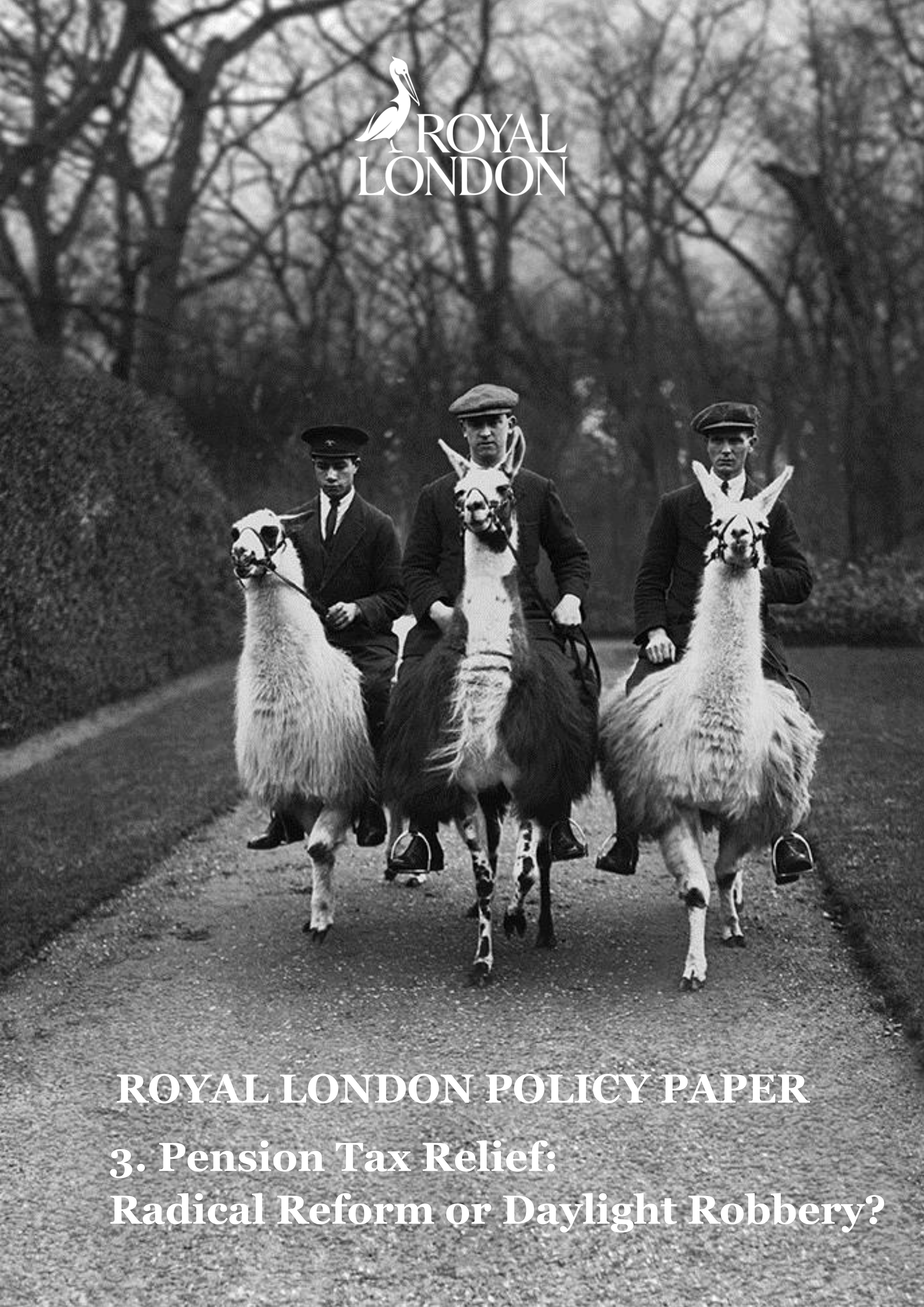

ROYAL LONDON

ROYAL LONDON POLICY PAPER

3. Pension Tax Relief: Radical Reform or Daylight Robbery?

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PENSION TAX RELIEF:

RADICAL REFORM OR DAYLIGHT ROBBERY?

Executive Summary

On 16th March the Chancellor faces one of the most difficult judgment calls of his time in office. Following a summer 2015 Green Paper, he will now have to decide whether to go for major reform of the system of pension tax relief, minor tweaking or simply leaving the system alone. His decision will affect millions of workers and firms, future generations, the financial services industry and the wider macro-economy.

This paper outlines the very wide range of factors which the Chancellor will be considering. As well as the desire to raise revenue he must think about the impact of any reform on the incentives to save both by individuals and firms. He will need to find ways of simplifying a hideously complex system and of making sure that the system genuinely does incentivise people to save for the long-term. And any reform must stand the test of time and put an end to the constant tinkering that we have seen in recent years.

We consider first the most radical reform – the Pension ISA. With this approach all pension contributions are made out of post-tax income, but thereafter no further tax is payable, either on the investments in the pension fund or on pensions in payment.

Such a reform is superficially attractive to a cash-strapped Chancellor, giving him the chance to bring forward billions of pounds of tax revenue from the time when today's workers retire to the present day. It also builds on the relatively popular and simple 'ISA' brand and would cement the Chancellor's reputation as a reformer.

