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Pensions tax relief: time for a TEE-brake?

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- The current tax treatment of pension saving – known as EET – has many attractive features and we should be cautious of radically overhauling it without good reason.
- An alternative, ISA-like TEE (Tax-Exempt-Exempt) tax treatment would suffer from some drawbacks compared to EET (Exempt-Exempt-Tax).
- There are other areas of pension tax treatment that are better prospects for reform. The ability to take a 25% tax-free lump sum and the exemption of employer pension contributions from National Insurance contributions are genuinely large subsidies to pension saving compared to a pure EET benchmark. If the government is looking to reduce or redirect existing subsidies, it should start by looking at these.
- The recent Treasury consultation provided no indication which groups they feel it is important to ‘strengthen the incentive to save’. In the absence of this, it is difficult to know whether some of the policies suggested – such as a single flat-rate of income tax relief, which would strengthen incentives for some but weaken them for others – would have the desired effect.
- If the government is looking to redirect subsidies, it would help promote better policymaking if they were clear about which groups they think need to be encouraged to save more and design policies based on robust evidence of what works.

CII Introduction: Much of the pensions debate over the past year has centred around the introduction of pensions freedoms and its aftermath. However, the new government's Green Paper on pensions taxation has the potential to be equally seismic in its consequences. As this Thinkpiece makes clear, some of the options being debated could radically shape the way the pensions – or more accurately the long term savings market – develops. This is because the debate goes to the heart of the tax incentives that are at the heart of how the public have been encouraged to save for retirement. What should be the level of incentives and when should they be applied, and for whom? Is this debate solely about the best public policy outcomes or is it in danger of being engulfed by deficit reduction requirements? This Thinkpiece from respected thinktank the Institute for Fiscal Studies (IFS) provides a distinctive view on some of the big calls which may arise from this Green Paper – which may have major ramifications for the industry and the wider public in the years ahead.

The government has recently completed its consultation on potential major reforms to the tax treatment of pension saving in the UK. One proposal that has received much discussion (despite not being explicitly mentioned in the actual consultation document) is to move from the current system of taxing pension saving (so-called EET, Exempt-Exempt-Tax) to one akin to the tax treatment of Individual Savings Account (ISA) saving, which are known as TEE: Tax-Exempt-Exempt. The current tax treatment of pensions is not perfect but it does have a number of attractive features and a move to TEE taxation would throw these away. TEE taxation is not the best option – this *Thinkpiece* discusses why and suggests some better alternatives for reform.

The current diet of EET

Currently (up to certain annual and lifetime limits) individuals can save money into private pensions, with these contributions being made from untaxed income, returns on pension investments being free of personal tax, but with income tax paid on pension withdrawals. This EET tax treatment has at least three attractive features.

First, by collecting tax only once and at the end, it ensures individuals' decisions about whether to spend today or spend in the future are not distorted, while at the same time ensuring that the government captures some of the benefit of high returns on investments. In contrast, under the TEE tax treatment of ISAs (and owner-occupied housing), the government receives no additional tax revenues if someone receives very high returns on their investments.

Moving to TEE tax treatment would deliver a boost to tax revenues in the short term but reduce revenues in the longer term.

Second, EET tax treatment allows people to defer taking taxable income from periods in which they face a high marginal tax rate to future periods when their income is expected to be lower and they will face a lower marginal tax rate. This tax-rate smoothing is often portrayed as unfair but it can in fact be seen as fair because it helps to ensure that the taxes paid over an individual's lifetime are more closely related to their lifetime income, rather than falling more heavily on those who have income that is more volatile over their life.

Third, by levying income tax when pension income is withdrawn rather than when pension savings are made, the EET tax system helps to align better the timing of the fiscal costs of an older population with tax revenues received. In other words, while a larger aged population will be expected to impose a financial cost on the Exchequer by placing greater demands on health care, social care and state pension payments, there will also be some bonus to the Exchequer at the same time as more people draw money out of private pensions and pay income tax on that income.

A move from EET tax treatment to TEE would throw away these advantages. Furthermore, perhaps the biggest concern about a move from EET tax treatment to TEE tax treatment of pension saving is a political, rather than economic, one. At the moment tax revenues are deferred from the present to the future. Moving to TEE tax treatment would deliver a boost to tax revenues in the short term but reduce revenues in the longer term. This would strengthen the headline fiscal position in the short-term by around £30 billion a year but much of this would simply represent revenue being brought forward. There is a risk that the current or a future government would be tempted to spend more or cut taxes in response to this short-term windfall, at the expense of weakening the long-term public finances. It would be a disciplined Chancellor who could resist such temptation.

Alternative options for reform

But that does not mean there are not sensible avenues for reform. Currently the tax treatment of pension saving deviates from the EET ideal in two main ways. First, up to a quarter of pension saving (currently up to a maximum of £250,000) can be taken as a tax-free lump sum (that is, enjoying extremely generous EEE income tax treatment). Secondly, unlike most other forms of remuneration, employer contributions to workplace pensions are not subject to employer or employee National Insurance contributions. Again this makes the tax treatment of such contributions much more generous than a benchmark EET system. This subsidy is estimated to cost the Exchequer £14 billion a year in lower revenues.

