Strengthening the Incentive to Save: a Consultation on Pension Tax Relief

Response to HM Treasury Consultation

October 2015

Document Version: 1.0 (October 2015).

Introduction and Executive Summary

Buck Consultants at Xerox is pleased to have this opportunity to respond to the HM Treasury consultation on pension tax relief. We continue to be supportive of the government's efforts to create an environment where individuals are encouraged to take responsibility for their pension saving so that they are able to meet their aspirations in retirement. We do believe the government has an important role to play in both educating the public and creating a pension tax system which encourages people to save for their retirement. There is still undoubtedly a need for workplace pension provision, if the UK is not to see a generation of pensioners faced with unenviable choice of living in extreme poverty or not retiring. We strongly agree that this should if possible be achieved through a simple and understandable tax system which removes unnecessary regulation and other barriers and are pleased the government is continuing to focus its attention on this.

It should be borne in mind that no tax system can ever be perfect and so it would be wrong to strive for unattainable perfection and to end up with an unduly burdensome regime or one that favours defined benefit provision over defined contribution arrangements in the private sector.

We are on balance in favour of maintaining the current system of tax relief but believe the pensions industry should partner with the Government to better communicate the benefits of the system to those saving into pensions.

We are of the view that:

- Pension scheme members do not generally understand the current system of tax relief, but that does not mean the system is flawed or that changing the system on its own would improve understanding.

- There is a higher understanding of how the pension tax system works amongst the better paid. Many of the lower paid are getting the benefit of the current system of tax relief, through automatic enrolment, even if they don't understand how it works.

- Changing to a Taxed-Exempt-Exempt model for all retirement savings is unworkable, in part because of difficulties it would create in the DB world. It would also involve running two systems in tandem significantly increasing costs at a time the government is trying to reduce them, and adding another layer of complexity. We are also uneasy about accelerating taxation in this way because of its impact on future generations. Perhaps more importantly it would have to be based on a belief that future governments, decades into the future, would not change the model, something this Government cannot control.

- Any change in tax relief should be accompanied by an abolition of the lifetime allowance.

- Whilst imposing a flat rate of relief of say 30% is superficially attractive it would have significant problems in the DB world. It would also add complexity and increase costs as employers and schemes sought to implement it. It also runs the risk of taxing some individuals (40% taxpayers who are 40% taxpayers in retirement) twice and therefore acting as a disincentive for those individuals to save into pension schemes.

We are concerned that:

- Moving to Taxed-Exempt-Exempt system would abolish the tax free lump sum on retirement. Many individuals plan their finances around receiving this sum at retirement and using it to clear their debts, including their mortgage.

- There is still generally a low level of understanding and appreciation of exactly how the pension tax system works. The tax system is complicated and the majority of people still don't understand how pensions are taxed. Accordingly whilst tax exemptions play an important role in ensuring that where money is put aside for retirement it provides an adequate pension, we believe for the majority of people the argument that tax incentives encourages extra pension contributions is overstated. When the government introduced its pension flexibilities in April 2015 it recognised the need to educate and inform the public through Pensions Wise. We would encourage any government/pensions industry initiative to improve the communication about and understanding of the taxation of pensions.

Buck response to specific questions

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

Whilst the incentive to save for retirement is undoubtedly a factor in encouraging some individuals to save, the low level of general understanding of how the current system works means that, for the majority of people, the argument that tax incentives encourages extra pension contributions is overstated. Greater education would in all probability lead to greater saving. The need to encourage greater saving has to a large degree already been recognised by the successful introduction of automatic enrolment which has reversed the year on year decline in the percentage of employees with workplace pensions since 1997.

Moving however from a system where tax relief is given on pension contributions at an individual's marginal rate to a system where the tax relief is say a fixed 30% would add a further layer of complexity rather than making the system simpler. It would of course raise more tax if that is the government's main aim.

The current tax system is complex and could be further simplified, however we do not believe this is the real underlying issue. The failure over the years to effectively engage with the general public, and properly communicate how the pension tax system works, appears to us to be the bigger issue.

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 pensions?