However, such a change would be fraught with difficulties. It would throw the whole system up in the air with unpredictable consequences for the attitudes of employers and employees to putting money into workplace pensions. It would require the 'dual-running' of pension systems for decades to come as each individual held one or more pension in a 'yet-to-be-taxed' pot, and a new pension in an 'already-taxed' pot. And it would move tax revenue away from our children's generation, when demographic pressures on public spending and the need for tax revenues are likely to be far more severe. It would, in a sense, be stealing funding for the public services the next generation will need for our own benefit.

An alternative major reform would be within the current tax relief framework where contributions are made out of pre-tax income but pensions in payment are taxable, save for a tax-free lump sum. Under the most likely reform, tax relief would be allowable at a flat rate for all rather than at the individual's marginal tax

rate. This would almost certainly mean that higher earners got less help whilst standard rate taxpayers got more.

Such a reform could also raise revenue for the Chancellor but would be far less disruptive than the ISA option. There would be no need for 'dual-running' of pension pots with different tax treatments and the tax revenues from pensions in payment would remain available to be spent by generations to come.

A flat-rate of relief would not be without administrative complexity. In particular it would be challenging (though not impossible) to make it fit easily with existing Defined Benefit pension schemes which account for the bulk of the cost of tax relief at present. But a flat-rate of up-front relief would fit more naturally with DB pensions than a wholly new ISA style approach.

A key question, however, is the level of the flat rate. A low flat rate, such as 25% would be of marginal benefit to lower earners but would 'steal' billions of pounds from the overall level of support given to pension saving. At a time when we need more pension saving, not less, such a low level of support would be unacceptable.

A final option which we consider – reluctantly – is further incremental tinkering with the system. There are, as ever, ways in which the Chancellor could raise valuable revenue by tweaking the details of the existing system in terms of annual and lifetime allowances or looking at the treatment of employer contributions in the National Insurance system.

But our plea is that the Chancellor does not go down the route of further tinkering. Tax relief has been a political plaything for far too long. A period of stability is needed. It would be a mistake to gamble on turning the system upside down, but it is possible to reform the system in a way that makes the incentives from tax relief more transparent and which distributes the benefits more towards those who need the most help. As part of any package of reform, the Chancellor must seize the opportunity to simplify the system, to make it fairer and then leave it alone for a generation so that individuals can plan for their later life with confidence.

1. Introduction – the issues the Chancellor should consider

In evaluating the various options for reform of pension tax relief, the Chancellor will have a number of competing objectives. We begin by asking the fundamental question of what reform is trying to achieve.

a) Reducing the overall cost of the system / raising revenue for the Exchequer

Many of the figures that are quoted for the 'cost' of pension tax relief are rather misleading. In principle, a system where individuals are not taxed when they put money into a pension but are taxed when they turn that money into a pension could be regarded as 'tax neutral'. If everyone paid the same rate of tax when they were working as when they are retired, and if there were no other tax exemptions, then it could be argued that there is no net cost to tax relief over a person's lifetime.

However, there are a number of features of the system which mean that there is a net cost to the Exchequer, potentially running into many billions of pounds:

- *The tax free lump sum* – in most pension arrangements an individual is allowed to draw the equivalent of a quarter of the value of their pension in the form of a tax free lump sum; if contributions are made tax-free, if investments within the fund are (mostly) untaxed, and if a quarter is withdrawn without taxation, then this is clearly a cost to the Exchequer; precise figures are hard to come by, but the loss of revenue from the tax free lump sum probably amounts to around £4 billion per year[1];
- *Different tax rates when working and when retired* – tax relief is given at an individual's marginal tax rate, so higher earners save more tax up front than lower earners for any given pension contribution; however, many of those who face income tax rates above the standard rate when they are working (ie pay at 40% or 45%) pay only at the standard rate (20%) in retirement; currently, around one in six of all taxpayers pays tax at the higher or additional rate, whilst only a very small proportion of pensioners pays tax at the higher rate; if contributions were taxed and pensions were tax-free, there would be a net gain to the Exchequer compared to the current system;
- *National Insurance exemption on employer pension contributions* – whilst strictly speaking not part of the tax relief system, the fact that money paid into a pension by an employer does not attract NI contributions is a significant cost to the Exchequer; where a firm pays money to a worker and that money is then put into a pension, employee and employer NICs are due on the wage paid; but

[1] Source: PPI, Tax relief for Pension Saving in the UK, July 2013

where the money is paid directly into a pension, no NICs are due; it is estimated that this currently costs the Exchequer around £14 billion pa;

Given the drive to balance the Budget in this Parliament and the general pressure on public spending, it seems reasonable to think that reducing the impact on current revenues of the pension tax relief system is likely to be high on the Chancellor's list of objectives. Even reforms which simply bring forward tax revenue from future generations (such as taxing contributions now and relieving pensions in payment) are likely to be attractive for the same reason.

b) Making the system simpler and more stable

The summer 2015 Green Paper on the reform of pension tax relief specifically mentioned 'simplicity' as one of the goals of reform. Given the great complexity of the current system, something to which successive governments have contributed, this would clearly be a highly desirable outcome. The more complex the system, the more difficult it is for individuals to understand, the more costly it is to operate and the more potential for 'gaming' the system with the need for new complexity in order to close down loopholes.

Two features of the current system which add considerable complexity are the system of annual and lifetime limits. A real prize for reform would be the simplification or abolition of these limits.

On annual allowances, April 2016 sees the introduction of a new system of 'tapered' annual allowances for those with higher earnings. Broadly speaking, those with total income (including the value of pension contributions) in excess of £150,000 per year face a £1 in £2 reduction in the value of their annual allowance up to an income level of £210,000. The basic annual allowance of £40,000 pa can thereby be reduced to £10,000 for those earning £210,000 or more.

