed to support pensions.

[3] PPI 2013, Tax relief for pension saving in the UK

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The current regime – strengths and weaknesses

The recent discourse on the taxation of pensions typically describes pensions as attracting tax 'relief' and 'costing' the taxpayer money. The NAPF believes that this is not the right lens through which to view pension tax. The reality is far more complex and, while pensions do attract some relief from tax, much of the special treatment afforded to pensions is in fact simply tax deferral. As a result, tax revenues today are lower than they would be without pension contributions (all other things being equal) but, with growing funds, tax revenues in the future are higher (and state benefits to those in later life can be lower) to recover the tax not paid at the time of contribution and investment growth.

Instead of thinking of today's system as a cost to society, we might instead think of it as 'pay as you spend' system where income tax is deferred until the money is accessible for savers to spend. Any radical change to this system will move tax to the point of contribution for all or some or risk the potential for double taxation of the same tranche of income.

The 'cost' of pension tax relief

Granting employees income tax relief on their own and their employers' pension contributions, employers' National Insurance relief on pension contributions and tax relief on the investment income of funds, is estimated by HMRC to have reduced income tax and National Insurance revenue to the sum of £48.3bn in the tax year 2013/2014[4], a figure that is slightly lower than in the previous three years. This calculation presumes that the money paid in pension contributions would otherwise have been paid as income in the hands of pension scheme members and taxed accordingly.

The biggest contribution to the 'cost' of tax relief is the income tax relief given on contributions which in 2013/14 is estimated to have amounted to £27bn. As Figure 1 below shows, by far the largest element of that figure (£17.1bn) is attributed to employer contributions to DB and DC occupational pension schemes, a figure that has been falling since 2010/11, the decline of DB contributions being the most likely factor driving the decline. On the Government's own reckoning, the figure is due to fall still further, by about £6bn over the course of this parliament[5], as a result of changes to the LTA and tapering of the AA due to come into effect in 2015.

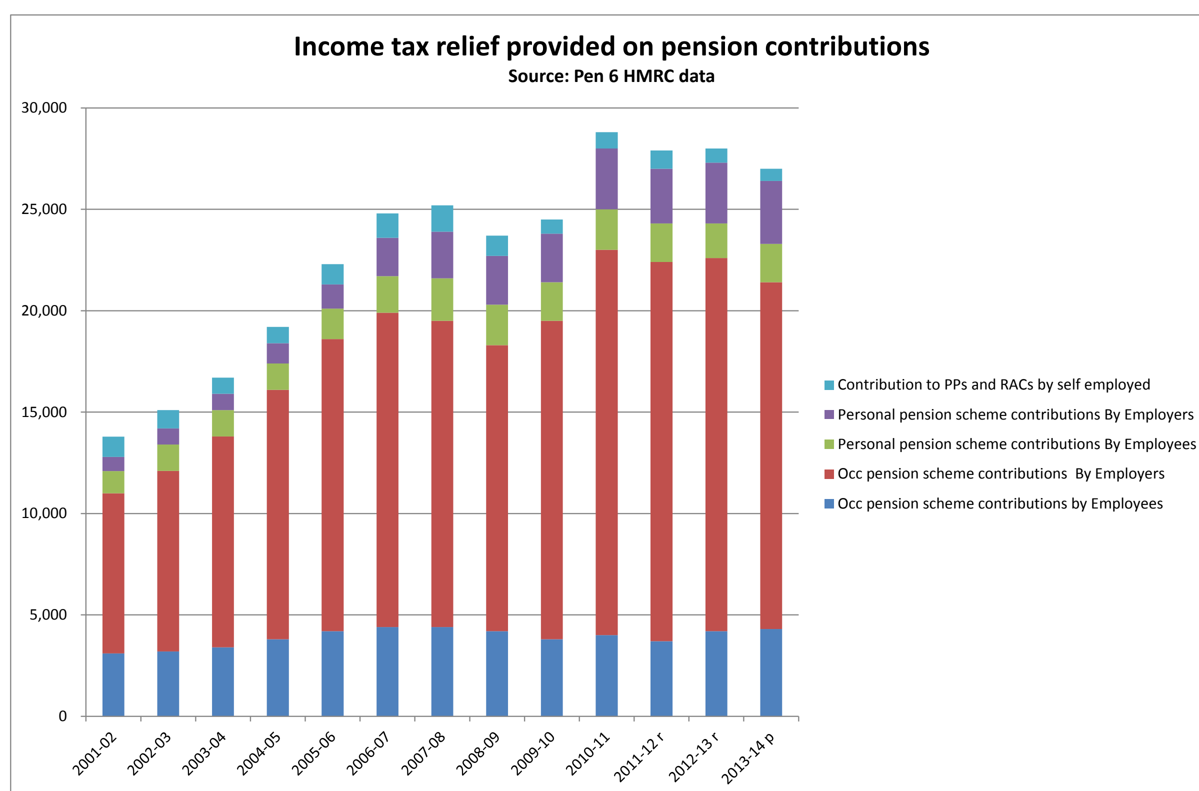
Analysis by Towers Watson[6] suggests that of the estimated £17.1bn, around 90% relates to DB contributions and that £5bn relates specifically to DB deficit funding, payments that relate not only to today's active members but also to pensioners and deferred members and benefits that have

4 HMRC, Table Pen6
5 HMT Policy Costings Summer Budget 2015
6 Towers Watson (2015), Ending higher rate relief on pension savings – not as obvious as it seems

been accrued in the past. As such, this figure should be excluded from any statement of the 'cost' of tax relief. One other factor that remains unclear from the numbers is whether the increasing number of payments of tax as a result of individual's breaching the lifetime allowance are being offset against these data.

As the data provided by HMRC and ONS in Pen6 illustrates, this 'cost' is offset in time by tax paid on pensions in payment. However, the amount that will be paid by today's savers is difficult to predict and HMRC instead offsets the relief given by tax payments from today's pensioners on their private pensions (currently standing at around £13bn – an amount that would not be available today had pensions been taxed as ISAs in the past). For a number of reasons, not least the very different levels of pension scheme membership among today's cohort of pensioners and the fiscal drag of tax bands not keeping pace with earnings or inflation, the comparison is far from ideal.

Figure 1: Income tax relief provided on pension contributions based on Pen6 data from HMRC/ONS



Source: NAPF analysis of HMRC administrative data compiled by ONS in Table Pen 6[7]

[7] https://www.gov.uk/government/statistics/registered-pension-schemes-cost-of-tax-relief

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EET system

At point of contribution

At the point of putting money into a pension and subject to certain limits, contributions from both employer and employee are not taxed as if they were income in the hands of the member of the pension scheme (the saver). Savers pay employee's National Insurance on their contributions but employers' contributions are free of employer National Insurance.

Instead, most of the contributions made are taxed when they are put into the hands of the saver, rather than when they are locked away in a pension. In effect, 75% of the contributions are, in the current system, taxed upon receipt after age 55. Most contributions are therefore not subject to tax relief but are tax deferred.

While invested

During the period of time that money stays in a pension scheme, it is partially free from income tax on income received by the pension scheme and free of capital gains tax (CGT) on gains made within the scheme. The tax not recovered during accumulation amounted to approximately £6.5 billion in 2010/11. In effect, 75% of the tax on this income and gains is recovered when benefits are paid out from the pension.

When paid out

On withdrawal of money from the pension scheme (from 6th April 2015) tax is payable (in modern schemes at least) on 75% of the pot at the individual's then marginal rate with 25% being available to take tax free.

A further exception to the general rule that benefits are taxed is that beneficiaries do not pay tax on any remaining DC funds should the original saver die before age 75.

For the entire £27bn of income tax relief on contributions to be 'recovered' today, today's savers would have to pay tax today on contributions to DB and DC schemes and on deficit recovery payments by employers to DB schemes. For all, this could mean that they pay tax today on income that they are unable to spend today and from which they may never benefit. This is particularly true for those DB scheme members with no dependents, who may never realise any benefits for themselves or their estate if they die before retirement age. It also assumes no behavioural change resulting in revenue being 'lost' in other ways.

Furthermore, recovering the tax today rather than in the future will deprive future Governments of revenue on pensioner incomes. Any change to the system of taxation should be accompanied by a thorough assessment of the revenue that will be generated today after allowing for behavioural change on the part of employers and individuals and the revenue that will be lost to future generations.

A long and complex history

The history of tax relief on pensions in the UK is complex and a series of many incremental changes has led to the potential reforms being discussed today. A specific set of tax rules is applied to pensions in the UK, differentiating pensions from other forms of savings and benefits. Some of these rules have been amended in 2015 as a result of the Taxation of Pensions Act 2014 while other changes are planned as a result of the 2015 summer budget.

Essentially, three sets of tax rules apply at different time periods: at the point of money going in; during the period that money is invested; and at the point of paying out, each of which is summarised in the adjacent box.

Barring the 25% tax free lump sum and the age 75 rule for beneficiaries, tax finally becomes payable on the original contributions as well as income and growth achieved during the period (in effect, the individual has lost out on any CGT relief that they may have been entitled to in other forms of investment).

The rate of tax payable at that time may be higher or lower to that which would have been payable at the time that contributions were made or growth achieved because:

- The individual has dropped down a tax band between at least part of their working life and retirement. Not only do some of those who were additional or higher rate taxpayers during part of their working life and for some of their contributions drop down a tax band but some basic rate taxpayers during working life become non-taxpayers in retirement, making the current system EEE for this latter group;
- There has been a fundamental change to the taxation of income and gains and/or the income tax bands and rates have shifted upwards or downwards during the individual's working life and into retirement;
- Less likely, but feasible, the individual is a higher rate taxpayer in retirement but was a lower rate taxpayer during their working life (perhaps due to an inheritance, receipt of a substantial spouses pension in retirement or finding well-paid work during retirement).