A simpler tax system on pensions would be a good thing. If you could achieve a simpler system then whether or not it would strengthen individuals desire to save for a pension would depend on the system. If it was easy to understand and not generous it could easily have the opposite effect. For example if you lower tax relief to say 30% on pension contributions and continue to tax at say 40% on the way out for higher earners, then the better off may opt-out of pensions altogether, completely undermining both pension provision and automatic enrolment. So such a system would add complexity and may not be effective.

We are concerned that any system which taxes individuals on pension contributions up front would see the demise of the tax free pension commencement tax sum at retirement. Experience suggests that individuals often need a greater income in the early years of their retirement, to pay up their mortgage, to settle other debts or go on expensive trips while they are physically able to do so. While individuals struggle with the complexity of the tax system generally we believe there is a strong understanding surrounding the pension commencement lump sum and many individuals have planned their finances in retirement around receipt of it. While the freedom and choice reforms would mitigate the loss of the tax free pension commencement sum to some extend in DC arrangements (but not DB arrangements), it would even in the DC world have a marked impact on retirement planning.

If simplification is the main aim for the government then abolishing either the lifetime or annual allowances (but not both) would as we have already pointed out save cost, make the system simpler and still protect against abuse of the tax system.

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?

The general failure of individuals to take greater responsibility for saving an adequate amount for retirement was a driver for the introduction of automatic enrolment, which to date is generally regarded as a success. Inevitably both employer and employee contributions will have to be increased over time if automatic enrolment is to provide adequate pensions in retirement. The Treasury is looking to make the cost of tax relief on pensions more “sustainable”. It is difficult to see how an alternative system with a lower level of tax relief would make a significant positive difference to the amount people are generally saving for retirement.

Automatic enrolment is a much more powerful incentive for pension provision than tax relief. People generally understand the concept of them putting £1 in means another £1 will come from the employer and tax relief, albeit on a limited amount of their income.

ISAs are easier to understand than pensions and have proved popular. We would support as an alternative to the current system the creation of a pensions ISA. They are a good idea, easy to understand, appropriate, hugely accessible and, because they would be set up with taxed income, are less likely to be tinkered with by future Chancellors. They would however have to be set up with some form of incentive for individuals and companies to use them, otherwise the majority of individuals will stick with existing ISAs, as most of the population do not maximise their ISAs, and there would also need to be some benefit over and above the incentives on existing ISAs to persuade someone to lock their money away until age 55. For members and employers, the real test of any pensions ISA take-up may turn out to be the size of the incentives on offer unless legislation is put in place to make ISA pension contributions compulsory. Unless the incentives are generous (which of course the Treasury might be trying to avoid if it is aiming to save money) paradoxically the only people interested in the pension ISA might be those who have already used their ordinary ISA’s allowance,-in all probability higher rate taxpayers.

We do not however see pension style ISAs replacing the existing system but supplementing it. Before embarking on such a route the Treasury would need to model different incentive regimes carefully, and assess the likely impact on both cost and contribution levels. That said we support innovation which expands the number of products available to individuals to save for their later years. This benefits both individuals who will by saving have a greater quality of life in their later years, and for the government which should see a reduction in the future welfare bill.

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

There will be some people who will think that paying tax on contributions now and having pension benefits paid tax free would aid their retirement planning as they would not have to factor in tax. Indeed if the current Chancellor can guarantee that no future Chancellor will tax pensions where contributions have been taxed on the way in, part of our concerns would be removed. The problem is that come the next financial crisis, perhaps at a time when the percentage of pensioners to workers has increased, the then Chancellor may feel it unfair for those in work to shoulder the entire burden. The European Commission's drive to harmonise pensions across member states has made it clear it supports deferred taxation as inter alia "it will help member states 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." A tax raid on pensions now will create a bigger problem down the line for future governments.

Accordingly it will always be an uphill task, in the absence of up front tax relief, to persuade individuals to put money away until they are at least 55, when they are other ways of saving, such as ISAs, that enable more flexible access to funds.