This system will create huge complexity and unpredictability, not least for those – such as the self-employed and those dependent on bonuses – who may not even know their likely level of income for the current year. A recent survey by the Association for Consulting Actuaries found that larger employers were actively looking at ways to make sure that higher earners were not affected by this tapering, including looking for non-pension forms of remuneration. If reform to pension tax relief raises money in other parts of the system that allows this complexity to be removed, this would be welcome.

The Lifetime Allowance is a cap on the accumulated pension pot rather than on the annual level of contributions on which tax relief can be obtained. The limit has been cut three times in the last six years and will fall to £1 million in April 2016. Each reduction has been accompanied by complex forms of transitional protection and each reduction widens the pool of workers who now have to worry about saving 'too much' for fear of penal taxation. Again, if the reform package allowed for the abolition of the lifetime allowance this could be a major gain in terms of the simplicity of the system.

Any reform should also be evaluated as to whether it is then followed by a period of stability. Given the long-term nature of pensions, there can be little doubt that the almost constant changes to rules and limits has undermined confidence in the system. We should be looking for a reform which has the potential to be immune from further regular reform and tinkering as far as is humanly possible.

c) Effect on employers

A crucial question for any new system must be its impact on employers. Around three quarters of all pension contributions are made by employers on behalf of their employees, and any reform which discourages firms from providing remuneration in the form of pensions would be a source of grave concern. At present, employer contributions into a worker's pension are exempt from income tax and National Insurance Contributions. Any change which reduces these tax advantages will cause more firms to consider alternative forms of remuneration and could reduce pension saving.

A linked issue is the interaction between any reform and the system of automatic enrolment. So far, more than 5.8 million workers have been automatically enrolled by their employers and the programme has been highly successful in broadening membership of workplace pensions. Any reform must be evaluated for its potential to support or reinforce the success of automatic enrolment.

d) Effect on employees

It is widely argued that pension tax relief is not well understood by most people and therefore does not achieve much in terms of incentivising people to save in the form of a pension.

For the average taxpayer, it is true that pension tax relief may be largely invisible. If their pension contributions are deducted from their gross pay by their employer then tax relief goes directly into their pension fund without the employee even being aware. By contrast, there is clear evidence from the UK and the US that the offer of a 'matching' employer contribution does have a positive effect in encouraging higher levels of pension saving.

It may be that a wholesale reform of pension tax relief with its replacement by a Government 'matching payment' would be one way of improving the visibility of this incentive. But it may also be the case that incremental reform of the present system accompanied by a change of language (eg describing up-front tax relief as a government top-up) could also achieve a similar effect.

e) Cost of implementation

Whilst any reform will clearly involve administrative costs, the different options open to the Chancellor vary considerably in the costs of implementation. These costs generally mean poorer pension outcomes.

The easiest reforms to implement would be those which build on the existing system. But a wholesale reform, such as ending up-front tax relief, would be a huge administrative upheaval. With all pension reform a key issue is the fact that there is a long and complex legacy of rights built up under an existing system. If up-front tax relief was switched off, it would create a storm of protest if tax was suddenly applied to so-far-untaxed pension wealth built up over decades.

So, on the assumption that this would only apply to future contributions, it would be necessary to retain all existing pension accruals in ring-fenced 'not-yet taxed' pots, and to set up new accounts for all future contributions in 'already-taxed' pots. This dual running would, for example, have to apply to all ten million workers set to be automatically enrolled by 2017, with each worker having to have two ring-fenced funds. This would increase the cost of running pensions and could also mean that reform would take longer to implement. Dual pots would also imply that each would be a smaller fund which is likely to produce poorer value during accumulation and also when the pension pot is turned into a retirement income.

f) Distributional Impact – between individuals

Even if the current system was regarded as largely 'tax neutral' in the sense that tax relief simply defers taxation to when the income is drawn, it could still be argued that more of the up-front relief needs to be given to those on lower incomes. There is clear evidence that many millions of workers are 'under-saving' – up to 12 million according to the latest DWP estimates – and many face a reduced standard of living once they retire. If the benefits of tax relief were more heavily geared towards lower and middle earners, those with the least spare cash to save into a pension would be helped to get nearer to their retirement income target.

It is worth saying however that assessing the distributional impact of any package of measures in the Budget is likely to be complex. If the Chancellor makes changes to tax relief he may well change other features of the system and this will change the overall picture. For example, if a flat rate of relief were to be introduced this could mean large cash losses for higher earners. So the Chancellor might use some of the revenue raised to increase the threshold at which higher rate tax starts to become payable in order to partially offset these losses.

A lot also depends on the behavioural response to the change, particularly by employers. If the tax privileges associated with employer pension contributions are reduced, employers may respond by reducing the money they put in to pensions and perhaps paying more money directly to employees. It is highly likely that this will reduce the overall level of pension saving. On the other hand, if tax incentives are made clearer and more visible, it may be that workers will decide to save more into pensions.

The very fact that the behavioural response to these changes is so uncertain suggests that the Government would be taking a big risk by introducing the more radical reforms currently on the table.

g) Distributional impact – between generations

One of the key issues in thinking about tax relief is to look at the lifetime of an individual and not just their situation at a point in time. For example, as noted above, tax relief on contributions followed by tax on pension in payment may not represent a tax 'privilege' when measured over someone's lifetime.