It is impossible to model accurately the tax that will eventually be generated from today's contributions. With fiscal drag, more individuals are being drawn into the higher rate tax band during working life (IFS estimates a rise from 3.3 million in 2010-11 to 4.9 million in 2015-16 [8]) and a similar effect might be expected during retirement. However, this may be counteracted by the latest limits on pension saving introduced through reductions in the annual and lifetime allowances that are limiting pension savings and may reduce retirement incomes in the future. The shift from DB to DC is also expected to have a negative effect on pensioner incomes, a trend that is exacerbated by current low investment returns and low annuity rates and, in time, by the behaviours that emerge as a result of the new pension freedoms.

[8] IFS (2015) Taxes and benefits: the parties' plans

Delivering incomes in retirement

The NAPF has modelled the effect of the current tax regime on different types of taxpayer with the results shown in Figure 2. The chart shows how £1,000 invested for 25 years with 25% taken tax free and tax at the marginal rate paid on the remainder at the time withdrawn[9].

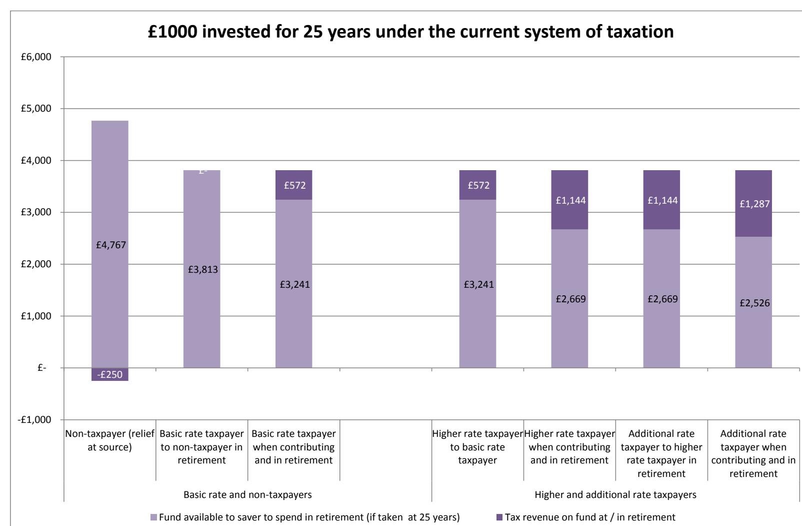
In terms of spending power in retirement, and assuming no major changes to the tax system, those who gain most proportionately in retirement in today's system are those who are non-taxpayers when making contributions and in retirement and those who move from basic rate during working lives to being non-taxpayers in retirement – neither group pays any tax on the savings that they are able to make. A non-taxpayer saving £1,000 (at a growth rate of 5.5% per annum) can generate a fund for spending in retirement of around £4,700 if they are able to attract a rebate equivalent to basic rate tax. A basic rate taxpayer while in work contributing £1,000 before tax can generate a fund of just over £3,800 if they revert to being a non-taxpayer in retirement or £3,200 if they pay basic rate tax on their private pension above the tax free cash. In practice, many basic rate taxpayers may find themselves paying no tax on some of their private pension and basic rate on some when added to their state pension and any other earnings in retirement.

For those who are higher rate taxpayers when they contribute but basic rate when they retire, the spending power in retirement is the same as the basic rate taxpayer throughout whereas the higher rate taxpayer who stays a higher rate taxpayer generates around £500 less in terms of spending power and pays around £500 more in tax. In practice, most individuals who become higher rate taxpayers will have been basic rate taxpayers during some of their earlier career and may end up as basic rate taxpayers later in their career as they transition to retirement. Moreover, some contributions may bridge basic and higher rate both at point of contribution and in retirement, making the picture even more complex.

For those who are basic rate taxpayers before and after retirement, 15% of the closing fund is paid in tax while the figure rises to 34% for the additional rate taxpayer in work and in retirement. On this basis, the overall picture presented by the current system appears less regressive than it does if simply examining the relief on contributions.

[9] NAPF model assumptions include: £1,000 paid out of gross pay, 5.5% fund growth net of charges over 25 years, 25% tax free at retirement, tax rates in retirement the same as today.

Figure 2: Tax and retirement income for different types of taxpayer from £1,000 invested from gross pay and taxed under the current system.



Key assumptions:

- Non-taxpayer receives 20% boost from relief at source
- Term of investment 25 years
- Investment returns after charges 5.5%pa
- Basic rate tax 20%, higher rate 40%, additional rate 45%
- All income in

Source: NAPF modelling

> *"The current system is relatively simple for lower paid employees but complex for higher earners."*
>
> NAPF member survey respondent

A complex system?

The current system of taxation is perceived to be complex by many commentators, and the consultation itself implies that this is the case. However, as Figure 3 reveals, there are mixed views on its complexity with just over a third of NAPF respondents to a recent survey[10] feeling that the system is relatively simple for savers and 41% feeling that it is relatively simple for pension schemes. Several respondents remarked that the complexity kicks in when individual members trip into the higher rate tax band. The AA taper being introduced in 2016 was mentioned by some as introducing more complexity.

[10] NAPF survey of all members September 2015

Figure 3 : NAPF member views on complexity of current system

Is the current system of pension tax simple or complex?	Simple	Complex
For most savers	38%	60%
For schemes	41%	57%

Source: NAPF survey of members 2015, 68 respondents

For most savers joining pensions through automatic enrolment, tax relief has been successfully translated into a simple message for most savers to understand. NEST describes relief in terms of savers receiving £1 in tax relief for every £4 that they put in.

An international perspective

While different countries adopt different methods of taxation of pensions, EET or some variant is the norm across most European countries and many other territories. Both the OECD and European Commission have considered the issue of pension taxation. The OECD's research[11] concludes that although the TEE system (collecting tax on contributions but not pensions in payment) works well for a country's exchequer, it has two drawbacks:

- behavioural economics and psychology suggest that up-front tax relief is viewed as more valuable
- future governments may be tempted to tax pensions in payment which will reduce the attractiveness of pensions to savers.

Furthermore, the European Commission has concluded that:

> ***"The Commission supports this system of deferred taxation (EET) since contributions to pension funds diminish a person's ability to pay taxes and since it encourages citizens to save for their old age. In addition, it will help Member States to deal with the demographic time-bomb, as they will be collecting more tax revenues at a time when more elderly people may call on the State for care."[12]***

The Commission is also looking to remove the tax barriers to a single market for occupational pensions. A move away from the European norm for taxing pensions could present an additional barrier to the single market emerging.

[11] OECD (The tax treatment of funded pensions, Edward Whitehouse
[12] European Commission website

Pension taxation systems – the options

In this section we explore some of the alternatives to the current system and ask what is the right lens or lenses through which to evaluate them. The options we examine, compare with the current system and evaluate are:

1. A shift to a pre-payment system (TEE) with a rebate of some of the tax paid up front, designed as both compensation for locking the money away and an incentive to save in a pension over other forms of saving;
2. A single rate of tax relief for all savers irrespective of their marginal tax rate, designed to redistribute tax relief from higher rate to basic rate and non-taxpayers;
3. The current system of EET adjusted to simplify and reduce the 'cost' of tax relief.

The tax position of these options is summarised in Figure 4. The most significant differences between the current system and the alternatives outlined below are:

- the TEE system of taxation (similar to ISAs) is assumed to require a tax rebate as a reward for locking money away until retirement but that this would be a flat rate regardless of the tax rate of the individual;
- the TEE system will require two accounts for every current active member of every pension scheme and potentially two statements showing the different tax treatments of their current and TEE pots;
- the TEE and single rate systems would probably both require all schemes to operate on a 'relief at source'[13] basis and would probably require employer contributions to pass through payroll and be taxed for DC;
- for TEE and single rate, members of DB schemes would have to be provided with a statement at the end of the year showing the deemed value of their pension contributions;
- a single rate at anything above the basic rate of tax would lead to a redistribution of tax relief between higher/additional rate taxpayers and basic rate taxpayers;
- modifications to the current system could lead to different regimes being put in place for DB and DC schemes, thereby creating the need for new anti-avoidance techniques to prevent arbitrage and abuse of the different systems; and
- moving to TEE removes (for future contributions) one of the benefits of the new pension freedoms: that of tax-free payments to beneficiaries on death before age 75.

[1313] Relief at source arrangements are those where employer contributions are paid gross but employee contributions are subject to income tax with basic rate tax then collected from HMRC by the pension scheme. Net pay schemes by contrast pay all contributions from gross pay.

Figure 4: Pension tax options evaluated

	Current	Minor changes to current	Single rate	TEE + rebate
Timing of income tax	'Pay when you spend' at marginal rate on 75% when withdrawn after age 55 (tax acts as brake on withdrawals)	'Pay when you spend' at marginal rate (on 75% or 100%) when withdrawn after age 55 (tax acts as brake on withdrawals)	'Pay when you spend' at marginal rate on 75% when withdrawn after age 55 plus tax on contributions for those in higher and additional rate tax bands	Pre-pay (tax at marginal rate on own and employer contributions with rebate of some tax paid) and tax free when you spend (no brake on withdrawals after age 55)
Annual Allowance (exceeding triggers additional tax charge)	£40,000 for majority (from 2016/17 tapered down to £10,000 for those with earnings over £150,000)	1a) Remove LTA from DC and lower the AA but remove the taper	£40,000 for all (remove taper)	An annual allowance might still be needed to prevent the avoidance of employer NI
Lifetime Allowance (exceeding triggers additional tax charge)	£1m from 2016/17 (unless previous protection in place) and indexed to RPI from 2018	1b) Remove the AA from DB but with a lower LTA 1c) Introduce new anti-avoidance measures	£1m from 2016 (unless previous protection in place) and indexed to RPI from 2018	No LTA for DC
National Insurance	No NI on employer contribution Employee and employer NI on employee contribution	No NI on employer contribution Employee and employer NI on employee contribution	No NI on employer contribution Employee and employer NI on employee contribution	No NI on employer contribution Employee and employer NI on employee contribution

	Current	Minor changes to current	Single rate	TEE + rebate
Tax-free lump sum (TFLS)	25% of total fund(s) (unless earlier protection in place)	25% of total fund(s) (unless earlier protection in place)	25% of total fund(s) (unless earlier protection in place)	No tax free lump sum
Tax rebate	None (unless using relief at source in which case basic rate relief claimed on employee contributions and higher rate taxpayers receive further rebate through self-assessment)	None (unless using relief at source in which case basic rate relief claimed on employee contributions and higher rate taxpayers receive further rebate through self-assessment)	All participants pay contributions after tax (employer and employee) and scheme claims 30% relief on all contributions	One in every £10 of gross contribution rebated into pension scheme (presumably subject to an annual limit of less than £16,000 – the current maximum)
Bequests	Tax free if death before age 75, thereafter taxable at marginal rate of beneficiary (but not IHT)	Tax free if death before age 75, thereafter taxable at marginal rate of beneficiary (but not IHT)	Tax free if death before age 75, thereafter taxable at marginal rate of beneficiary (but not IHT)	Tax has been paid on contributions so no 'tax-free' payments to beneficiaries. Assume not subject to IHT

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Evaluating the options

In this chapter we evaluate each of these options against the principles set out by HM Treasury in its consultation paper and the implications for savings at retirement. We then consider the potential for behavioural effects among both employers and savers.

