Hymans Robertson LLP
Fair, Sustainable Pension Taxation
Response to the Consultation on **Pension Tax Relief**

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Changing the pension tax regime to a 'Taxed, Exempt, Exempt' (or 'TEE') approach will fail to deliver the Government's policy objectives and will embed unsustainable pension costs for future generations. Our research shows that modifying the current EET regime by capping income tax relief on contributions would be simpler and cheaper to implement and lead to stable long-term costs that are fair across generations.

About Hymans Robertson LLP and our research

We are a leading independent pensions and risk consultancy and are experts in UK private sector and public sector pensions. Our response to this consultation provides economic, consumer and industry research evaluating the options for the future pension tax regime. Our research is guided by the following principles:

- The outcome must be fair, across generations and across income groups.
- The regime must be simple, so consumers understand and implementation costs are acceptable.
- Both tax costs and pension incomes must be sustainable, to avoid lower workplace pensions necessitating higher state benefits for the elderly.

Summary of our findings

Our research shows that consumer saving is not incentivised by the pension tax regime itself. But, change and complexity undermine consumers' willingness to save and employers' willingness to provide savings vehicles.

Whilst a TEE system would bring forward tax net receipts, it has many drawbacks, in particular:

- The complexity of either a two tier system for past and future or a transitional 'tax raid' on past pensions.
- Loss of consumer confidence and distrust of future governments making further changes.
- Unstable, rising long-term costs; which are ultimately higher than an equivalent EET regime.
- Significant complexity and cost to enable future TEE pension saving, for no perceivable long-term gain.

However, modifying the current EET system by introducing a cap on the rate of income tax relief would achieve the Government's policy objectives with less cost and complexity. A capped income tax relief regime would:

- Be simple to explain and be the smallest change for the greatest policy benefit.
- Enable the removal or simplification of the current complex system of annual and lifetime limits.
- Target pension tax relief at low and middle earners, who are currently under saving for retirement.
- Dovetail with existing EET savings, leading to lower cost and complexity of change.
- Avoid undermining the Government's pledge to not change public sector pensions for the next 25 years.
- Work equally well for public and private sectors and across defined benefits and defined contributions.
- Provide stable long-term costs as a percentage of GDP.
- Provide the Government with an additional fiscal control, by introducing a controllable cap on pension tax relief which can be changed independently of the marginal income tax bands.
- Retain the 'tax-free cash lump sum', which is disproportionately highly valued by consumers.

As an alternative, moving to flat rate income tax relief would positively redistribute income tax relief from higher earners to low and middle earners. However the case for flat rate relief is finely balanced. The higher transitional costs and complexity do not appear justified by the modest increase in incomes for low and middle earners that flat rate relief would generate.

Research and rationales **supporting our findings**

Evidence supporting the retention of an EET regime

Our position	Why
Moving away from EET will not improve the incentive to save	Our focus group research revealed that savers understand that they receive tax relief on pension savings and that they pay tax on pension income. We found no evidence to suggest changing this structure would incentivise savings. ♦ 48% feel a lack of control in savings due to the constant regulatory change. ♦ 37% are not interested in pension saving because policy could change again. ♦ 49% believe future governments will change the tax treatment of pensions. It is clear that change is a disincentive to save. We conclude that a fundamental change to the pension tax regime will not to boost consumer confidence in pensions. In particular, people would be nervous about future governments attacking the 'final E' of a 'TEE' regime at some point in the future. Additionally, two thirds of UK workers say that they would be more encouraged to save if there was a clearer long term Government plan for pensions. This would support decoupling pension policy from party politics and the creation of an independent body to oversee pension policy. Giving the Treasury control of the rate of tax relief on an EET regime would go some way to separating pensions policy from the management of public finances.
Keeping some element of 'tax-free cash' is important	Our focus group research also showed that savers place a disproportionately high value on the 25% 'tax-free lump sum' (now technically known as a Pensions Commencement Lump Sum). Two reasons supported this commonly held view: ♦ It allows individuals to access some cash at retirement, which is beneficial. ♦ The 25% tax free limit provides a 'handbrake' on spending, with a good level of residual income. The FCA's own research states less than half of 55-65 year olds expect their pension to last more than 10 years. Together, this evidence suggests that allowing access to all pension income, free of tax in retirement, would lead to pension savings being spent too early in retirement. A consequence of this would be incomes being too low in older age and higher reliance on state benefits for the elderly.
Employers favour retaining EET	We have surveyed 120 large employers on their views of an EET or TEE regime for future pension provision. An overwhelming 93% favour retaining an EET regime. The most common arguments supporting this view were the costs of change for a lack of perceived benefit of change.