The same is true when thinking about the impact of any reform on the public finances. Some reforms, such as abolishing up-front relief and making pensions tax-free would appear as a big positive in the Budget 'red book' published in March 2016. But if that document also covered the accounts of future generations it would show a corresponding debit. Abolishing up-front tax relief would allow the Chancellor to bring forward large amounts of tax relief, without necessarily improving the net position of the public sector in the long-run. This is a key issue to which we return in the next section.

h) Tax relief for non-taxpayers

A specific issue which has arisen in recent years has been the fact that some of those who earn below the tax threshold still benefit from 'tax relief' on their contributions whilst others do not. The reform of tax relief offers the opportunity to address this issue.

In brief, pension tax relief is delivered in one of two ways – through the 'net pay' arrangement (NPA) or via the Relief At Source (RAS) system[2].

Under the NPA system, an individual makes pension contributions out of their pay packet before they are assessed for tax. This means that the gross amount of their contribution (net contribution plus tax relief) goes directly into their pension fund. For non-taxpayers, no tax is taken from their pay, so no tax relief goes in to their pension fund. Around two thirds of all tax relief is delivered via this route.

By contrast, under the RAS system, individuals make net contributions into their pension scheme out of their take-home pay and basic rate tax relief is added back in by HMRC in respect of all contributions. This means that even non taxpayers benefit from tax relief. Higher rate taxpayers have to claim their additional tax relief via their annual tax return.

This issue has become more important in recent years because of the combination of millions of lower paid workers being automatically enrolled into workplace pensions and because of the rising level of the tax free personal allowance.

[2] Rather confusingly, these two methods are actually the opposite of what they sound like!

With a threshold for automatic enrolment of £10,000 per year and an income tax threshold of £11,000 per year, many thousands of non-taxpayers are being automatically enrolled each year. If their scheme operates under NPA they will get no tax relief, whereas if their scheme operates RAS, they will get tax relief. For each net contribution of 80p into a pension, the effect of tax relief is to gross it up into £1 going in to a pension. Whilst the absolute cash amounts are relatively small, it does seem arbitrary that some low earners are getting a 25% uplift on their contributions whereas others are not, simply because of the administrative arrangements of the scheme which their employer has chosen.

If, for example, all future tax relief were to be delivered via the RAS system or if a move were made to some form of government 'matching' payment, then this anomaly could be resolved as part of any reform.

i) Impact on Defined Benefit pensions

Much of the discussion of reform has centred around 'Defined Contribution' (DC) pensions where a pot of money is accumulated through a working life. Most new workers join DC arrangements and the balance of pension provision is very much shifting in this direction.

However, most of the cost of tax relief currently arises in relation to Defined Benefit (DB) pensions. And the majority of this tax relief relates to funding shortfalls in respect of payments to pensioners and on benefits that accrued to members in previous years. Around five million public sector workers are active members of salary-related DB schemes, with more than a million private sector workers still accruing rights in such schemes. If a major reform of the tax relief system were to be introduced, considerable thought would have to be given to how it would impact on DB pensions.

The key issue is that, unlike with DC pensions, with DB there is not a single ring-fenced 'pot' which applies to a named individual, and where the value of the employer contribution can easily be assessed and taxed in the year it occurs. Instead, contributions are made into DB schemes each year by employers and (usually) employees at a rate designed not only to cover the cost of the additional benefit built up by current workers during that year but also to deal with any deficit that may have been built up in respect of the pensions due to all members of the scheme, including pensioners and those who are no longer employed by the employer.

Probably the only realistic way to value this contribution would be to use something like the current rules for calculating how much of the annual allowance an individual has used up. Roughly speaking, an individual's rights under the scheme are valued at the start of the tax year and at the end, and any difference in value above inflation is counted towards their annual tax allowance[3].

[3] To be more precise, the annual pension at the start and end of the year is multiplied by 16 to give a lump sum equivalent value, and any growth in this value above inflation counts towards the annual allowance.

This is a complex calculation and is currently not needed for most taxpayers so there would be a considerable administrative cost to this. More problematic is that this system can catch people on relatively modest earnings who happen to enjoy a promotion or significant pay boost. If all past service is now valued on the basis of the new salary and not the old one, this can generate a big single-year rise in the value of the worker's pension rights. In a world where such increases are taxed for those who pay tax above the standard rate, this could generate large lump sum tax bills as higher rate relief is recovered. Conversely, if ordinary workers paying the standard rate were given tax relief at a rate above the standard rate, this would generate large numbers of low value tax refunds which would again generate considerable complexity.

2. Option 1: the Pension ISA (PISA) – taxing contributions, not pensions

The July 2015 Green Paper had few specific proposals for reform, but the Chancellor's Budget speech did float the idea of treating pensions more like Individual Savings Accounts (ISAs). Under ISA tax treatment, contributions are made out of post-tax income but investment growth and withdrawals are tax free. Under a 'Pension ISA' or PISA, there would be no up-front tax relief but there would be a promise of no further taxation on the fund, either during the accumulation phase or during retirement. However, given that the money in a PISA would need to be 'locked up' in some way compared with a regular ISA, the Government would need to provide some incentive for individuals to contribute to a PISA rather than an ISA. One route would be some form of government top-up or matching contribution when money is first contributed.

a) Advantages of the PISA route

Proponents of the PISA argue that the tax rules around ISAs are simple and well understood. By contrast, the rules around pension tax relief are complex and little understood. By building on a simple and familiar system of incentives, they argue, people will be more inclined to save through a pension. It also has the potential to generate very substantial up-front revenues for the government.