We firstly explore the effects which can be more clearly assessed or modelled including:

- the retirement outcomes for different types of taxpayer and saver in terms of funds available in retirement;
- the implications for tax revenues and the implications for sustainability of the system for current and future governments;
- the implications for automatic enrolment;
- the one-off and on-going cost implications for employers and pension schemes in implementing the new system; and
- any differential effects on DB schemes.

We also consider the potential for behavioural effects which are harder to predict, specifically:

- the potential for different systems to act differently on savings incentives for both employers and individuals and the scope for incentivising or disincentivising savings and influencing personal responsibility; and
- the potential effect on schemes and market structure.

Treatment of employer and employee contributions

In developing the evaluation below we have concluded that it will be necessary to tax employer and employee contributions in the same way. In the TEE version (for example), it is assumed that both employer and employee contributions are paid out of taxed income – in other words, the employer contribution is taxed as income in the hands of the employee with the tax being paid to HMRC and the net contribution paid to the pension scheme.

Not to do this would, we believe, create an even more complex system where employee contributions are taxed differently to employer contributions. In addition to any administrative complexity, such a system would also potentially create unfairness between savers with different blends of employer and employee contribution or drive some savers to renegotiate contracts to seek the most tax-favoured contribution mix (or to use salary sacrifice methods to achieve the same aim). We have assumed throughout that employer contributions remain exempt from both employer and employee National Insurance.

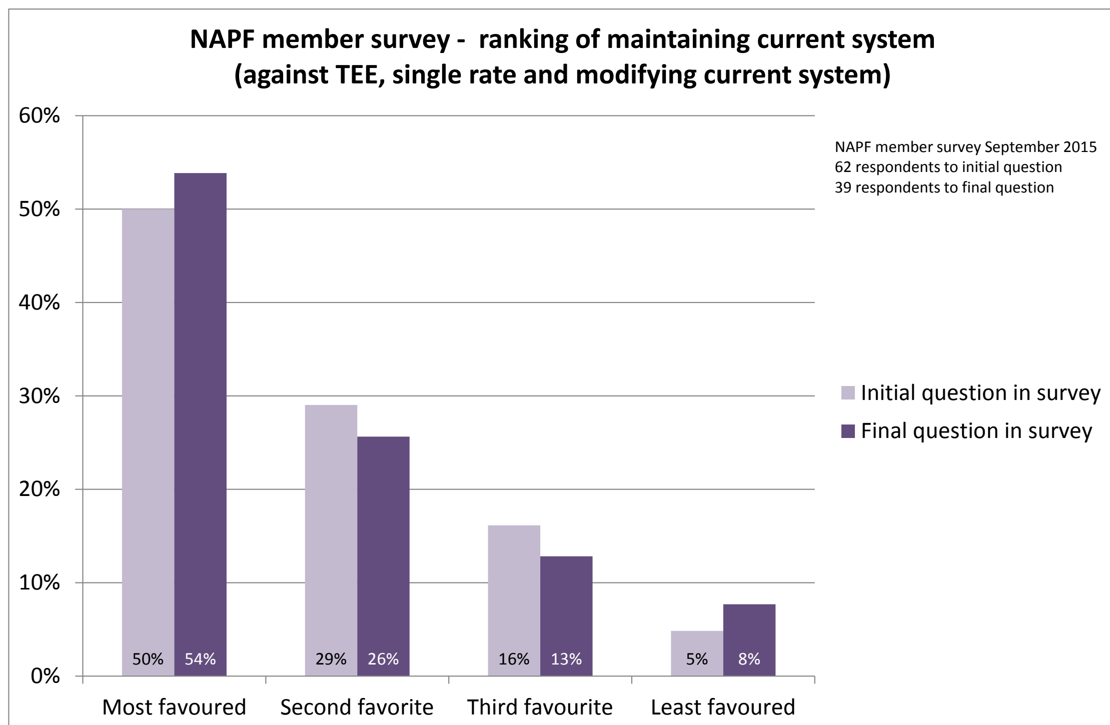
NAPF member ranking of the options

"The current system works well. My employer went through auto enrolment 2 years ago. The tax and NI (salary sacrifice) saving on employee pension contributions were a significant factor in most auto enrolled employees staying in the auto enrolment scheme"

NAPF member survey respondent

NAPF members when surveyed on this consultation in September 2015 expressed a strong preference for maintaining the current system. At the outset of the survey, 79% of respondents selected this as their first or second option. By the end of the survey, this had risen slightly to 80% (although this latter figure related to fewer respondents).

Figure 5 : NAPF member ranking of current system (against other options evaluated below)



The findings in relation to other options evaluated are summarised in the sections below.

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Securing the future of pensions

TEE taxation with a rebate

Taxing pension contributions at point of contribution but not at point of consumption would fundamentally change the way that pensions are taxed in the UK. The NAPF believes such a move would have detrimental effects for schemes, sponsors, savers and the Exchequer. It would:

- create additional complexity in the pension system for anything up to 40 years with two, possibly three, different systems being applied to legacy and future benefits;
- make pensions communications with savers even more difficult and reduce the efficacy of Government initiatives including the pension passport and pension dashboards;
- significantly disrupt the roll-out of automatic enrolment by creating market uncertainty and additional costs for employers and schemes;
- increase administration costs and fundamentally undermine the efficiency of pension schemes leading to higher costs for members;
- create complexity and additional cost for employers;
- lead to lower levels of pension saving in the UK, particularly among higher earners (another pressure point on the efficiency of schemes) and the potential for a knock-on effect on the housing market if savings are diverted;
- creates a perverse environment where individuals are better off saving more when their savings are low (and affordability is difficult) than they are when their earnings are higher and they might logically be better able to save more;
- reduce employer engagement with pensions to the point that some currently offering good schemes reducing contributions to the statutory minimum;
- remove an important brake on withdrawals under pension freedoms;
- potentially lead to the requirement for employers to re-negotiate contracts with employees;
- lead to further closures of DB pension schemes where feasible (if applied to those schemes);
- undermine the 25 year deal struck by the previous Government for public sector pensions if applied to DB schemes or, if not applied to DB, create tensions between public and private sector pensions with DB seen to be given beneficial treatment;
- generate more complexity in anti-avoidance measures if DB pensions have a different tax treatment;
- create a future generations of pensioners who are contributing less and less in terms of income tax but costing more and more to support, thereby creating the potential for social tension;
- increase short-term tax revenues for today’s Government but reduce long-term tax revenues for future Governments due to the loss of tax receipts on investment growth; and

- dis-incentivises pension saving among some groups of savers while not obviously creating an environment for greater personal responsibility.

We explore some of these points in more detail below.

TEE and funds in retirement

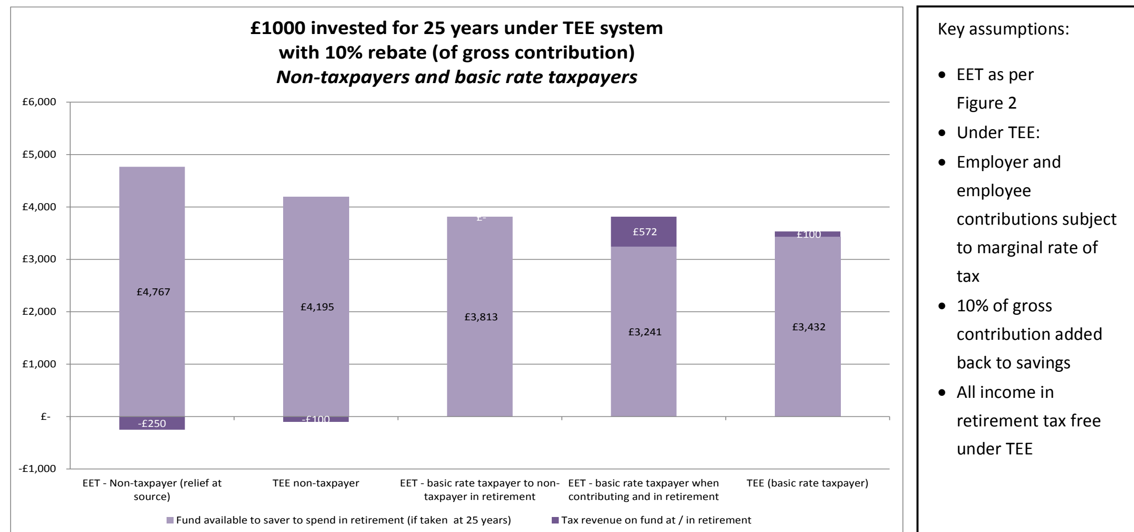
In order to understand the implications for different taxpayers, the NAPF has modelled the effect of a TEE system on different taxpayers and compared this to the outcomes under the current system. Figure 6 compares the results for basic rate and non-taxpayers on a £1,000 contribution invested for 25 years comparing the results under TEE with the results under EET.