Government pledge to not change public sector pensions for 25 years	Around a third of current pension saving is through defined benefit public sector pension arrangements. Whilst future defined benefit pension provision is possible under a TEE regime, it would require significant changes to the current structure of provision. We therefore find shifting away from an EET regime irreconcilable with the Government's pledge to not change public sector pensions for the next 25 years. Were the government to retain an EET regime for the public sector we would expect considerable criticism if a TEE regime were implemented for the private sector.

Evidence against a two-tier regime (EET for past, TEE for future)

Our position	Why
Cost of transition to a new system is huge	We estimate that the cost of transition from an EET to TEE system would be between £2.5bn and £3bn, for what appears to be no clear benefit. Transition costs would initially be borne by pension providers, but then passed on to employers as they implement change and upgrade systems. This would come at a time when auto enrolment is gaining traction (although we are seeing smaller firms struggle with its implementation). This partially explains why 93% of large employers have told us they would not support a move away from an EET system.
Lack of employer support will reduce incomes in retirement	Employers paying contributions which match employee contributions in some way is an important driver in encouraging pension saving and improving outcomes. Without employer support, it can be contended that employer contributions would fall, with a consequent reduction to pension incomes in retirement. This runs contrary to the early success of auto-enrolment.
Implementing TEE must lead to one of two criticisms	Transition to a TEE regime would lead to 3 generations of workers having to navigate both the old (EET) and new (TEE) regimes. It's hard to see how this will help to engage consumers in pension saving. An alternative way to move to a new single TEE system would be through a transitionary tax charge on existing pension savings. This is likely to be perceived as a "raid" on pension savings pots. Whilst this could yield significant immediate tax income, it would do so with significant loss of consumer confidence in pensions.

Evidence supporting the retention of current levels of spending

Our position	Why
Projected levels of pension income are inadequate	Our Guided Outcomes research of over 600,000 private sector employees shows that less than 1/3rd of earners in the 20% and 40% tax bands are likely to provide acceptable levels of pension incomes through the defined contribution schemes they participate in. However, a higher proportion of lower and higher earners are more likely to achieve acceptable levels of pension income. Given this backdrop, there appears little scope to reduce the level of pension savings. As shortfalls in pension income put pressure on future Governments to provide higher state benefits for the elderly, any policy changes which reduce pension incomes are unlikely to reduce overall Government spending.
Moving to TEE increases cost in long term	Our macro-economic modelling shows that a TEE regime leads to an unstable cost of pensions tax relief as a percentage of GDP. Furthermore, the eventual level of tax cost is higher under a TEE regime than an EET regime which provides an equivalent level of pension income. Since any form of pension tax regime can be adjusted to target a desired level of Government spending, we see little to commend a TEE regime over an EET regime.
Equivalent levels of pension income can be provided under any regime	Our macro-economic modelling suggests that the following regimes would provide equivalent levels of pension income in retirement: ♦ The current EET regime with full marginal rate income tax relief ♦ A TEE regime with a Government top-up of 40% of net contributions. ♦ An EET regime with income tax relief on contributions capped at 35%. ♦ An EET regime with flat rate income tax relief on contributions of 30%.
Reducing spend will drive poorer outcomes	Total Government spending on pensions is 12% of GDP. On an international comparison of government spending, this places the UK as 'mid-table'; spending less than a number of European countries, but spending more than some other developed countries. A significant proportion of this spending is the tax relief on non-state pension savings. This tax relief in-turn makes up a significant proportion of the eventual pension incomes which are generated. Given the UK's standing as a developed economy and linked with the points that: ♦ pension saving is providing inadequate incomes in retirement for many; and ♦ lower private pensions would to need to be topped-up with state benefits; there seems little scope to reduce the overall level of spending on pensions.