As noted earlier, a key question if a PISA were to be introduced is the nature of the government incentive. If individuals can put their take-home pay into a regular ISA with instant access or a Pension ISA with no access until (say) 55, they would need an incentive to do the latter.

One obvious incentive is the employer contribution. If there is some link between pension contributions made by the worker and contributions made by the firm, then this would tilt the balance towards contributing into a PISA. For example, where firms offer 'matching' of pension contributions up to a limit, a pound put into a Pension ISA becomes two pounds with the employer contribution, and this is a very attractive option compared with a regular ISA.

However, as things stand, employer matching contributions are not mandatory, save up to the 3% of 'qualifying earnings' which will be required of employers by April 2019 under the automatic enrolment regulations.

It may well be the case therefore that the Chancellor would need to introduce some form of government top-up to help PISAs get off the ground. A large top-up would use up much of his up-front revenue from the change, but the cost of a top-up could be cash-limited and geared particularly to help lower earners, unlike the current system. In addition, the PISA would not suffer from the anomalous treatment of low earners under the 'Net Pay Arrangement' system for tax relief – all workers would be treated the same and the top-up to low earners could be more generous than the current system of tax relief.

b) Disadvantages of the PISA route

Following the publication of the July 2015 Green Paper, the reaction to the PISA proposal has been overwhelmingly negative. A wide range of concerns has been highlighted:

- A move to pensions where tax has already been paid would require the 'parallel running' of (at least) two pension pots for each individual, one where tax has already been paid and one where tax is yet to be paid;

- Ending tax relief on pensions would bring forward tax revenues to the benefit of the current generation at the expense of future generations; yet the big unfunded pressures of an ageing population on health care, social care and public pension liabilities will be much greater in future generations; if future pensioners (who will be a growing proportion of the population) all become non taxpayers, the tax burden on the working age population in future will be even greater than is currently projected and could reach unacceptable levels;

- Employers may disengage from workplace pensions, beyond the legal minimums imposed by automatic enrolment; unless new forms of incentive are introduced, if employer pension contributions into a PISA have the same value to an employee as cash in their pay packet, then neither the employer nor the employee has much incentive to see money paid into the PISA;

- Such a system is hugely exposed to future changes, both in the short and long term; in the short-term, the limits on contributions and the extent of any matching contribution from the government would simply be parameters of the system which could be changed on an annual basis; more importantly, the crucial promise of 'no further taxation' on pension pots could not be binding on future governments who may face huge spending pressures and a great temptation to raid pension pots again; similar issues have already arisen in Australia where plans to make pensions tax free were at risk of being reversed within a few years of being implemented;

- One of the features of the present system which makes pension saving unique and relatively attractive is the existence of the 'tax-free lump sum'; in most cases, individuals can contribute into a pension tax free, see their investments grow (largely) tax free and then withdraw one quarter tax-free; in other words, a part of their earned income which goes into a pension is never taxed at all; under the ISA treatment however, all income is taxed as soon as it is earned, and nothing escapes taxation; as a result there would be no 'tax-free lump sum' and one of the longstanding cornerstones of pension saving would be gone;

A move to PISAs would create real disruption for DB pensions; it is hard to see how the concept of a pension account filled with taxed-income could be reconciled with the concept of a DB pension pot containing yet-to-be taxed income; the Chancellor could consider a complete 'carve-out' for DB pensions, retaining the existing structure on the basis that a dwindling number of private sector workers are still building up DB pension rights; but this would be likely to exacerbate perceptions of unfairness in the tax treatment between DC and DB pensions, and would raise political challenges given the preponderance of public sector workers amongst the active membership of DB pension schemes;

3. Option 3: incremental change – further tinkering with the parameters of the current system

If the Chancellor was minded to retain the current basic framework of providing tax relief on pension contributions and taxing pensions in payment, but felt that high earners got too much of the benefit from the current system, he might consider offering up-front tax relief at a single, common rate for all. Such a proposition has been advanced by, among others, the Association of British Insurers in its ideas for a 'savers bonus'.

The pros and cons of such a scheme depend crucially on how it would be delivered in practice, so we consider first the practical implications of a flat rate of tax relief, before moving on to the evaluation of such a system.

a) How would a flat rate work in practice?

As discussed in the introduction, tax relief is currently delivered in one of two ways – either through the pay packet under a 'Net Pay' arrangement (NPA), or via a transfer from HMRC to the pension provider under the 'Relief at Source' (RAS) scheme. A move to a flat rate would most naturally fit with the RAS approach.

The basic idea would be that contributions into a pension would be made by all workers from take-home pay, with no tax relief given at that point. As with the current RAS system, HMRC would then pay the tax relief due on those contributions to the pension scheme in question. If all tax relief was available at the current basic rate, for every 80p contributed by an individual into a pension, HMRC would add 20p[4].

It would be reasonable to assume that the HMRC top-up in any reformed system would be more than 20p for every 80p contributed. Such a top-up rate would leave most standard rate taxpayers unaffected and would generate huge cash losses for higher-rate taxpayers. Unless the public finances were in a desperate situation, it is assumed that the flat rate could be 25% (ie a 25p top-up for every 75p contributed) or even 33% (ie a 33p top-up for every 67p contributed). However, the latter is unlikely to generate any significant savings, so a rate of relief of 25% is probably the most likely outcome if the Chancellor follows the flat-rate route[5].