This model assumes a rebate of 10% of gross contributions before tax (whether employer or employee) is collected by the scheme (under relief at source) for all savers irrespective of their tax rate. This would be represented for a basic rate taxpayer as their receiving half of their tax back. For higher rate taxpayers it would be a quarter of their tax back.

The non-taxpayer and the basic rate taxpayer who moves to being a non-taxpayer in retirement are worse off under the TEE system than the current system, assuming no major changes to the tax system. Only people who would pay basic rate tax on their contributions under TEE or basic rate tax on their fund in retirement (after taking the tax free cash) would receive the same outcomes under both systems.

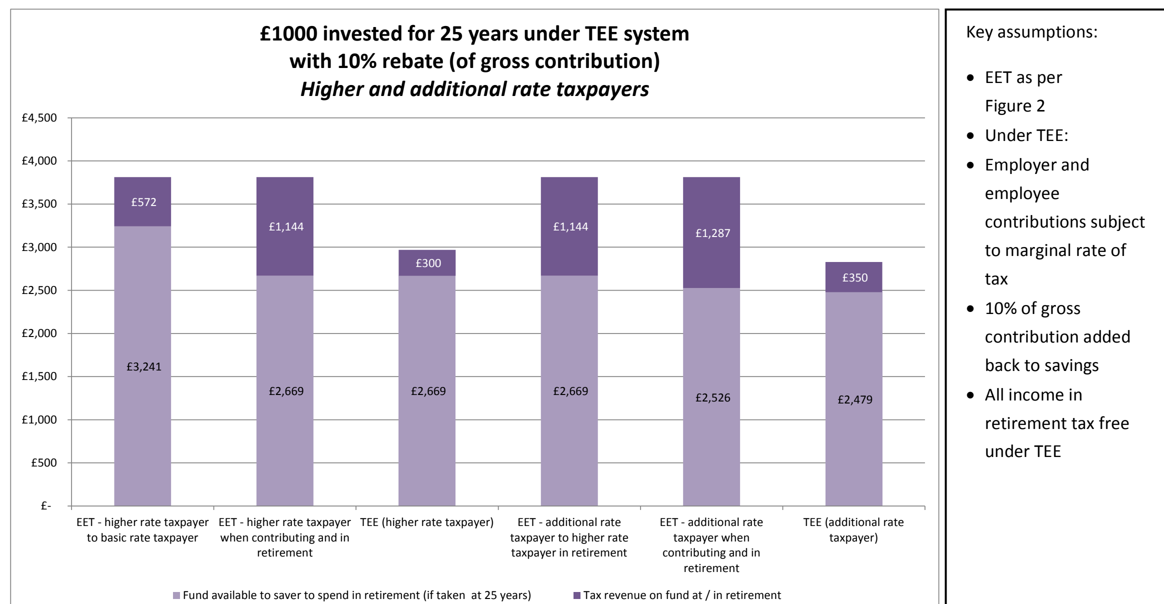
However, the tax received under TEE for the basic rate taxpayer would be considerably less, albeit paid up front, at £100 compared to £572 paid in 25 years' time under EET. Discounting the £572 at 3.5% per annum for 25 years generates a value today of £242, significantly more than £100.

Figure 6: NAPF modelling of TEE with 10% rebate of gross contribution (basic rate and non-taxpayers)



The position in retirement for higher and additional rate taxpayers under TEE is more pronounced, as shown in Figure 7. While those who do not drop down a tax band at retirement are no worse off, the loss of tax revenue is even starker, while those who do drop down a tax band would also be significantly worse off in retirement.

Figure 7: NAPF modelling of TEE with 10% rebate of gross contribution (higher and additional rate taxpayers)



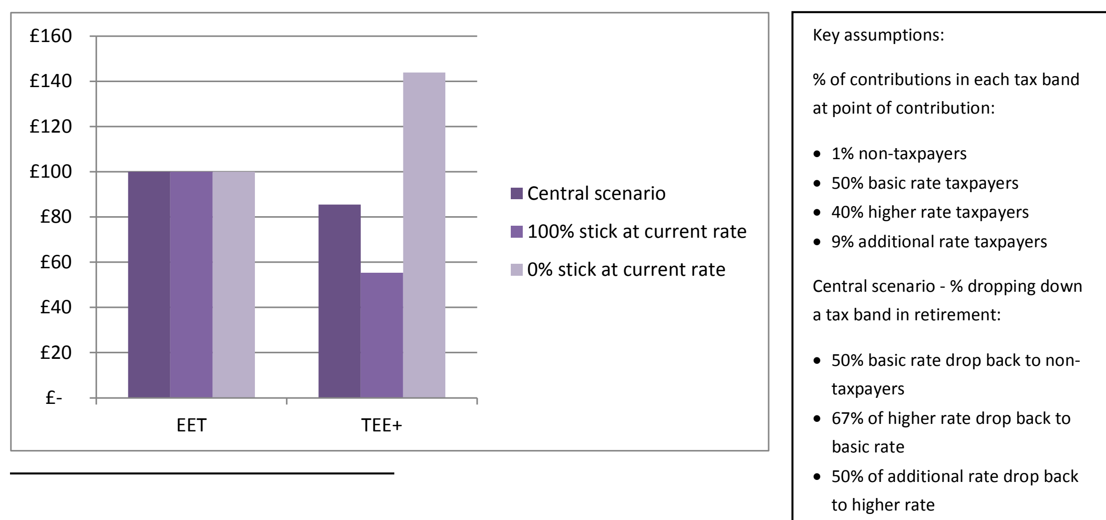
TEE, tax revenues, sustainability and intergenerational tensions

In addition to modelling the effect on individuals, the NAPF has produced some indications of the effect of a move to TEE on the value of revenues generated by such a new regime and the existing system of pension taxation. There are a significant number of assumptions at play that could change the outcome, most notably future income tax rates and bands, investment growth, the movement of individuals between tax rates at retirement and the discount rate applied to future revenues under TEE. However, the NAPF modelling suggests that TEE with a rebate could generate up to 45% less revenue than an equivalent EET model generating tax revenue in 25 years when discounted at 3.5% pa. The reason for the difference is due to the failure of the TEE model to tax future investment growth and only to tax contributions.

Figure 8 shows the relative tax revenues generated by different types of taxpayer under EET and TEE + rebate systems for every £100 in tax revenue generated through EET. The central scenario weights the tax revenues by two factors: the proportion of pension savers in different tax bands at point of contribution; and the proportion of contributions derived from pension savers in different tax bands at the point of retirement[14]. The net present value of the revenue collected in 25 years is discounted back to its net present value by 3.5% per annum[15]. The two other scenarios show the relative outcome if:

- no taxpayers drop down a tax band in retirement, a scenaio which favours the EET system since more revenue is collected in retirement;
- all taxpayers drop down a tax band in retirement, a scenario which favours the TEE system since more revenue is collected on contributions and less in retirement.

Figure 8 Summary of NAPF modelling of tax revenue under EET and TEE + rebate systems



[14] Asssumptions based on PPI analysis in PPI paper (2013) Tax relief for pension saving in the UK
[15] HM Treasury - discount rate recommended by HM Treasury in Green book for periods of 30 years or less

Not only is revenue being taken up front under TEE but the value of the revenue is likely to be less. This reason alone would suggest that a TEE system, even with a rebate, is unsustainable.

A move to TEE for DC only will also create the potential for some in the industry to devise schemes that have the tax advantages of DB without all of the risks and costs. HMT and HMRC will then have to find new ways of dealing with such schemes, which in itself will introduce new complexities.

Eventually having a pensioner population that is not paying income tax may also prove to be a problem for future Governments in terms of social stability and cohesion. The rise in healthcare, social care and state pension costs could eventually put pressure on any Government to look at pensioner incomes as a source of tax revenue. For a change to TEE to look convincing in the eyes of savers, today's Government will have to put forward a very strong argument why this would not be likely or possible. Without that, there is unlikely to be trust in the change of policy.

TEE, the pay packet and automatic enrolment

Savers, in DC schemes at least, would be faced with a fundamental change in the way their pension contributions appeared on their pay slip, particularly those currently in net pay schemes where contributions are not subject to tax on their way into the scheme. Figure 9 illustrates the changes that basic rate employees could see as a result of a move to TEE assuming that their pension contributions were in excess of the statutory minimum.

While their net pay would look the same (assuming that employee NI is not payable on the employer contribution), they would see tax being deducted from their pension contribution before being invested which might trigger a behavioural response. The effect would be most marked for an individual where the addition of the employer contribution tripped them into a higher tax band. We have not sought to evaluate the effect on working benefits but believe that the inclusion of the employer contribution as pay could have an impact for some individuals.