These subsidies are likely to encourage greater saving in private pensions than would otherwise occur. The exemption of employer pension contributions from National Insurance contributions allows employers to offer their employees a given level of remuneration while incurring a significantly lower tax liability than if they were to offer the same package entirely as current salary. However, these subsidies may not be well targeted at, or well understood by, those who the government is most worried about undersaving for retirement. They could, therefore, be ripe for reform.

A move to TEE tax treatment could be accompanied by the removal of both the tax subsidies just mentioned but it is not an essential prerequisite. The tax-free lump sum could be reduced or removed and the government could start charging National Insurance on pensions in receipt. These changes could either be enacted immediately – that is, applying not only to new pension saving but also to existing accrued funds – or phased in over time so as only to apply to new contributions. A phased approach would be more complex and would mean that it took some time for much additional revenue to be raised but it might be seen as fairer to those who had made their pension savings in the expectation that the current tax treatment would endure.

A flat rate of tax relief?

Another proposal that was put forward in the Treasury's consultation – as a way of strengthening incentives for lower earners to save in a pension – is to offer a single, flat-rate of 'tax relief' on pension contributions, which is the same regardless of an individual's marginal income tax rate.

Perhaps now is not the time to make yet more radical changes unless there is strong evidence that the benefits will be substantial?

Proposals for a flat-rate of relief typically advocate increasing the 'relief' offered to basic rate income tax payers, while reducing it for higher and additional rate tax payers. The effect of such a reform would be to increase the incentive for lower (and non-) earners to save in a private pension, while reducing it for higher earners.

But the Treasury's consultation document was oddly short of details on which groups they perceive as being in need of stronger incentives to save. It is, therefore, hard to know whether such a reform would be effective in helping the Treasury's target group – even if there were good evidence on how behaviour responds to such changes in incentives. In fact, such evidence is rather scarce.

Analysis by the Department for Work and Pensions suggests that it is actually those on higher earnings who are most likely to be at risk of having a low replacement rate in retirement. For example, their analysis from 2014 suggests that 67% of those earning over £52,000 a year (and 62% of those earning between £32,500 and £52,000) are undersaving for retirement, compared to just 23% of those earning between £12,300 and £22,700. These figures are calculated assuming that individuals need to achieve a particular replacement rate of working life income, which is a higher cash figure (though a lower fraction of earnings) for higher earners.

If it is this 'undersaving' outcome that the Treasury are desirous to avoid, then cutting incentives for higher earners to save and increasing them for lower earners may be counterproductive. Knowing which groups the policies are intended to be targeted at and basing any further policy changes on good empirical evidence about the likely effect of such reforms would be a step forward.

In addition, if tax relief is offered at a flat-rate on contributions and this is set below the higher and additional rates of income tax, it might seem unfair (and act as a disincentive to save in a pension) if pension income were then subject to higher or additional rates of income tax. This problem could be avoided by aligning the maximum rate of income tax on pension income with the rate of tax relief offered upfront.

Further upheaval?

The thing that will perhaps be most important in encouraging individuals to lock their money away for retirement is a stable policy environment that gives them the confidence that, if they put money into a pension now, they will not regret it later.

I started working on pensions policy 11 years ago, at around the time that Tony Blair's government was legislating the so-called 'A Day' reforms. The consultation that preceded these reforms ambitiously aspired that 'these plans for reform are developed in partnership with those who will use the new rules so that they are simple, durable and readily understood'. Yet since then we have seen several other major new pension changes. And those who have been working in this field for longer than I will remember countless previous government Green and White Papers that claimed to be the final word on state or private pension reforms.

Over the last three years alone we have seen the introduction of two major reforms to pension saving in the UK: automatic enrolment and the ending of compulsory annuitisation. At the moment we have little idea what effect these policies (particularly the latter) will have. Perhaps now is not the time to make yet more radical changes unless there is strong evidence that the benefits will be substantial?

Even in theory TEE tax treatment of pension saving does not look to confer these sorts of substantial advantages but would be a significant upheaval of the pension saving landscape. If the government is looking to reduce or redirect public subsidies for pension saving, the most obvious candidates for reform – that is, the elements of the current tax treatment that represent genuinely large subsidies to pension saving compared to an ideal EET system – are the tax free lump sum and the exemption from National Insurance contributions for employer pension contributions. If the government is looking to redirect subsidies, it would help promote better policymaking if they were clear about which groups they think need to be encouraged to save more and design policies based on robust evidence of what works. It is difficult to discern either of these from the Treasury's recent consultation on pension tax reform.

If you have any questions or comments about this Thinkpiece, please contact us: thinkpiece@cii.co.uk **+44 (0)20 7417 4783.**

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