As well as the rate of relief, a key question is what would happen to employer pension contributions?

[4] In current terminology, this would be regarded as giving tax relief at the standard rate of 20%. However, in reformed system this might be described as a "25% government top-up". The two would be identical in effect, but the Chancellor might wish to use the language of the latter rather than the former.

[5] He could, of course, opt for any rate of relief. The rate need not even be a whole number. But the great advantage of 25% or 33% is that it allows the language of matching to be used most readily – £1 from the Government for every £3 or £2 from the worker. This in turn might mean that future government were less likely to 'tinker' with the headline rate of relief.

The issue here is that if the rate of relief on employee contributions were restricted to (say) 25%, there would be a huge incentive for all pension contributions by higher earners to be diverted via the employer – even more so than under the current system. If workers only get tax relief at the standard rate but pay tax on their wage at the higher rate, then instead of putting their own take-home pay into a pension they would prefer that the employer put a pound into the pension on their behalf and they gave up a pound of gross pay. This would reduce their take home pay by 60p (ignoring National Insurance Contributions) but would mean one pound went into their pension – in effect they would have achieved higher rate relief.

In order to avoid this, the Government might say that employer pension contributions would generate a tax charge on the worker, equivalent to the value of the higher rate relief which they had obtained over and above the new flat rate of relief. This could be calculated via the annual tax return which most higher earners complete and could be collected via the PAYE tax code. This would add somewhat to the complexity of the system but would ensure that workers had no more incentive than at present to divert pension contributions via the employer.

A further radical solution would be to levy employer NICs on employer pension contributions. Given the current incentives for 'salary sacrifice' to avoid employer and employee NICs on pay which goes into a pension scheme, only levying employer NICs on contributions would fully remove this incentive. It is estimated that the exemption of employer pension contributions from employer NICs costs the Exchequer around £14 billion pa, so this change could provide considerable extra resources for any reform package. The revenue could partly be recycled to employers (who would object to a huge increase in their NICs bill) and could also be used to ensure that the flat rate of relief was set at an attractive level.

b) Advantages of the flat rate of relief

If the Chancellor's first concern is to raise revenue from reform, then variations on the flat rate of relief offer the potential for very large revenue-raising. Removing higher rate relief on employee and employer contributions and applying NICs to employer contributions could generate tens of billions of pounds. Even if some of this revenue was recycled to firms and to higher earners (for example by a rise in the higher rate income tax threshold), it would still be possible to finance a worthwhile rate of relief for most savers and leave the Chancellor 'in pocket' to the tune of several billion pounds.

The big attraction of this approach is that although it would still be quite radical, it would remain within the current framework of the tax treatment of pensions. In particular, employers would be more familiar with this approach to the tax-incentivisation of pension savings and would be less likely to radically change their attitude to workplace pension provision.

This more incremental approach would greatly reduce the cost of implementation and would not face issues around moving tax between generations.

Another important issue is the way that it would affect the incentive to draw down income from a pension pot in retirement. Staying with the present system where pension withdrawals are taxed (potentially taking people into higher tax bands if they withdraw a large amount at once) gives people an incentive to spread their withdrawals through their retirement. This is a preferable system to the ISA treatment where all withdrawals are tax-free and there is therefore no tax penalty on those who take all their money in one go, potentially leaving themselves with inadequate savings for later in their retirement.

A headline rate of relief of 25% or 33% would have the potential to bring stability to the system as it would be quite hard to change from year to year, and in messaging terms it would enable government, employers and pension providers to talk about a 'matching contribution' from the government rather than about tax relief. This is likely to improve the clarity of the incentive to save.

Revenue from a flat rate might also provide the opportunity to make welcome simplification to the system, perhaps abolishing the lifetime limit altogether and ending the 'tapering' of the annual allowance for higher earners due to be introduced in April 2016. Both of these would be a big prize.

A flat rate would ensure that more of the overall cost of tax relief went to those who needed it most, and moving to the 'relief at source' method would ensure that even those below the tax threshold also benefited from pension tax relief.

c) Disadvantages of flat-rate relief

For higher-rate taxpayers, the reduction of relief to a low flat rate would represent an element of 'double taxation'. A generous rate of relief together with the continuation of the tax-free lump sum would keep pension saving attractive to higher earners, but a low rate of relief would mean that such workers were taxed in part when they put money into a pension and also when they withdrew money. However, given that many higher rate taxpayers do not pay higher rate tax in retirement, this issue would not necessarily affect large numbers of people.

A second challenge for flat-rate relief is making it work in the world of Defined Benefit pension schemes as there is not a readily identifiable figure for the employer contribution in the same way as there is with a DC pension.

As noted earlier, one possible solution is to look to the Annual Allowance calculation that pension schemes are already required to calculate for members whose tax position might be impacted by the Annual Allowance. The rules could be changed to require all DB schemes to calculate that figure for every active employee member of the scheme. This figure could then be used in PAYE tax codes to make sure that DB scheme members received the flat rate of relief rather than relief at their marginal income tax rate.

Where a DB scheme member enjoys a promotion or a large pay rise, they can find that the 'annual allowance' calculation produces a large growth in the value of their pension rights and potentially a large lump sum tax bill. However, this effect can be mitigated by the use of the 'scheme pays' approach where all or part of any such tax bill is paid from the pension scheme rather than out of an individual's take-home pay.