Figure 9: Current payroll slip and TEE payroll slips – 15% contributions

Current pension tax system (net pay scheme)

Company name			
Really rather good company limited			
Employee number	**Employee name**	**Payslip date**	**National Insurance No.**
777564	Sally James	30/09/2015	XX676767H

Payment	Amount	Deduction	Amount
Salary Overtime Pension	£2,000 £ 200 -£ 100	PAYE tax NI	£ 243 £ 183

Address	This period		Year to date	
Sally James No 5 Big House Long Street Smiley Town Gorgeous County PC27 8RD	Taxable pay PAYE tax National Insurance	£2,100 £ 243 £ 183	Pay PAYE tax National Insurance	£ 12,600 £ 1,460 £ 1,028

Pay method	Period number	Dept	Tax code	
Bank	6	Sales	1060L	Net Pay £ 1, 673

NAPF

TEE or single rate pension tax system (relief at source)

Company name			
Really rather good company limited			
Employee number	**Employee name**	**Payslip date**	**National Insurance No.**
777564	Sally James	30/09/2015	XX676767H

Payment	Amount	Deduction	Amount
Salary Overtime Employer pension contribution	£2,000 £ 200 £ 200	PAYE tax NI E'er pension contribution Own pension contribution	£ 343 £ 183 £ 160 £ 80

Address	This period		Year to date	
Sally James No 5 Big House Long Street Smiley Town Gorgeous County PC27 8RD	Taxable pay PAYE tax National Insurance	£2,400 £ 343 £ 183	Pay PAYE tax National Insurance	£14,400 £ 1,820 £ 1,100

Pay method	Period number	Dept	Tax code	
Bank	6	Sales	1060L	Net Pay £ 1, 673

NAPF

The position would be different for an employee with contributions at or close to the statutory minimum for automatic enrolment. With no change to the automatic enrolment legislation or an increase in contribution levels by their employer, these savers will experience a cut in net pay. Under automatic enrolment legislation, a minimum of 8% of banded earnings must be paid into the scheme. Figure 10 illustrates the potential effect on the payslip of an individual on minimum contributions (8% of gross pay) under a shift to TEE with a 10% rebate.

Figure 10: Current payroll slip and TEE payroll slips – statutory minimum contributions

Current pension tax system (net pay scheme) – 8% gross contributions

Company name			
Really rather good company limited			
Employee number	**Employee name**	**Payslip date**	**National Insurance No.**
777564	Sally James	30/09/2015	XX676767H

Payment	Amount	Deduction	Amount
Salary Overtime Pension	£2,000 £ 200 -£ 100	PAYE tax NI	£ 243 £ 183

Address	This period		Year to date	
Sally James No 5 Big House Long Street Smiley Town Gorgeous County PC27 8RD	Taxable pay PAYE tax National Insurance	£2,100 £ 243 £ 183	Pay PAYE tax National Insurance	£ 12,600 £ 1,460 £ 1,028

Pay method	Period number	Dept	Tax code	
Bank	6	Sales	1060L	Net Pay £ 1, 673

NAPF

TEE + rebate tax system (relief at source) – 8% gross contributions

Company name			
Really rather good company limited			
Employee number	**Employee name**	**Payslip date**	**National Insurance No.**
777564	Sally James	30/09/2015	XX676767H

Payment	Amount	Deduction	Amount
Salary Overtime Employer pension contribution	£2,000 £ 200 £ 60	PAYE tax NI E'er pension contribution Own pension contribution	£ 275 £ 183 £ 48 £ 120

Address	This period		Year to date	
Sally James No 5 Big House Long Street Smiley Town Gorgeous County PC27 8RD	Taxable pay PAYE tax National Insurance	£2,260 £ 275 £ 183	Pay PAYE tax National Insurance	£13,560 £ 1,652 £ 1,100

Pay method	Period number	Dept	Tax code	
Bank	6	Sales	1060L	Net Pay £ 1, 639

NAPF

Were any change to be made before the final roll-out of automatic enrolment, those employers about to stage would be faced with more complexity and uncertainty about both the payroll changes required and the scheme that they might wish to choose. Pension schemes themselves would be in a state of flux with uncertainty about the economics of the

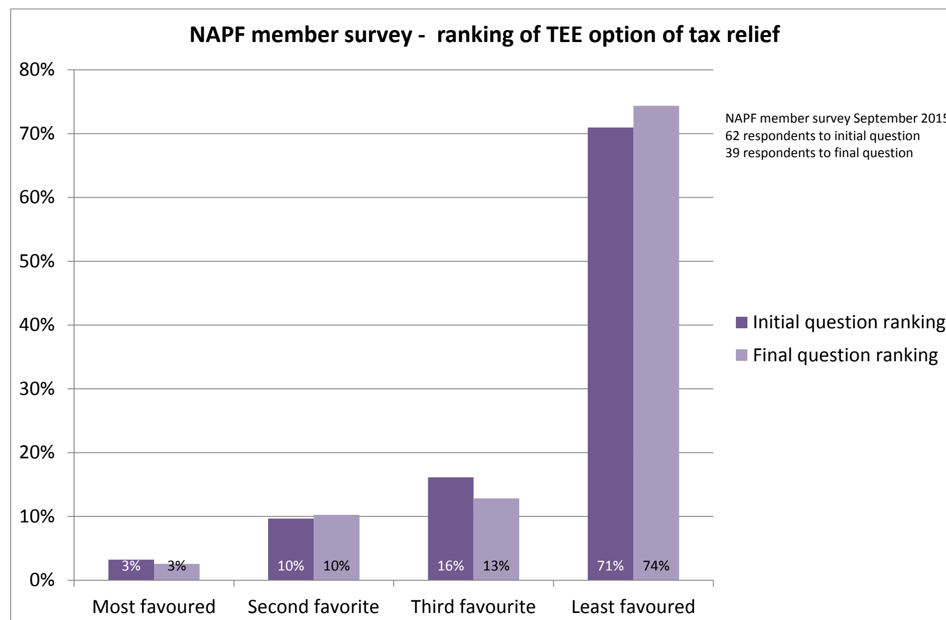
scheme, systems changes required and their charging structures for members. A change to TEE could potentially disrupt the roll-out programme.

TEE, employers and schemes

While at face value, ISAs may be simpler to administer than pensions, applying a TEE system to pensions would introduce more complexity. The collection of tax rebates and, moreover, adding a new system to what would become a legacy system of benefits accumulated to date would, in fact, add considerable cost and complexity for employers and for pension schemes. It would seem difficult, if not impossible, to convert all existing pensions to a TEE equivalent, although such a move would reduce the additional on-going costs.

In the survey of NAPF members, employer and pension scheme respondents were clear that a radical shift to TEE would increase the costs of running a scheme, the administrative complexity and confusion for pension savers. Only 2 respondents from 68 chose TEE as their favoured option at the start of the survey (before any detail on how TEE might operate had been disclosed). The majority (71%) selected TEE as their least favoured option, a figure that rose slightly to 74% by the end of the survey. The results are summarised in Figure 11.

Figure 11: NAPF member ranking of TEE option.



> *"Payroll nightmare, administrative nightmare, any trust or faith in the UK pension system will be shattered and what little confidence there is in people to make pension saving will be lost. Trustees will find it very difficult to convey the message that a comfortable retirement requires significant savings"*
>
> NAPF member survey respondent in response to questions about TEE

For employers, the most significant, immediate change would be to payroll systems to accommodate the taxation of employer contributions. Members of the NAPF estimate that the cost of this would be in the region of £50,000 per large employer (although the mean figure among respondents was in excess of £100,000). If replicated across all 6,595 employers with 250+ employees[16] (all of whom have a workplace pension scheme in place), £50,000 average cost would amount to more than £300 million in one-off costs. Should TEE result in employers having to renegotiate contracts with employees, the costs will be considerably higher.

Both employers and schemes would find themselves with new messages to communicate to those in their pension schemes with the message particularly complex for those on the statutory minimum for automatic enrolment. NAPF member respondents to the survey estimated a median one-off communication cost of £30,000 (mean in excess of £120,000). Again, extrapolated simply to all larger employers this could add nearly £200 million in implementation costs.

> *"The changes are complicated and difficult to communicate – there would be additional administration cost and burden when pension costs are already under strain."*
>
> NAPF member survey respondent

The more complex issue for employers will arise if their higher paid employees no longer wish to participate in the pension scheme. This might be expected to lead to both new benefit packages being developed for higher paid employees and a change in the demographics and levels of contributions to pension schemes. This may in turn lead employers to reconsider how they provide pensions in the future and result in structural

[16] BIS statistical release

change in the pension market. We anticipate significant re-negotiation of administration contracts and/or schemes moving administrator and/or movement away from trust based schemes towards contract-based arrangements or Mastertrusts.

The requirement for net pay schemes to move to relief at source to claim the tax rebate will bring change for schemes, as will the need to run both legacy accounts for EET funds already built up and new accounts for TEE contributions. NAPF members estimate that the costs of converting to relief at source would amount to £25,000 per scheme (median, mean value of £40,000) adding around £165 million in one-off costs if all larger employer schemes are currently operating net pay.

Unless a way can be found to 'grandfather' legacy arrangements to the new tax system through some type of tax amnesty or tax-advantaged transfer, schemes will also have to make changes to their administration systems to accommodate running both the legacy accounts under EET and new accounts under TEE. One-off costs were estimated by NAPF survey respondents at around £50,000 (median, mean value in excess of £170,000) leading to an aggregate cost for the schemes of larger employers in excess of £300,000.

In total, the NAPF estimates that the one-off costs of change for employers / schemes could amount to more than £1,000 million. In addition, costs would need to be borne by smaller employers and schemes and schemes would need to allow for additional on-going costs of administration and communication.

42% of NAPF respondents to the survey thought that a move to TEE would bring about a change both to how and where their scheme was administered and changes to the benefits of the scheme. When asked about those changes to benefits, 75% thought that TEE would trigger a change in benefits suggested that employers would respond to the change by reducing contributions and offering either cash or other benefits in their place.

Respondents also felt that such a change would not only affect contribution levels but also the charges that schemes levy on members. The effect of running two accounts, more complex communications to members and lower contributions overall should not be underestimated. 63% of NAPF respondents believe that TEE will add more than 10 basis points to member charges (32% believe that it will add more than 20bp). For some, that might lead to a risk of breaching the charge cap which in turn would lead to other changes being required. The loss of higher earners from schemes would, in time, lead to higher charges still as the cross-subsidy from larger funds to smaller funds is diminished or lost.

TEE and DB schemes

While TEE is complicated, costly and appears to have largely negative consequences for retirement savings, they pale into insignificance in comparison to the challenge that would be faced by DB schemes (open to any future accruals) and their employer sponsors. TEE would be technically possible within DB. However, the way to achieve it would probably involve closing the scheme or section and reopening again with benefits pinned to net pay rather than gross pay. The consequences for employment relations, particularly in the public sector (undermining as it would the public sector deal struck under the previous Government), would be considerable, the costs of closing the schemes and recasting them would be sizeable and the behavioural effects on both employers and employees would be unlikely to be positive.

