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Response to HM Treasury's Consultation Document Cm 9102

STRENGTHENING THE INCENTIVE TO SAVE: A CONSULTATION ON PENSIONS TAX RELIEF

By Dr Hugh Pemberton and Professor Roger Middleton,
Department of History, University of Bristol.

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Summary

1. History suggests that the present proposal to change the basis of pension taxation, moving from an EET system with tax relief on pensions contributions and taxable pensions to a TEE system in which contributions are taxed but pensions are tax-free, is likely over the long-term both to reduce tax receipts and result in lower pensions in payment (thus in turn producing pressure for higher state spending). The short- to medium-term tax revenue gained by the shift will, in short, be vastly outweighed by the long-term costs.

The Historical Perspective

2. History matters in pensions because of all areas of public policy it is the most long-term. Decisions taken now on contributions can have effects that last for over 80 years and they need to be taken with great care if those long-run effects are not to be malign.

3. Unfortunately there is a long history of UK policy changes made with only the short-term in view; changes which turned out to have unintended and unwelcome consequences over the long-term. The proposals set out in Cm 9102 risk repeating such mistakes.

4. One important lesson of history is that the logic of compound interest can turn a relatively small series of pension contributions into quite a large fund over time. This basic insight has for many years been a key element in the campaign to encourage people to save into a personal pension, and to do so as soon as possible so as to gain the largest possible fund by the time they retire. It was effectively the raison d'être of auto-enrolment into NEST (one of the most significant innovations for many years in pensions and one likely to have a highly beneficial long-term effect even at levels of contribution that are widely seen to be too low).

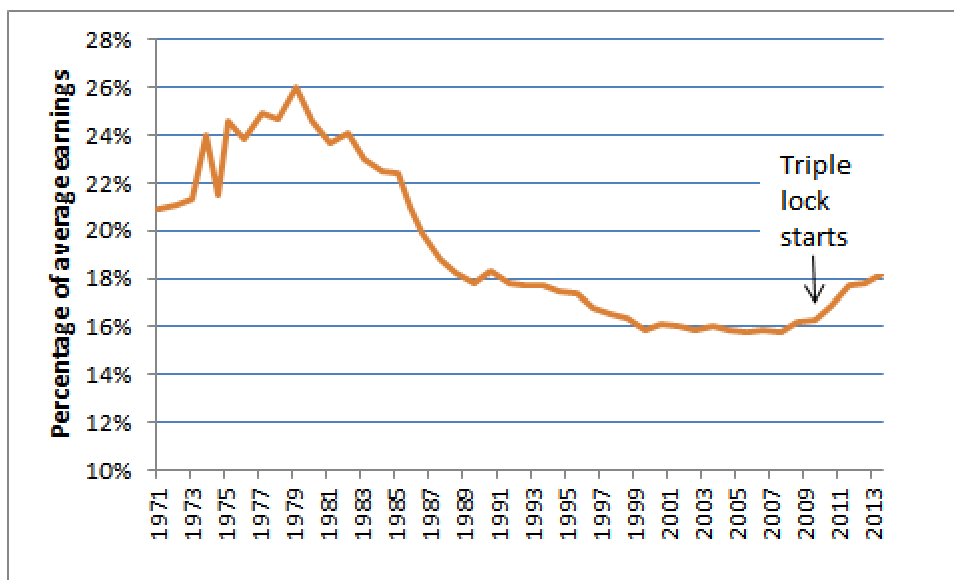
5. But the effects of compound interest can also be negative. One historic example of this which is particularly pertinent to the present proposals is the 1980 Social Security Act's shift to indexing the annual uprating of the state pension to retail prices rather than average earnings.

   Implemented with a view to short-term expenditure control the decision to change the state pension indexation basis in 1980 was, as recently released government records show, taken with virtually no consideration of the likely long-term effects. Yet as can clearly be seen in Figure 1 the change of index served radically to reduce over time the BSP as a percentage of average earnings. By 2000 it had dropped to just 15.9% from an already relatively meagre, by European standards,

26% in 1979). Only with the introduction of the so-called 'triple lock' in 2010 did the BSP start to rise as a percentage of average earnings.

Thus the 1980 re-rating change was an exercise in short-term (at most medium-term) cost control that ultimately played a part in pushing the UK pension system into the major crisis that the Pension Commission attempted to address in its 2004-6 reports.

Figure 1: The long-term effect of indexing the BSP to RPI not average earnings, 1979-2010



Source: DWP Abstract of Statistics, 2014.