It is clear that any reform of pension tax relief will require additional administrative costs, but it also seems likely that the additional costs of a reform that is within the structure of the current system (such as the flat-rate approach) will generate less upheaval than a wholesale reform such as a Pension ISA.

d) The level of the flat rate

A crucial question in evaluating a flat rate system is the level of the flat rate.

It has been estimated that a flat rate of around 33% would be broadly cost-neutral for the government, depending on what other changes were made. Whilst higher rate taxpayers would get less support than under the current system, a combination of relief at 33% plus the ability to withdraw one quarter of the pension pot tax free, would mean that pension saving would still be attractive overall.

By contrast, a 25% rate of relief would take around £6 billion pa away from pension savers. For a standard rate taxpayer on average earnings and contributing 8% of 'qualifying earners' under the automatic enrolment rules, the following table shows the annual value of tax relief at 20% and at 25%.

Table 1. Value of tax relief to worker on average earnings under a) current system and b) flat rate relief at 25%

	Current system	Flat rate relief @ 25%
Gross contribution	£1,742	£1,857
Net contribution	£1,393	£1,393
Tax relief	£ 348	£ 464

We have assumed that the individual is on average earnings of around £27,600 pa. Contributions are based on 8% of "qualifying earnings" (the amount in excess of £5,824 pa). This gives a gross annual contribution of £1,742. Tax relief of 20% of this gross amount comes to £348, leaving a paypacket cost of £1,393.

We assumed that if the system was reformed the individual would continue to make available £1,393 from their take home pay to put into a pension. This would be equivalent to a gross contribution of £1,857.

Comparing the two columns shows that the change in the gross amount going into a pension as a result of the reform is an increase of around £115 pa or just over £2 per week. Whilst any increase in pension saving is welcome, the amount is so small that it is unlikely to make a material difference to the quality of life of average earners in retirement.

By contrast, the impact on higher earners would be substantial. Table 2 repeats the above analysis but for someone who receives higher rate tax relief on all of their pension savings.

Table 2. Value of tax relief to worker on £60,000pa under a) current system and b) flat rate relief at 25%

	Current system	Flat rate relief @ 25%
Gross contribution	£4,334	£3,467
Net contribution	£2,600	£2,600
Tax relief	£1,734	£867

Again, assuming that the individual responds to the change by maintaining their after-tax income, Table 2 shows that the amount going in to the pension falls by over £800 per year. There is a real risk that higher earners will respond to this 'double taxation' by investing in other more tax privileged assets such as their primary residence rather than in pension savings[6].

[6] See, for example, the recent report by the Institute for Fiscal Studes: "The effects of taxes and charges on saving incentives in the UK"

4. Option 3: incremental change – further tinkering with the parameters of the current system

In the previous sections we have seen that either a Pension ISA or a new system of flat-rate relief would be major changes. Whilst each could generate large amounts of revenue they would each, to varying degrees, generate significant upheaval and large numbers of gainers and losers. The Chancellor might conclude that the political and economic benefits of reform did not justify the political risk of creating large numbers of losers amongst higher income pension savers.

However, even if grand reform options were rejected, it seems unlikely that the Chancellor would make no changes at all, not least because of the pressure on the public finances. The most likely areas for incremental change are:

a) Valuation of DB pensions for the purposes of the Lifetime Allowance

One of the apparent anomalies of the current system is the way in which DB pension rights are valued for purposes of the Lifetime Allowance. In order to assess DB pension rights against the Lifetime Allowance, a multiplier of 20 is applied to annual DB pension entitlements. So, for example, an entitlement to a DB pension of £50,000 per year would exhaust the lifetime limit which will be set at £1 million from April 2016.

Many have commented that this is a relatively generous treatment of DB pensions. Most DB pensions have extensive inflation protection through retirement and also offer pensions to surviving spouses. To buy an index-linked pension of £50,000 per year with provision for a widow/widower would cost far more than £1 million at current annuity rates. So the Chancellor might be tempted to increase the multiplier of 20 to something more representative of current annuity rates for index-linked pension income.

This change would certainly raise revenue for the Chancellor over the medium term but there would probably need to be complex transitional arrangements for those who had previously been below the £1 million threshold under the old rules but over the threshold under the new ones. In addition, if and when annuity rates began to rise there would almost certainly be some pressure to reverse the change, so the revenue gain may be temporary.

b) Further reductions in the Lifetime Allowance (LTA)

Despite the fact that there have been reductions in the LTA in 2012, 2014 and now again in 2016, the Chancellor might, in principle, be tempted to make a further reduction below £1 million. The reduction from £1.25m to £1m was estimated to raise £300m in 2016/17 rising to £550m in 2018/19 according to the Treasury. A further reduction to £750,000, for example, would raise far more than this as many more workers would be brought within the scope of the limit.

c) Further reductions to the Annual Allowance (AA)

The annual allowance has already been cut in recent years to £40,000, but further reductions would be possible. Whilst relatively few people would be in a position to consider contributing this amount into a DC pension pot, a lower limit such as £30,000 would start to capture many more people in DB schemes who, for example, see a significant rise in their pensionable pay because of a promotion. Whilst this issue will gradually become less significant as public sector schemes transition to a 'career average' basis, many more senior and long-serving public sector workers still have years of rights built up on a 'final salary basis' where a promotion can lead to a large rise in their accumulated pension rights. It may be that the Chancellor judges that alienating senior teachers, doctors, civil servants and others is not worth the modest additional revenues which he might obtain.

d) Changes to the tax free lump sum

An often mooted source of tax revenues for the Chancellor would be to abolish or scale back the value of the tax free lump sum. With an estimated cost of around £4 billion per year, this option will no doubt have been considered.