Evidence supporting the a separate fiscal tool for pension tax relief setting

Our position	Why
Tax relief was introduced to prevent double taxation, not incentivise saving	It's important we remember why tax relief was brought in. Our focus group research shows that the choice of pension tax regime does not incentivise saving. We therefore encourage the Government to focus on policy objectives of fairness and adequacy of pension incomes.
The current system doesn't distribute relief to those most in need	The secondary issue is then the fairness of the distribution of tax relief. The Government's own figures shows that the around 2/3rds of income tax relief absorbed by higher earners is too high. Introducing steps which redirect tax relief to middle and low earners would redress this. Making income tax relief capped rate or flat rate would help achieve this.
Setting rates of relief is more effective way to control spending	We currently have a complex system of relief and allowances. Our research shows this acts as a disincentive to save, which is exacerbated by perpetual Government tinkering. Having a single, clear, lasting mechanism for constraining pension tax relief would remove much of this confusion and mistrust. The Government may wish to retain an annual cap on pension saving to prevent gross abuse of the system, however we would encourage a bold clear system without such complications.
Fixed v capped is a complex discussion	Capping income tax relief would be the easiest policy change to implement of those we have considered. Much of the required infrastructure is already in place and the concept is one that can be easily communicated. Fixed rate pension tax relief would more actively redistribute pension tax relief away from higher earners to low and middle earners, but we are unconvinced that the benefit outweighs the practical challenges. Although the message can be simpler, there will be particular difficulties implementing systems for high and low earners. For example, how will the Government be sure that any top-up to low earners implemented through income taxation will be allocated to pension savings, rather than simply boosting current income?

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Appendix 1:
consumer research

In September 2015 we conducted two streams of consumer research. The first was qualitative: we held a series of focus groups in London and Glasgow. The second was an online survey of over 2000 people, which further tested the findings of the focus group sessions with a broader audience.

Finding	Supporting evidence
People feel a lack of control over pensions	This contributes to 'rational ignorance' – in other words savers feel it's pointless to try and understand the system due to Government changes. This helps to shine a light on why financial education efforts largely fail. People resist education as they feel there is no point as the system will change and their efforts will be wasted. Statistics to support this include: Only 23% feel in control of their pension ♦ When asked why people don't feel in control, 64% said they don't know what income they'll get when they retire and 48% said it's because the system changes too much. ♦ Over half (53%) lack confidence that the government won't change the tax treatment of pensions before you retire and 37% feel there is no point in learning about pensions as the rules change all the time. ♦ When asked what would make them feel more in control, 39% said a long-term plan for pensions from the government, 39% said fewer changes to pensions by the Government and 34% said clearer communications from Government in relation to their pension.
Taxing payments into pensions will act as a disincentive for saving	People saw the removal of tax relief on contributions as a disincentive to saving. This was for two main reasons. First, they were worried about paying more tax as they could be in a higher tax bracket when earning than retired. Second, they were worried that this would result in a drop in take home pay if they wanted to keep contributing the same amount to their pension. When we asked what acted as incentive to save through the online survey, 68% said tax efficiency.
The status quo is the favoured option	On balance they'd prefer status quo as changes to the system make them feel vulnerable and add to a sense of a lack of control. People also value and are very enthusiastic about the tax free cash lump sum – a tangible benefit they don't want taken away. They value the ability to take some cash at retirement, but they also value the fact that it's not all 'tax free' as it acts as a brake on spending.