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

Of the £34bn a year of tax which the government forgoes in pension tax relief some £25bn (or 72%) of the whole amount spent on tax relief goes to defined benefit pension scheme members. The majority of open defined benefit schemes are public sector arrangements, where the employer contributes between 15% and 20% of pay, and that contribution is of course funded by taxpayers. If the Treasury were to treat defined contribution differently to defined benefit then private sector taxpayers will be funding pension costs and tax relief for public sector workers whilst receiving a lower level of support for their own pension savings.

Some £9.5bn a year is allowed in tax relief for defined contribution pension schemes of which £7.3bn is up front tax relief and £2.2bn is the gross roll-up in defined contribution savings.

If the cost of tax relief is to be reduced then it makes no sense to treat defined benefit arrangements differently as they account for 72% of the amount of tax relief given. It could also be seen as favouring public sector workers against those in the private sector.

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

Any change to the pension system will result in increased work for administrators, pension providers and employers changing booklets and Rules and preparing member communications including changing standard letters and process maps, creating new IT platforms and adjusting/amending records of every active pension scheme member. The more radical the change, the more work involved. Taxing pension contributions would effectively mean all members of existing schemes would have to have a second record established for them going forward, with old and new benefits separated and ring fenced and tax being payable in due course on the first set of benefits and not the second. Administration would be far more complicated and communications more difficult for members to understand. Members in many schemes who already have deferred defined benefits and current defined contribution pension saving would find their defined contribution pension saving divided into two. Insurance companies and providers would have to keep old and new funds segregated for the next fifty years, no doubt at an increased cost. There would also have to be processes for dealing with old and new benefits on statutory transfers or when pension sharing orders are issued. It would further be necessary to look at how scheme pays operates against the first or second set of benefits. Every pension scheme would end up with a large unavoidable bill from their consultants.

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

If pension contributions are to be taxed, and no tax levied on payment of the pension, then inevitably employer contributions as well as employee contributions would have to be taxed up front. Otherwise schemes will simply become non-contributory to get round the tax issue. Likewise if a limit is placed on tax relief on contributions, e.g. 30%, higher rate tax payers would have to be taxed up front on the difference between the rate of tax relief and their marginal rate in respect of employer contributions made on their behalf, as well as their own contributions.

There is no easy or simple way of taxing employer contributions to DB schemes up front. Unless employers are suddenly to get the extra tax bill, presumably their contributions would have to be taxed on the employee as a benefit in kind. In either case this would add significant complexity to payroll systems.

A significant proportion of pension’s tax relief is given on employer contributions which are made to reduce a deficit in a scheme. A further amount of tax relief goes to employers in respect of national insurance contributions, which are not taxed. Neither up front taxation or a limit on tax relief would address these issues

If you cannot solve the problems in a DB environment then we do not believe you can have one system for DB pension schemes and another for DC arrangements.

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

No government can stop the next one making wholescale changes, or deciding what this government views as sustainable is not in its view sustainable. Neither can today’s government predict the next economic crisis, or the actions that future governments will have to take, for example to deal with an aging population.

This government has made repeated steps to contain the cost of pensions by reductions in the lifetime and annual allowances, the tapering of the annual allowance for high earners and increases in the state pension age. There comes a point at which further cost reduction could deal a fatal blow to pension saving and undermine the success of automatic enrolment.

About Xerox

Within Xerox, Buck is the consulting strength of the Human Resource Services (HRS) division. Buck offers advisory, technology, and administration solutions to help you effectively manage your programmes while engaging your employees in their health, wealth, and career. By integrating our HR consulting know-how with HRS' core services, we can offer additional innovative and customised solutions to help you overcome your HR challenges. Together, we can ensure you have the right people in the right positions at the right time to save money and achieve your business goals. Learn more at www.xerox.co.uk/hrconsulting.

Xerox is helping change the way the world works. By applying our expertise in imaging, business process, analytics, automation and user-centric insights, we engineer the flow of work to provide greater productivity, efficiency and personalisation. We conduct business in 180 countries, and our more than 130,000 employees create meaningful innovations and provide business process services, printing equipment, software and solutions that make a real difference for our clients – and their customers. Learn more at www.xerox.com.

For further information, please contact:

hrconsultinguk@xerox.com