The long-term costs of moving to TEE as the basis for pension taxation

6. The foregoing brief historical exegesis is directly relevant to the proposed move from an 'Exempt-Exempt-Taxed' (EET) basis for pension accumulation and decumulation to a 'Taxed-Exempt-Exempt' (TEE) basis. Such a shift, whilst it plainly has advantages for the Exchequer in the short- to medium-term through its removal of the contribution tax subsidy embodied in the present EET arrangements, will have most unwelcome long-term repercussions.

7. The present system of granting tax relief on pension contributions has two obvious benefits that will be lost if the proposed reform is implemented.

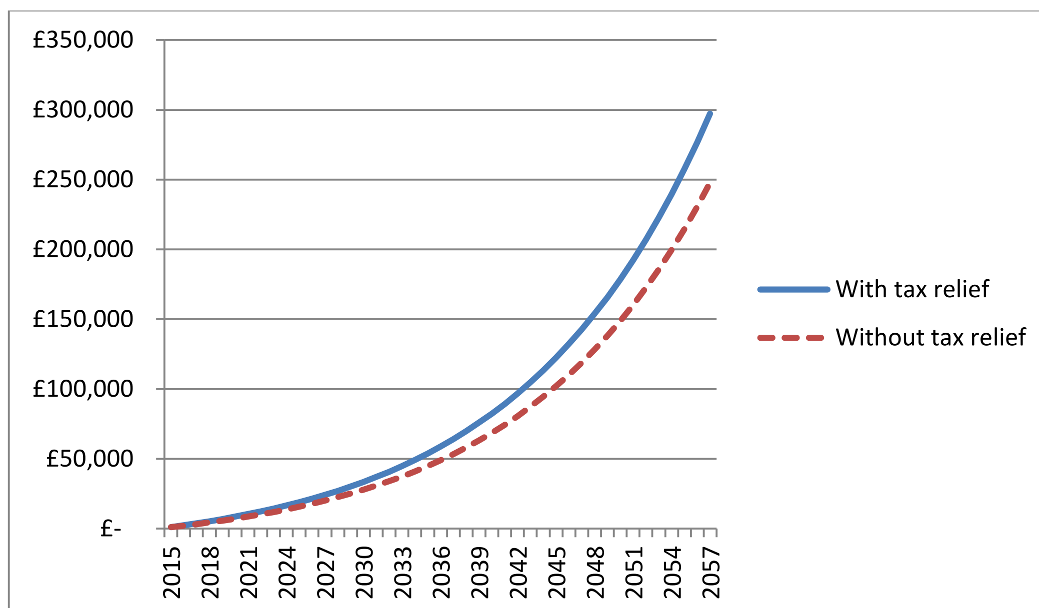
8. **First**, the knowledge that a given rate of contribution will be 'topped up' by the government at the marginal rate of taxation represents a significant incentive to save into a pension. Without such an incentive, rates of contribution (already widely seen to be inadequate) will fall.

   (We doubt the claim in Cm 9102 paragraph 3.9 claim that many consumers are unaware of the tax benefits of private pension saving and we note both that no evidence is advanced to support this claim and that pension companies all highlight the tax advantages in their marketing).

9. **Second**, and even more significant, contributors presently receive the benefits of long-term capital growth on the value by which tax relief increases their contributions. Over time the logic of compound interest works to deliver a significantly larger capital sum at retirement. As can be

seen in Figure 2, a 25 year-old starting to make a relatively modest pension contribution today will find the change to TEE reduces the final value of their fund considerably (in this case by 17%).

Figure 2: An illustration of fund growth with and without tax relief on contributions



Assumptions: 25 year-old makes contributions of £1000 p.a. to retirement on 68th birthday (c.4% of current average earnings); income tax rate 20%; annual rate of return on investment 7%.

10. This long-term reduction in fund value under TEE will result in a lower after-tax retirement income: in this case our notional contributor, on current mortality estimates, would see their net annual retirement income in addition to the state pension fall by around 7%, to £13,650 from £14,650 under the present EET system (the latter including drawdown of the 25% Tax Free Lump Sum to expected age of death).

    [Non-escalating single life annuity quotation from Legal & General's online retirement income calculator].

11. One should also note that the savings that would accrue to the exchequer by taxing contributions made by basic rate income tax payers under a TEE system would be significantly lower than the revenue that flows from taxing the pension in payment as at present. (In the illustration above tax relief on total contributions to retirement amounts to just £8600 whereas taxing the pension in payment over 15 years to expected date of death yields almost £40,000).

    In short, for basic-rate tax payers, the majority of pension savers, over the long-term the proposed TEE system will actually cost the state significantly more than the present EET system.