What would act as an incentive to save	More stability in the pensions system would incentivise savings: ♦ 68% said fewer changes to pensions system would encourage them to save more ♦ 66% said having a long-term plan for the pensions system from Government would act as an incentive to save Greater clarity around how much money they will have in retirement would also encourage more saving: ♦ 68% said having greater clarity about the impact contributions have on pension pot would be an incentive to save more ♦ 72% said having complete picture of what all pensions plus state pension will provide in retirement ♦ 56% reliable source of information that explained choices with simple, relevant examples ♦ 64% said having access to online tools would also incentivise savings The majority are supportive of building on the success of auto-enrolment with automatic escalation to contributions as a way to save more: ♦ 59% said small automatic increases to pension contributions would encourage people to save more

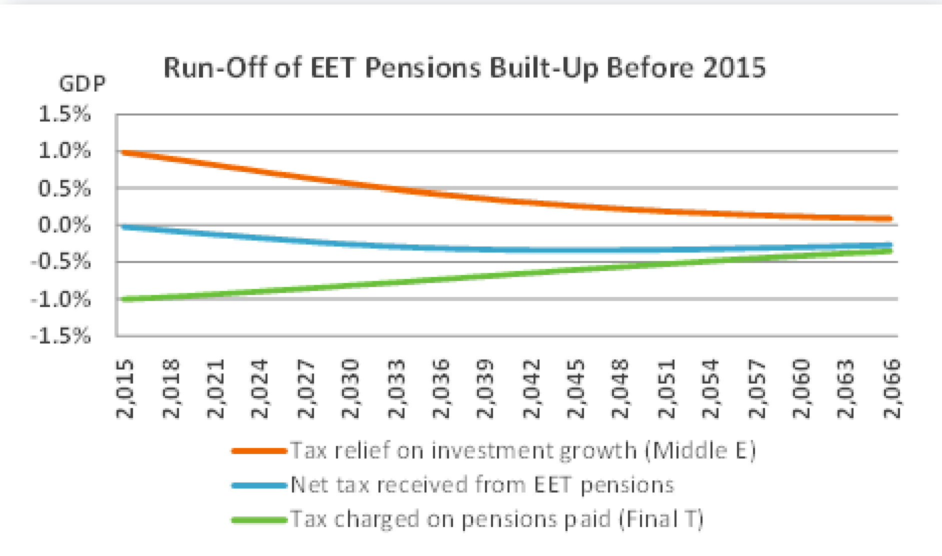
Appendix 2:
summary of macro-economic modelling

The charts below summarise our macro-economic modelling of the net costs and incomes provided under different pension tax regimes, over the next 50 years. We have used data sourced from the Office for National Statistics for population projections and saving and wealth rates, and workplace pension data from the Pension Protection Fund and the Pensions Regulator.

Our model uses a number of assumptions about the future which may not be borne out in practice. The central economic assumptions we have used are:

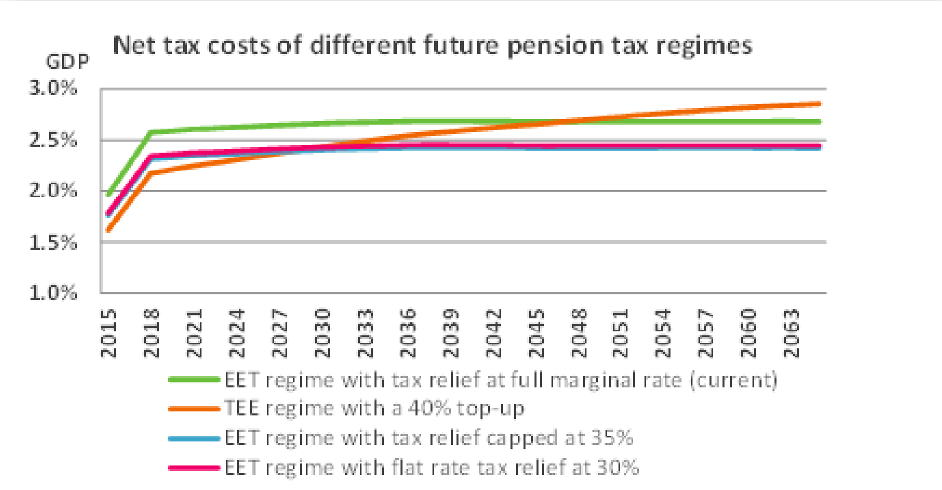
- Real earnings growth of 0.5%pa
- Real GDP growth of 1.0%pa
- Pension assets are assumed to return 2.0%pa above inflation before retirement
- Automatic Enrolment is assumed to be fully embedded with 90% of workforce in a pension scheme in 2018