> *"Any change to the tax system may mean the end of future accrual under our DB scheme"*
>
> NAPF member survey respondent

The NAPF has not attempted to quantify the cost or effect on schemes, deficits, cashflows or membership but would impress upon the Government the need to undertake a thorough analysis if there is any intention of changing the tax basis for DB pensions. What is clear is that most, if not all, DB schemes that remain open to future accruals and that have the ability to do so, would close altogether.

Even if TEE is not applied to DB schemes, applying it to DC will have knock-on effects for employers with DB, most notably:

- those with AVCs will potentially have to deal with different tax regimes for the main scheme and the AVC arrangements;
- those with hybrid schemes could face similar complexity;
- it is not clear how transfers from DB to DC would be affected or whether they could still be permitted, thus undermining the Government's Freedom & Choice policy;
- extensive and complex anti-avoidance measures would be required to prevent abuse and arbitrage between the two systems thereby adding more opacity;
- a move to limit the tax advantages of DC would presumably be accompanied by further change to the tax position of DB, thereby making it even less attractive to certain members and herald a further departure of members from schemes creating cashflow and benefit problems for employers.

TEE and behavioural change among savers

The NAPF believes that a change from EET to TEE will inevitably lead to behavioural change among savers. Locking money away for 30+ years requires compulsion, discipline or needs to be social norm where savers know that saving for the long term is beneficial and sustainable (without needing to know the detail). While the existence of a rebate would make TEE more attractive than taking the money as cash and investing in an ISA and the NI exemption for employers would make pension contributions more attractive than paying contributions as cash, other factors will come into play.

The direction of change is difficult to predict with any precision but will depend to a large extent upon four factors:

- the way in which the media presents the change – negative coverage of the change would seem to point towards the change dis-incentivising savings;
- the way in which employers and pension schemes respond to the change which in turn is affected in part by the response of their more senior staff to the change and the costs of transition and running a pension scheme;
- the confidence that savers have in the sustainability of the system and in future governments not to tax their savings again;
- the new social norms that emerge from the change.

The output of the modelling above points leads us to conclude that a change to TEE will lead to lower levels of retirement saving. The scale of this change is difficult to predict but it is feasible that savings will gravitate towards the statutory minimum for automatic enrolment.

82% of NAPF members who responded to the survey on pension tax felt that TEE would have a detrimental effect on overall pension savings. 14% felt that it would have little effect and no respondents thought that it would incentivise more savings.

Single rate of tax relief

The second alternative evaluated by the NAPF is a move towards a single rate of tax relief under the EET system. Work by PPI[17] revealed how at a 30% rate of tax relief for all, higher rate taxpayers would still be better off than saving through an ISA, basic rate taxpayers would be better off and the costs to Government would be close to neutral. However, the PPI work did not explore the implementation issues for schemes, the operational complexities afforded by the change or the potential for behavioural change on the part of employers and schemes. Moreover, there has been little work on how to apply the single

[17] PPI – reference work with Age UK and Friends

rate to employer contributions which the NAPF believes would be necessary to avoid unfairness and arbitrage.

The arguments for a single rate are predicated on the perceived regressive nature of tax relief and the belief that a single rate will be simpler to communicate to savers. However, the analysis carried out by the NAPF and outlined above shows that, played through to retirement, the current system is less regressive than simply looking at the relief on contributions paid in would suggest. Pound for pound those on lowest incomes during work and in retirement benefit most from the current system. Those able to contribute most and therefore capable of generating a higher income in retirement pay most tax, albeit that they also generate the most tax free cash.

While a move to a single rate undoubtedly puts more money into the hands of the lower paid in retirement, the NAPF believes that the pension system is too complex to use for redistribution. The income tax system itself is a more appropriate tool to achieve this social objective.

The NAPF believes that a move to a single rate of tax will ultimately do more damage to retirement savings than good:

- the change will introduce more cost and complexity for employers due to necessary changes to payroll, particularly for those currently using net pay schemes;
- implementation changes and costs to net pay schemes and to DB schemes (if applied to these);
- if DB schemes are not included under single rate, additional complexity will be introduced to avoid unfairness, abuse and arbitrage;
- it creates some disturbance to automatic enrolment by creating more change at a time when new employers are staging;
- the message that will be given to higher rate taxpayers is that they risk being taxed twice on the same tranche of income – a message that could override any messages about the benefits of pensions remaining attractive;
- pressure could be put on employers by senior employees to pay pension contributions as cash or other benefits;
- the loss of higher earners and higher contributions from schemes would lead to a loss of efficiency and cross-subsidy which in turn would lead to higher charges for those who remain;
- there would be scope for employers to restructure pension benefits to something closer to the statutory minimum for all;
- those who choose to save in other ways, particularly higher earners who may receive cash payments instead of pension contributions, may divert money to the

housing savings with the potential for a knock on effect on the housing and rental markets;

- moving to a single rate only delivers more tax revenue to the Exchequer today if the single rate is set at a level below 30% and even then delivers very little benefit in net present value terms. The lower the single rate, the less incremental benefit to the basic rate taxpayer and the less attractive the system is for higher rate taxpayers, thereby accelerating their withdrawal from pension schemes.

Many of these issues are similar to the issues considered above for TEE. However, we examine below the peculiarities that a single rate introduces.

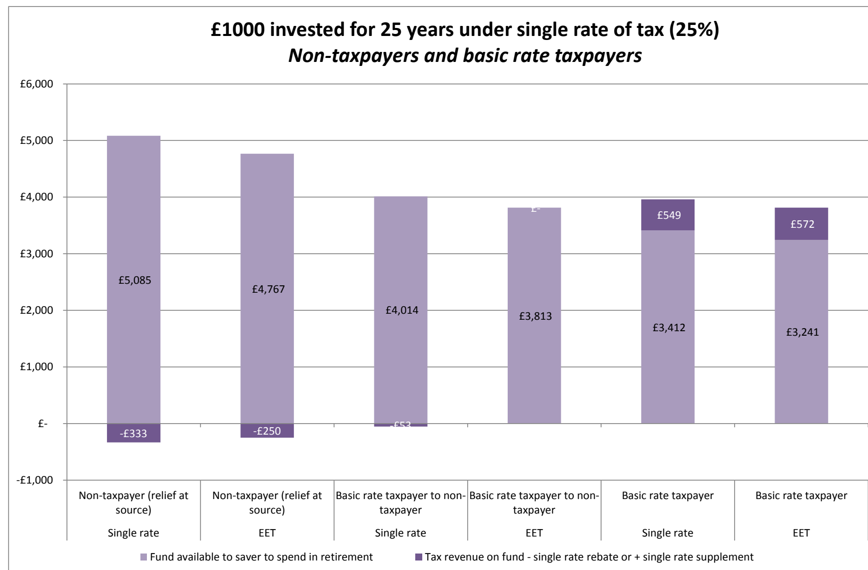
Single rate - impact on pay packet, retirement funds and automatic enrolment

For the single rate to be implemented, the NAPF believes that it will be necessary to initially tax all pension contributions, including employer and to then reclaim the 30% through relief at source. Implementing a single rate through net pay would be extremely complex and perhaps unworkable through payroll systems and scheme administration systems. This would bring about the same changes to payroll and costs to employers identified under TEE above. Employees would see their pension contributions initially reduced by tax. In much the same way as with TEE, a single rate could lead to an employee being tripped into a higher tax band or potentially losing working benefits.

The single rate would not create as many difficulties with automatic enrolment as TEE since basic rate taxpayers would in fact receive more than 8% into their pensions. However, the single rate would create problems for higher earners contributing at the statutory minimum since less than 8% would flow into their pension scheme under a single rate. Nonetheless, all employers would be faced with further changes to their payroll, many having just funded major change to accommodate automatic enrolment.

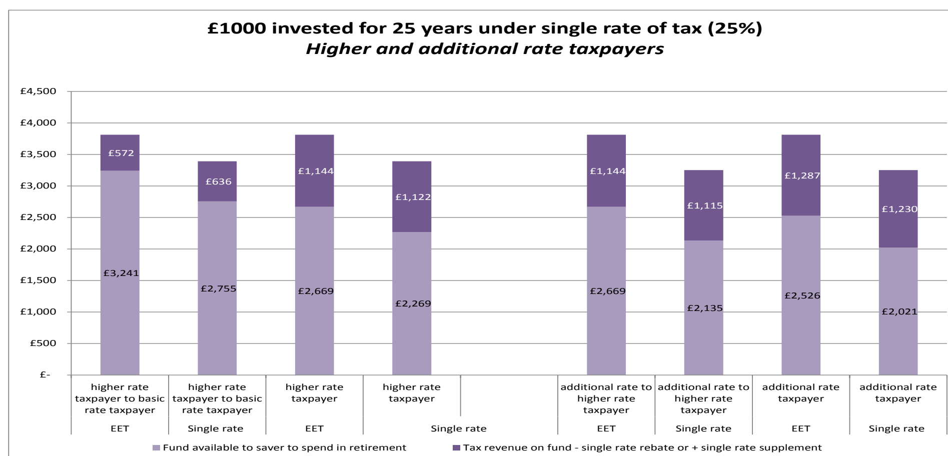
One of the key determinants of the impact of a move to a single rate will be the rate itself. On the assumption that any change must generate additional revenue (reduce the cost) to the Exchequer than the current system, the NAPF believes that the single rate would need to be set at a rate below 30%. The results of the NAPF modelling below have used a single rate of 25% which can be represented as “save three, get one free” for basic rate taxpayers (but not higher earners).