However, it would take a long-time to get significant amounts of money from such a change. Millions of people have saved through a pension with a promise of a tax free lump sum and would be outraged if that privilege were to be withdrawn retrospectively. Former Chancellor Nigel Lawson famously referred in a Budget speech to the 'much loved but anomalous' tax free lump sum, but judged that the politics of reducing it were too unattractive.

It might be possible to cap the lump sum or restrict the amount of tax-free cash that could be built up from future service, but this would create yet more complexity and would yield very little cash in the short-term. Given the political flak associated with such a change, it is hard to see the Chancellor going down this route.

5. Conclusions

In Table 3 we have attempted to summarise our judgment on the relative merits of each of the main approaches against the criteria set out in the introduction. A tick indicates that the reform option performs well against that criterion, a question mark indicates an uncertain or mixed impact, and a cross indicates that the reform performs badly. The different criteria may not be regarded as equally important, but a reform which scores a large number of crosses and question marks is unlikely to commend itself.

Table 3. The reforms evaluated

	PENSION ISA	*FLAT-RATE*	*INCREMENTAL CHANGE*
Potential for Raising Revenue	√	√	?
Simplicity	√	?	x
Stability	?	√	x
Impact on employers	?	√	?
Impact on employees	√	√	x
Administrative cost	X	?	?
Distributional impact: rich v poor[7]	√	√	?
Distributional impact between generations[8]	x	√	√
Help for non-taxpayers	√	√	x
Applicability to DB pension schemes	x	?	?

[7] A tick indicates that the value of tax relief would be moved more towards those on lower incomes.
[8] A tick indicates that the tax base of future generations, when demographically-driven public spending pressures are likely to be more intense than at present, is not undermined.

Starting with the option of incremental change, Table 1 shows very clearly that further incremental change is a very unattractive option. Whilst it may allow the Chancellor to raise modest additional sums it would simply represent another round of 'tinkering' which simply added more complexity without addressing the fundamental problems of the current system. If the Chancellor is not minded to reform the system in a significant way, he should clearly resist the temptation instead to 'tinker'.

The 'Pension ISA' column does show why the Chancellor was attracted to this option. It could yield significant revenues and could allow a relatively simple way of presenting tax relief as a 'government top-up' to pension saving. However, if DB pensions were excluded, the revenue from this reform would be substantially reduced, at least in the short-term. The big downsides of the approach are the uncertain and possibly negative impact on employer attitudes to pension provision, the administrative cost of running parallel systems for half a century or more, and the spending of 'tomorrow's' tax revenues by the present generation.

The 'Flat Rate' approach appears to score better overall but only if set at a realistic rate. It is not without its complexity but could allow pension tax relief to be communicated in a much simpler way. It could be implemented more easily as it is an evolution of the current system (albeit a significant one), and might provide the basis for a more stable and simpler system of tax relief going forward, especially if part of the package included the abolition of the lifetime allowance.

If the Chancellor is minded to reform the system, he should resist the temptation to tinker. Our judgment is that a 'Pension ISA' is a high-risk strategy which could undermine the whole edifice of workplace pension saving, particularly if employers cease to see the value in pension provision beyond the statutory minimum. A generous flat-rate of relief would present its own challenges but could help millions of ordinary people to put more money into their pensions and could make the incentives for pension saving clearer and more attractive. If reform is to happen, this is the route which a reforming Chancellor should adopt.

Appendix 1

A common way for members of pension schemes to get their tax relief is through the system known as relief at source (or RAS).

Here the level of contribution made is grossed up by the basic rate of tax (higher rate payers can claim the difference in their tax return) and normally providers invest the higher amount in the pot immediately (later reclaiming the tax due from the Government).

It should not cause any significant problem (relative to some of the other proposals) for providers to change their systems to increase the rate they gross up the contributions by.

There is a potential problem for auto enrolment (AE) minimum contributions. To ensure increased tax relief (for basic rate payers) turns into increased savings, changes would need to be made to AE minimum contribution levels. For example:

Current basis (marginal rate), AE minimum

Date (phasing)	Employer cont.	Member cont.	Govt cont.	Total
10/12-09/17	1%	0.8%	0.2%	2%
10/17-09/18	2%	2.4%	0.6%	5%
10/18 onwards	3%	**4%**	**1%**	**8%**

If alterations were not made to the minimum levels then although the cost to the member reduces, there is no increase in the amount of saving (which is a key priority):

33% relief, no change to minimum

Date (phasing)	Employer cont.	Member cont.	Govt cont.	Total
10/12-09/17	1%	0.67%	0.33%	2%
10/17-09/18	2%	2.01%	0.99%	5%
10/18 onwards	3%	3.35%	1.65%	**8%**

To ensure that in any move to a flat rate of relief above the basic rate then the AE minimum levels should be changed as follows:

Proposed basis

Date (phasing)	Employer cont.	Member cont.	Govt cont.	Total
10/12-09/17	1%	0.8%	0.4%	2.2% (+0.2)
10/17-09/18	2%	2.4%	1.2%	5.6% (+0.6)
10/18 onwards	**3%**	**4%**	**2%**	**9% (+1.0)**

In the proposed basis the overall total contribution increases due to increasing the gross level of the member contribution while keeping the net member contribution stable.

This increases pension saving without increasing the cost to the member. Should any change away from marginal rate be considered we would propose that this could be done from October 2017 to allow time for employers and providers to update systems and communications messages.