Chart One:



Over £ 2½ trillion is built-up in the current EET regime (including public sector defined benefit (funded and unfunded), private sector defined benefit and private sector defined contributions). As pensions come into payment the store of assets is realised and income tax is paid, creating a net economic gain of up to 0.3% of GDP. Stopping the EET regime would realises this economic gain for the benefit of the current working generation; penalising subsequent generations. Continuing an EET regime would maintain a steady state (with tax on pensions paid offsetting tax relief on contributions and investment growth); providing greater intergenerational continuity.

Chart Two:



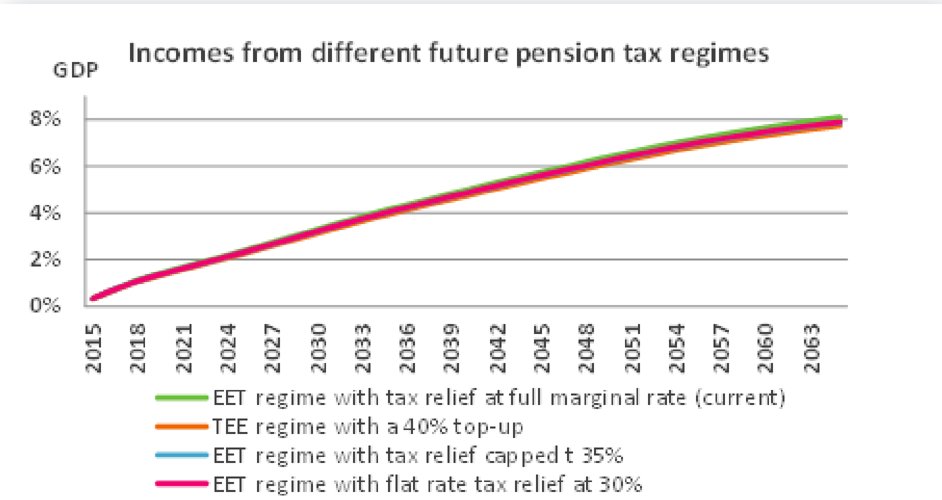
Auto-enrolment increases the cost of pension saving by 0.5% of GDP over the next three years under all regimes.

Retaining the current EET regime for future pension savings has stable costs of c2.6% of GDP. This is before offsetting the tax gain from EET pensions already built-up.

Modifying the current EET regime to either a capped rate or flat rate of income tax relief could reduce overall costs. The examples shown target costs under 2.5% of GDP, through 30% flat rate tax relief or a 35% cap on tax relief. Using flat rate relief would be more effective in redistributing tax incentives to middle and low earners.

A TEE regime does not produce stable costs as a percentage of GDP. Whilst the initial costs under TEE are lower initially (as tax is received sooner under TEE than under EET), future costs would be higher than a modified EET regime by 2030 and higher than the current EET regime by 2045. This has little intergenerational fairness, with benefits for current workers and pensioners at the cost of future generations.

Chart Three:



The four different regimes provide very similar levels of net pension income for the overall population (we intentionally set the levels of tax relief and top-ups to achieve this).