Figure 12 NAPF modelling – single rate of tax relief (25%) for basic and non-taxpayers



As Figure 12 demonstrates, the retirement benefits for basic rate taxpayers and non-taxpayers are enhanced under a single rate. However, this is explicitly at a cost to higher and additional rate taxpayers who will be worse off, as shown in Figure 13. The inescapable headlines will be that, for higher earners, the benefits of pension saving have been removed. The message that 'saving in a pension is still better than an ISA' might well get lost.

Figure 13 NAPF modelling – single rate of tax relief (25%) for basic and non-taxpayers

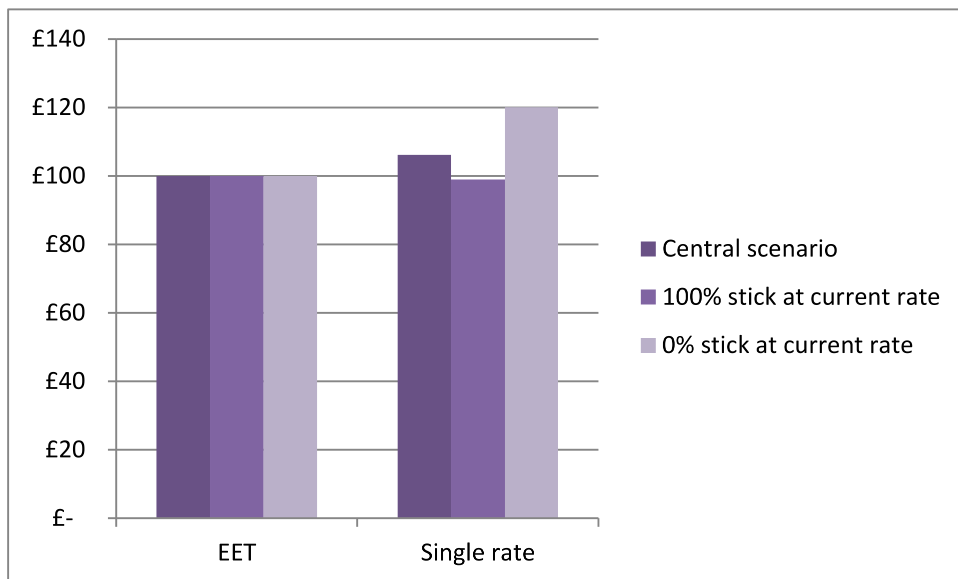


Single rate and tax revenues

At first glance, it would seem that taxing higher earners on their contributions at a rate of 15% or 20% (additional rate taxpayers) and giving an additional 5% to basic rate taxpayers and then taxing all again at retirement would generate significant additional revenue. However, the picture is much more complex. NAPF modelling suggests that, in net present

value terms, a single rate of 25% would raise only 6% more in tax revenue based on NAPF central assumptions and broadly the same if all taxpayers stay at their current rate in retirement. Only if most or all taxpayers drop down a rate (something that is difficult to predict) does the single rate generate substantially more revenue. The main reason for the limited difference is that higher and additional rate taxpayers pay less into their pensions on a single rate, resulting in lower funds at retirement and less tax revenue generated.

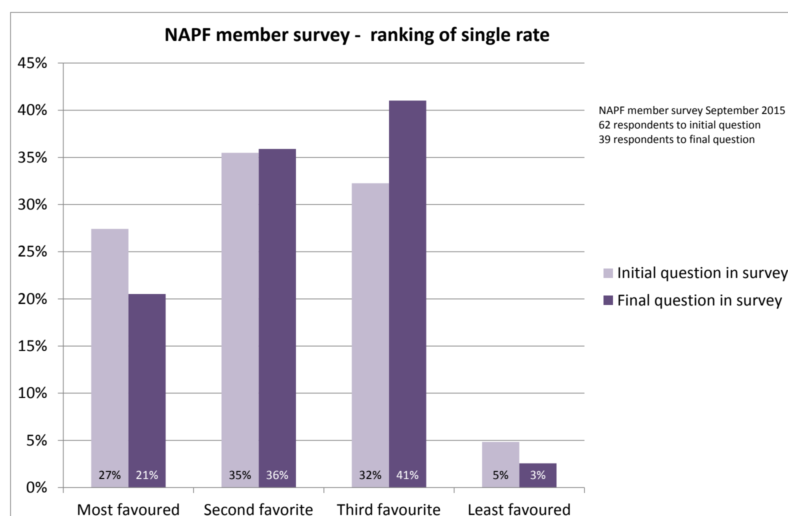
Figure 14: Comparison of tax revenue between EET and single rate at 25%



Single rate, employers and schemes

Of all of the options evaluation, the single rate saw most movement between the initial and final question in the NAPF member survey. At the outset, 27% of respondents chose single rate as their preferred option, dropping away to 21% by the end of the survey (Figure 15).

Figure 15: NAPF member ranking of TEE option



The arguments put forward in favour of the single rate included fairness, the benefits and additional incentive to lower earners, its simplicity of communication and administration.

> *"I think it's fairer - The positive messaging for the masses would be very helpful. Higher rate taxpayers are generally in a better position to sort themselves out."*
>
> *NAPF member survey respondent*

Those against the single rate pointed to its complexity and a lack of evidence that it would support additional savings.

The costs to employers of moving to the single rate would be similar to those outlined above for TEE. Employers would have costs of payroll changes to bear and potentially difficult communications and negotiations with their higher paid employees. For DB schemes, the costs and complexities would be compounded by inevitable changes to the formula for arriving at a calculation of the accrued benefits each year and working out how to credit basic rate taxpayers with more pension benefits and reduce benefits for higher earners. Whereas the current system typically affects only a few members of a DB scheme each year, under a single rate, schemes would be required to assess every higher rate taxpayer in the scheme each year, thus increasing the costs to the scheme.

> *"No evidence that it does anything supportive and will almost certainly introduce huge amounts of complexity."*
>
> *NAPF member survey respondent*

DC schemes operating on a net pay basis would have to move to relief at source with similar costs to those outlined for TEE.

> *This would be the worst of all worlds as it feels like a half-way house and very unclear. Everything would need to be reviewed and changed.*
>
> *NAPF member survey respondent*

Other findings from the NAPF member survey relating to a move to a single rate included:

- 65% of employers / schemes would keep the benefits the same, 20% would change benefits;
- among those who would change benefits, a minority (7%) would increase employer contribution, half would reduce contributions and replace with cash / other benefits, and the remainder would mostly not change contributions but change other aspects of the benefit structure;

- 27% would change administrator or move to contract based arrangement;
- Of 21 who answered, 86% said that their DB scheme would close to accrual and move to DC;
- 25% (of 44) thought a single rate would incentivise more saving, 36% thought it would have detrimental effect on pension saving.

The one benefit that a single rate would have over a move to TEE would be that dual accounts would not be necessary unless there was also a change to the way that benefits in payment were to be taxed for future contributions, for example by also imposing a new limit on tax free cash. If future tax free cash is restricted in a different way to existing arrangements (say by applying an absolute limit), it might then become necessary to run separate accounts for legacy and new arrangements.

Modifying the current system by separating DB and DC

In considering how the system of taxation might be modified less radically, the NAPF also examined whether it would be possible to apply different regimes to DB and DC savings. While at first glance this appears an attractive option, the NAPF has concluded that the process of separating out DB and DC would itself give rise to new complexities.

Removing the annual allowance for DB schemes and the annual allowance for DC sound appealing. However, doing so could very well lead to further significant reductions in both allowances and a host of anti-avoidance measures designed to limit abuse or arbitrage of the new systems.

Moreover, any change would very likely be introduced alongside significant reductions to the current levels of savings permitted in either type of pension, a move which the NAPF believes would lead to less rather than more pension saving and would ultimately undermine the pension system and retirement incomes in the future.

Pension tax and incentives

Most pension saving takes place, as it always has done, through the workplace in partnership with an employer. And most people's contribution level is at the level (or at one of the levels) built into their employer's schemes. Automatic enrolment is exacerbating these trends, broadening the partnership between employees, employers and, importantly, tax relief in getting people into pension schemes and setting a statutory minimum contribution level which is rapidly becoming the most prevalent level of pension saving.

Most schemes' member communications and the Government's own 'We're all in' campaign all feature this tripartite partnership:

> ***Millions of workers are being automatically enrolled into a workplace pension by their employer. Once you're enrolled, not only will you pay in to it but so will your boss and the government.***
>
> ***Example: John puts in £40, his employer puts in £30, the government adds £10 tax relief. A total of £80 will be paid into John's pension.***[18]

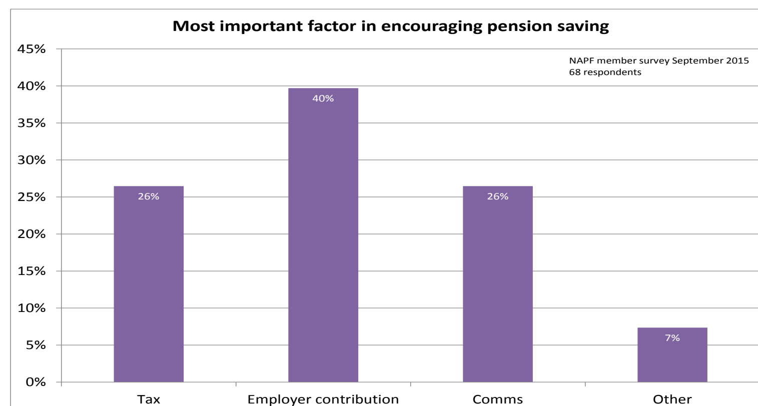
In this context, the consultation's focus on pension tax relief and its impact on individual savers feels too narrow. The assertion that moving to a TEE system might make the Government's contribution more transparent, more engaging and more likely to take personal responsibility seems to be lacking in evidence and again, too narrow a perspective.

Respondents to the NAPF survey ranked tax one of the important factors that incentivises pension saving and on a par with member communications. However, as

Figure 16 illustrates, employer contributions were felt to be the most important factor by the largest group of respondents.