The illusion of simplification

12. CM 9102's summary of questions on p.23 embodies an underlying assumption that the proposed changes will deliver a less complex system and thereby increase incentives to save into a pension. There is no evidence to support the claim that the system will become less complex if the proposed reforms were to be enacted. In fact it would become more complex.

13. There has been a common historical misperception that 'reform' can easily deliver simplification. In fact, apart from the forthcoming move to a unified state pension, every significant pension

reform since 1945 has served to complicate the system because each has grafted a new system layer onto those already existing. It is quite feasible for a person retiring today to have state pension entitlements that include not just the basic state pension but contributions made under the 1959 graduated state pension, its 1975 successor the state earnings related pension and in turn its successor the state second pension. In addition they may have accumulated multiple occupational pensions, to which they may have made additional voluntary contributions under separate conditions, and had one or more free-standing AVC policies as well as made contributions into the new NEST scheme. They may also have taken out a personal pension. This is a hugely complex system and the frequency with which that complexity is added to appears to be increasing.

14. This would also be the case with the present proposals: pension contributions pre-dating the proposed tax reform will continue to yield a taxable pension (at least one presumes they will continue – for if they do not then the state will forgo the chance to recoup the tax relief awarded on those contributions, the very antithesis of the prudent oversight of public money). It will be <u>future</u> pension contributions that will be affected by the change.

    Thus under the present proposals the result will actually be two parallel systems of pension taxation: one for income on funds arising from contributions under the existing EET system; the other for contributions to and retirement income arising from pension saving under the new TEE system.

Other observations

15. Cm 9102 is a profoundly muddled document.

16. That is evident from its first paragraph (1.1) in which the claim is made that demographic change has served to change the way in which people are saving for their retirement. No evidence is advanced to support this claim. Whilst demographic change has had effects, principally in occupational pensions, the main factor driving changes in the way people save for old age has been government policy such as regulatory change, quantitative easing, and changes in the tax system such as the institution of tax-free ISAs.

17. One might also question the assertion in paragraph 1.24 that average contribution rates (presumably to NEST, though this is not actually stated) will rise. The assumption here is that government tax relief will be a factor in such a rise, yet a move to TEE will remove that incentive.

18. In addition, with the annual lifetime allowance to be reduced to just £1m a large number of middle-income earners are going to be drawn into its net over time. This too must surely act as a disincentive to pension saving.

Conclusions

19. Cm 9102 is an attempt to dress up a policy aimed at bolstering tax revenues over the short- to medium-term as a long-term reform to incentivise pension saving and improve the level of income replacement in old age. It is inconceivable that it will achieve either long-term aim.

20. This is partly because the proposals outlined in this document are so confused.

21. But our main point is that Cm 9102's proposed shift from EET to TEE as the basis for pension taxation, via the elimination of the tax incentive to save into a pension coupled with the logic of compound returns on investment, can be expected at once to:

    a. Reduce the value of future income replacement in old age over the long-term; and
    b. Reduce net tax revenues over the long-term.

22. At the same time, unless the Treasury is proposing to allow contributors who have already benefitted from tax relief on contributions to receive the resulting pension tax-free, the proposed reform will further complicate a pension system that is already one of, if not the, most complex in the world. It will lead to consumer confusion, inertia, and consequently even more inadequate saving for old age.

23. Thus, as with the 1980 re-indexing of state pensions, the shift from EET to TEE can be expected to increase pressures for higher state pension spending over the long-term – the exact opposite of Cm 9102's objective of containing public expenditure growth.

Recommendation

24. The government should resist the short-term temptations of moving to a TEE basis for pension taxation. If the Treasury is determined to reduce the cost of tax relief on pension contributions it should instead consider removing higher-rate relief, a costly subsidy to those least in need of an incentive to save into a pension.

Notes

The authors of this submission are

Dr Hugh Pemberton
Reader in Contemporary British History
University of Bristol, Department of History
9 Woodland Road, Bristol. BS8 1TB

Email: h.pemberton@bristol.ac.uk
Web: http://hughpemberton.org.uk

Professor Roger Middleton
Professor of the History of Political Economy
University of Bristol, Department of History
9 Woodland Road, Bristol. BS8 1TB

Email: r.middleton@bristol.ac.uk

Dr Pemberton is Principal Investigator and Professor Middleton Co-investigator on an Arts and Humanities Research Council project that is presently researching the pension reforms of the 1980s: 'The Thatcher Pension Reforms and their Consequences' (project reference AH/L004739/1, further details on the website of Research Councils UK).

Thatcher's Pension Reforms website: http://pensions-history.uk/