The UK population is not saving adequately for retirement. If changes to the pension's tax regime led to lower pension incomes, any shortfall would need to be funded by higher state benefits for the elderly. This would negate any perceived savings on pension tax relief and replace them with higher state costs for future generations on a pay-as-you-go basis.

Although overall pension incomes are the same, the capped and flat rate EET regimes provide higher incomes for lower and middle earners; at the expense of lower pension incomes for higher earners. This would partially alleviate the need for state benefits for future generations.

Appendix 3:
macro-economic modelling

The charts below show the levels of cost and pension incomes as a percentage of GDP of:

- An EET regime, with the level of pension tax relief capped at different levels; and
- A TEE regime, with different levels of Government top-up to employees' net pension contributions.

The same data, methodology and assumptions have been used as described in Appendix 2.

Chart Four:

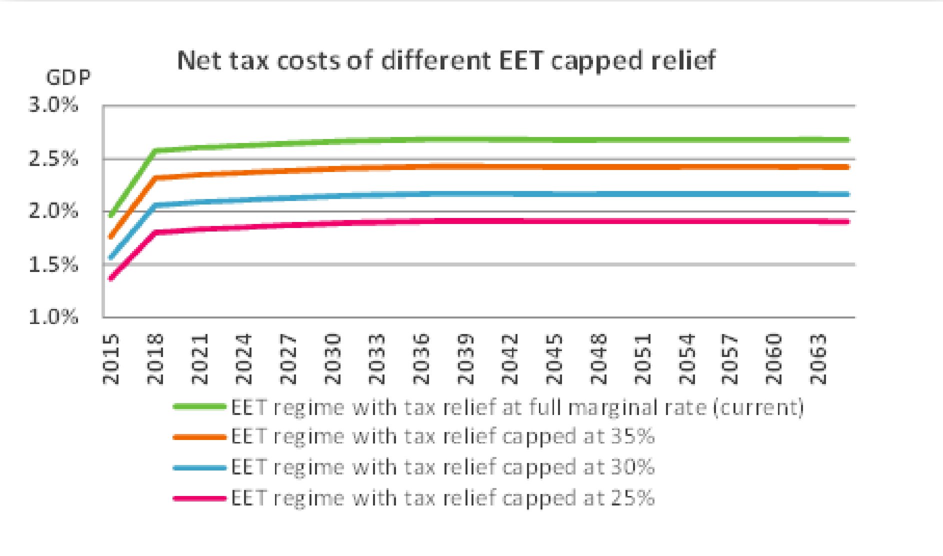


Chart Five:

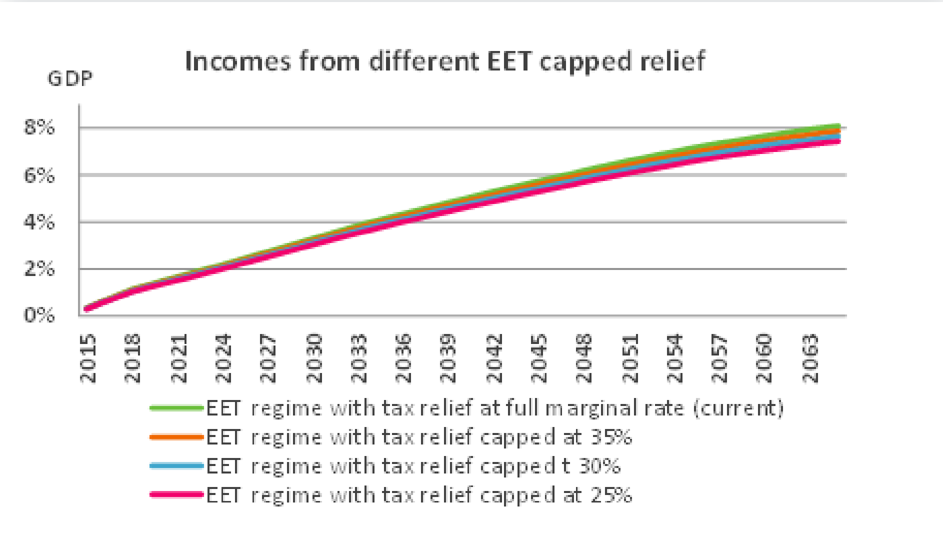


Chart Six:

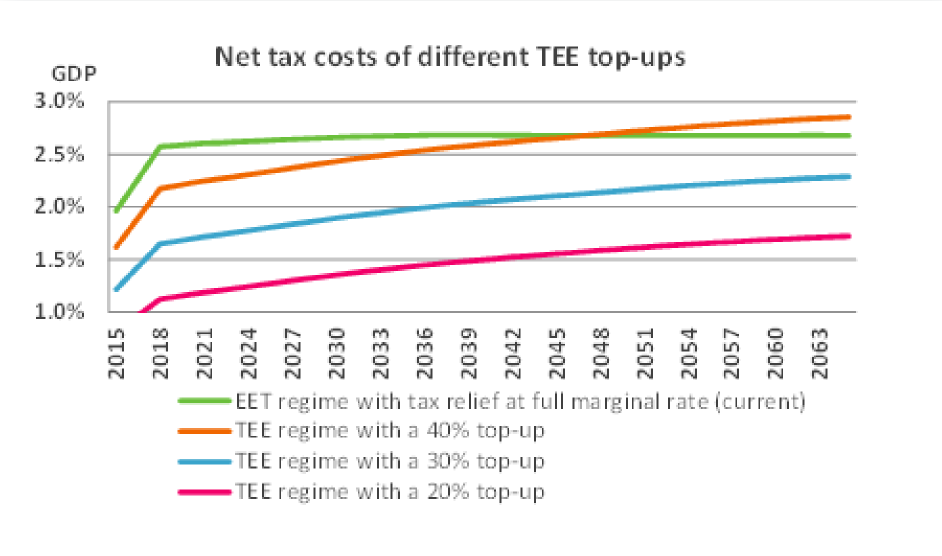
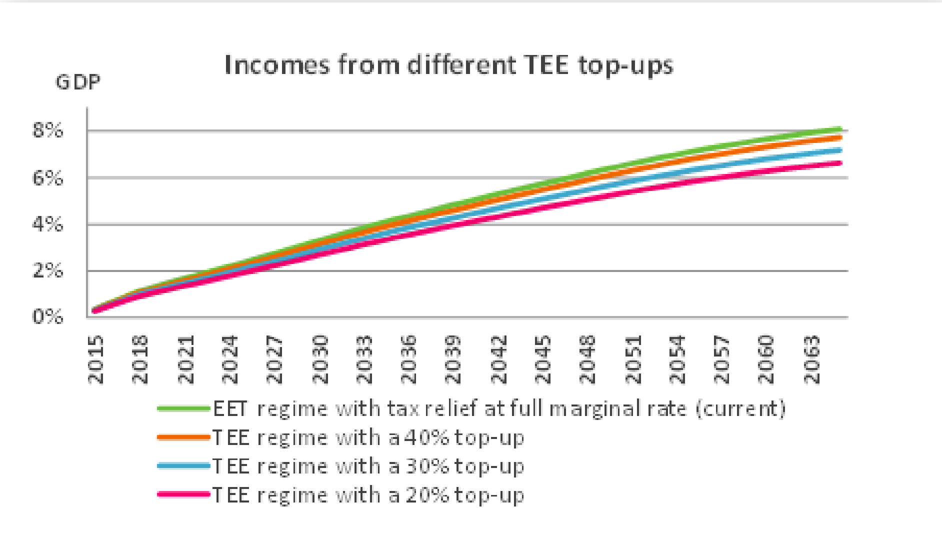