[18] https://www.gov.uk/workplacepensions

Figure 16: The most important factors encouraging pension saving (NAPF member survey)



Incentives and individuals

There is no evidence to show that moving to a TEE system or to the higher match for lower earners implicit in a single rate set higher than the basic rate will incentivise greater saving. The best available evidence of the impact of shifting tax relief from contributions to pensions in payment is probably the experience of New Zealand where there is reported to have been 'a dramatic reduction in pension saving'.[19] The evidence on matching is largely derived from US 401k experience. Numerous studies[20] suggest that the existence of a match is more important than its level. A match drives participation but an increased match does not necessarily drive higher contributions and may drive lower contributions (if employees are able to reduce their contributions they may do so perceiving that the amount they need to contribute falls as someone else contributes more).

Behavioural economics, and in particular Daniel Kahneman's[21] work on loss aversion also suggests that the losses in tax relief, which some taxpayers will inevitably face under either option, are likely to have a greater impact than the gains which the intended beneficiaries receive. We can, in other words, have confidence that redistributing tax relief from one group to another is more likely to reduce pension saving than it is to increase it. Moreover, the same theory would suggest that those losing out will focus more on the losses than on any benefits still inherent in the pension system (e.g. that saving in a pension is still better than saving in an ISA), most likely resulting in lower pension saving among that group.

[19] Whitehouse, Edward. 2005. *Taxation : The Tax Treatment of Funded Pensions*. World Bank. Reform in New Zealand also included an element of taxation of investment gains.
[20] Most recently: Adams, Salisbury and VanDerhei, *Matching Contributions for Pensions* 2012
[21] Amos Tversky and Daniel Kahneman ,The Quarterly Journal of Economics ,Vol. 106, No. 4 (Nov., 1991), pp. 1039-1061

Incentives and employers

"Employers are likely to provide minimum contract based DC to meet auto-enrolment requirements, so employer contribution lower. Members won't trust Government not to levy tax in future."

NAPF member survey respondent in response to TEE

Employers matter to pensions. And the incentives and disincentives which reformed tax systems give to employers are at least as important as those they give to employees. As the analysis above shows major structural changes such as TEE or a single rate of relief will cause many employers to disengage from pension provision and reduce contributions towards, or even to, the statutory minimum. The adjacent quotes are just one of several provided by survey respondents that indicate scope for contribution rates to fall. We found very little support among NAPF membership for the idea that any changes would result in higher contributions either by employers or employees.

"Will increase the cost to the employee of contributing to a pension. Is therefore likely to lead to many employees opting out of pension saving or reducing their contributions."

NAPF member survey respondent in response to TEE

Moreover, it is likely that employer disengagement will have a knock-on effect on employee contributions. The way in which schemes are designed and contribution options framed has been shown to have a crucial impact on employee contribution rates.[22] An employer who shifts their contribution structure from, say, an 8% employer contribution subject to an 8% employee contribution to, say, a 4% employer contribution subject to a 4% employee contribution is likely to see employee contributions very quickly settled at the new, lower 'norm'.

Building on automatic enrolment

Automatic enrolment works. It works because of inertia but also – and this is why almost all automatic enrolment communications reference the three sources of contribution – because

[22] Kusko, Poterba and Wilcox (1994) : *Employee Decisions with Respect to 401(k) Plans*. NBER Working Paper

it can be presented to people as a good deal. Building on this success seems to be the logical next step in encouraging employees to save more for their retirement.

The available evidence strongly suggests that this next step should have the role of employers at its heart. While beyond the scope of this consultation there are a number of ways in which this step might be taken including: mandating an increase in statutory minimum contributions beyond 8%; helping employers design scheme structures which normalise employee contributions above the statutory minimum; providing incentives to employers who contribute above the minimum themselves. These are issues for the broader review of retirement provision which the NAPF believes must very quickly follow this consultation. What is very clearly within the scope of this consultation though are the risks of structural change unpicking the engagement of the very employers who could be instrumental in driving higher contributions in future.

Conclusions and recommendations

The NAPF would agree that the current system of pension taxation in the UK is not ideal and with the focus of the consultation on helping people save more for their retirement. However, we do not believe this to be a challenge which can be met through reforming tax relief and call on the Government to quickly follow this consultation with an independent review of our pension and retirement savings system in the round.

Our analysis above leads us to conclude that none of the alternatives evaluated are attractive for savers, employers, pension schemes, the Exchequer or to the social benefits of pension savings. Figure 17 illustrates our summary of the impact of the three alternatives evaluated. None appear to meet the objectives of improving retirement savings, simplifying the system for members, employers and pension schemes or of meeting the social objectives of retirement savings outlined at the start of this response. Because all three options have the potential to damage retirement savings and some to reduce the tax take from pensions overall, we do not believe that they serve the current or future Exchequers well.

Figure 17: NAPF summary of the options evaluated

	Basic rate tax payer	Higher rate tax payer	Employers	Exchequer	Social objective
TEE + rebate					
Single rate					
Current system amended					

Poor outcome
Neutral outcome
Improved outcome

In conclusion, the NAPF does not support change to the current system either by a move to TEE or a single rate. Furthermore, separating DB from DC, while initially appealing, is impractical and will introduce more complexity over time. No change to the system is the most appropriate solution if we want to continue to: support automatic enrolment; sustain employer engagement in pensions; allow low earners to benefit from cross-subsidies from higher earners in schemes; deliver private incomes in later life; and protect future governments against increased dependency on the state.

We urge the Government quickly to follow this consultation with a thorough, independent review of pensions and retirement policy in the round so that we can seek sustainable solutions which continue the alignment of Government (both current and future), savers, employers, industry and broader society which has driven the success of automatic enrolment so far.

Appendix One – Consultation questions

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

   The consultation paper is built on the presumption that the current system is complex but provides little evidence in support of this view. The Government's own 'We're all in' campaign and many NAPF members believe that for most savers the current system is not complex and that moreover, tax plays only one part in a complex incentives model. The counter argument also needs to be considered: would a simpler model incentive savings more? Without specific recommendations on what that model would look like, it is very hard to draw any conclusions. However, the NAPF's analysis would suggest that among those alternatives that appear to be up for consideration, there is at best insufficient certainty that further savings would be incentivised and at worst that any new system could undermine pension saving.

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?**

   There are two aspects to our answer to this question.

   Firstly, it is not evident to the NAPF that any of the alternatives considered would lead to a simpler system of pension taxation, at least not for many years to come. Indeed, they would create even more complexity.

   Secondly, we have found no evidence that a simpler system would lead to more pension saving. What does appear to lead to more pension saving, although we are only part way through the experiment, is engagement and contributions by the employer. There is evidence that simple products do not necessarily translate into greater consumer engagement: cash saving is simple and yet many people don't have any rainy day savings; ISAs are simple and yet many do not save in this way, particularly beyond cash ISAs. Data from the Wealth & Assets survey (wave 3)[23] shows that 42% of households do not have an ordinary savings account (up by 10 percentage points from the previous wave) 55% do not hold a cash ISA and 87% do not hold share ISAs. Previous waves of the survey have shown that ownership rises steeply by age with most share ISAs owned by the over 45s.

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[23] ONS, Chapter 5: Financial Wealth, Wealth in Great Britain 2010-12, Wealth & Assets survey

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?**

   Again, we find no evidence of this. Furthermore, automatic enrolment is predicated on tri-partite responsibility between individual, employer and state.

   The targeting of retirement savings in DC is a complex matter, bringing together as it does behavioural aspects such as whether to target a fund or an income (something that the FCA has investigated as part of its Retirement Income Market Study), the issue of small pots and pot consolidation and the much wider issues of financial capability, guidance and advice, and scheme communications.

4. **Would an alternative system allow individuals to plan better for how they use their savings in retirement?**
   We find no reason why changing the tax system should allow individuals to plan better. Many will still be saving in a DC system, which is inherently uncertain in its outcome which for most which makes planning difficult. Pension freedoms add to the complexity of outcomes for many. Other Government initiatives like default funds, transfers, pension passports and the pension dashboard, guidance and advice would seem more likely to make a difference in helping people plan than changes to the tax system.

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

   While at first glance this appears an attractive option, the NAPF has concluded that the process of separating out DB and DC would itself give rise to new complexities.

   Removing the annual allowance for DB schemes and the annual allowance for DC sounds appealing. However, doing so could very well lead to further significant reductions in both allowances and a host of anti-avoidance measures designed to limit abuse or arbitrage of the new systems.

   Moreover, any change would very likely be introduced alongside significant reductions to the current levels of savings permitted in either type of pension, a move which the NAPF believes would lead to less rather than more pension saving and would ultimately undermine the pension system and retirement incomes in the future.

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?**

   As set out in detail above, any changes to pension tax lead to changes being required to administration systems, all of which come at a cost. Fundamental changes to pension taxation such as those evaluated above would also lead to considerable payroll changes

for employers as well as on-going additional costs for administration systems and new and more complex communication with members of pension schemes. The knock on effects of change on member charges could also be significant, even with a charge cap.

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

   In developing our response we have concluded that it will be necessary to tax employer and employee contributions in the same way. In the TEE version (for example), it is assumed that both employer and employee contributions are paid out of taxed income – in other words, the employer contribution is taxed as income in the hands of the employee with the tax being paid to HMRC and the net contribution paid to the pension scheme.

   Not to do this would, we believe, create an even more complex system where employee contributions are taxed differently to employer contributions. In addition to any administrative complexity, such a system would also potentially create unfairness between savers with different blends of employer and employee contribution or drive some savers to renegotiate contracts to seek the most tax-favoured contribution mix (or to use salary sacrifice methods to achieve the same aim).

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

   It probably can't but establishing a system that has broad political consensus would certainly help, as might setting clear targets on how much relief (for example, as % GDP) is sustainable. We urge the Government quickly to follow this consultation with a thorough, independent review of pensions and retirement policy in the round so that we can seek sustainable solutions which continue the alignment of Government (both current and future), savers, employers, industry and broader society which has driven the success of automatic enrolment so far.