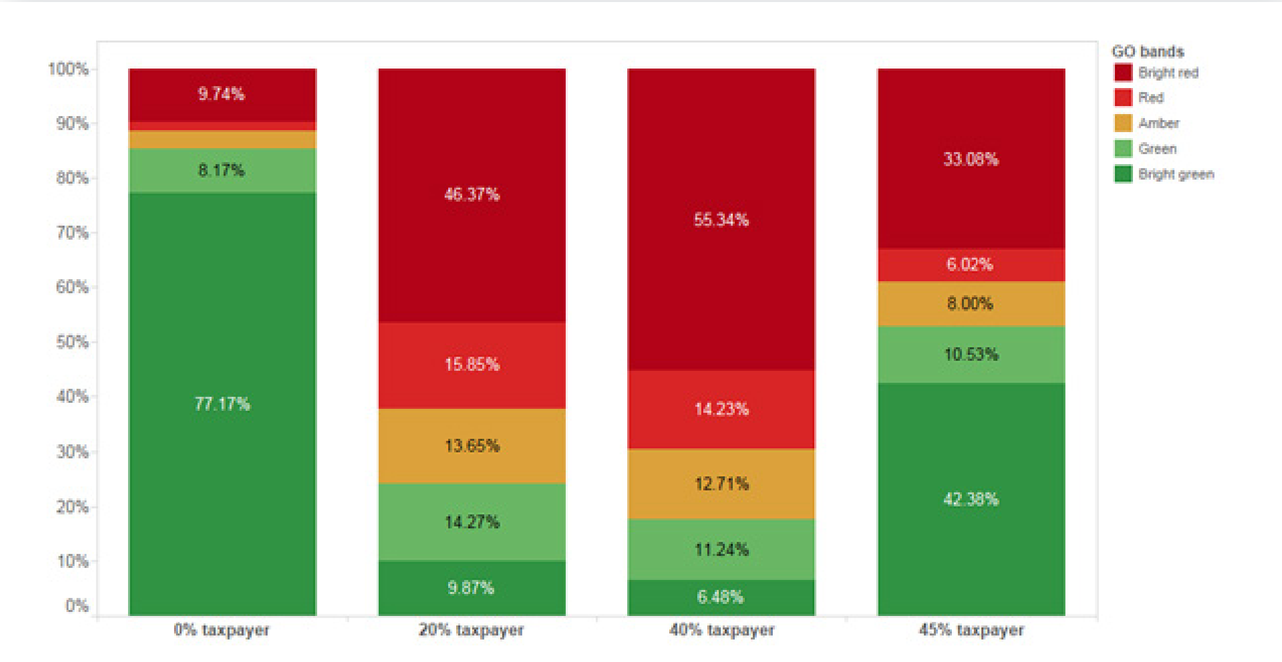
Chart Seven:



Appendix 4: distribution of DC savings outcomes

This analysis shows that low and high earners have a much better chance of achieving an acceptable level of pension income in retirement. However, middle earners in the 20% and 40% tax bands are unlikely to achieve their target pension incomes through current private sector defined contribution pension provision alone.

Chart Eight:



This analysis shows the projected pension outcomes from over 600,000 private sector employees we have analysed using our Guided Outcomes approach. This tests the likelihood of an employee's pension income from their defined contribution scheme achieving the target replacement ratios set by the Pensions Commission. Bright green shows a very high likelihood of achieving this target and bright red shows a very low likelihood.

The data set is divided into employee incomes by tax band, based on pensionable pay. This will lead to some distortions compared to total income, however we consider the overall pattern of results would be similar. The analysis includes allowing for state pensions by excludes previous pension savings which employees have (which may be significant for some employees).

Appendix 5: **international comparison of spending on pensions**

Pensions in total (from Eurostat):

"The 'Pensions' aggregate comprises part of periodic cash benefits under the disability, old-age, survivors and unemployment functions. It is defined as the sum of the following social benefits: disability pension, early-retirement due to reduced capacity to work, old-age pension, anticipated old-age pension, partial pension, survivors' pension, early-retirement benefit for labour market reasons."

Chart Nine: