Low Incomes Tax Reform Group
A voice for the unrepresented

Strengthening Incentives to Save for Pensions
Response from the Low Incomes Tax Reform Group (LITRG)

1 We welcome the opportunity to respond to the questions both asked and unasked in the consultation document on strengthening the incentives to save into a pension. The need to make adequate provision for a retirement which can be almost as long as the working life preceding it has become increasingly urgent as longevity expands and state pension, even after the move to the flat rate single tier pension, will require substantial supplement from other sources to sustain what most people would consider a decent standard of living. Both men and women should be preparing to fund 20 or 30 years of post-work life in large part out of their own savings, some of which years may well lack even the prop of the state pension unless they are willing – and able – to work to 67, 68 or later.

2 Executive Summary

2.1 Pension savings is long-term and must therefore offer stability in order to engage the trust of the savers. Rules and systems should only be changed in the future if necessary to ensure improvement, not to meet the passing needs of Chancellors and vagaries of the economy.

2.2 Education in what will be needed to provide an adequate income in retirement and how much must be contributed to produce that pot is essential, especially among those on low incomes who have little to spare in their daily lives and often have a more tenuous grasp of financial affairs.

2.3 Savers must be encouraged to start early, bearing in mind the conflicting pressures of low starting salaries, paying off student loans, saving deposits for a house, starting a family and other more immediate demands on their limited money.

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2.4 Fairness to all and control of public expenditure would be best met by a flat-rate tax relief on pensions contributions regardless of the level of income or employment status of the saver. A 33.3% rate would be an encouraging lift to the basic rate taxpayer while not depressing unduly the contributions of the higher rate taxpayers. It would abolish the complex apparatus of controls and limits currently deployed against higher earners while leaving largely unchanged the system for granting tax relief, thus avoiding costly developments for employers and pension schemes. EET would remain the core principle.

2.5 The ability to save into a specialised "pensions ISA" would add a simple and transparent route via a trusted savings vehicle for those unhappy with a sometimes opaque pensions system. These ISAs would be less likely to be vulnerable to the constant tinkering with the system to which future Chancellors may be prone.

3 About Us

3.1 The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.

3.2 LITRG works extensively with HM Revenue &Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.

3.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

4 General

4.1 It is refreshing to ponder on a consultation document which genuinely seeks ideas about what measures might improve the extent and quantum of pension saving, even to the point of admitting that no change might be a sensible answer. We note that the only serious restriction on suggestions is that any proposals should control the vast cost to the public purse, some £50 billion, in tax subsidy to pension contributions according to the consultation document, although this figure appears to include both employers' exemption from National Insurance Contributions (NIC) on their contributions as well as tax foregone during the investment period. It also excludes tax collected from pensions subsequently paid.[1] We have therefore approached the paper equally open-mindedly, but viewing it from the standpoint of the low income saver with certainly less money to invest and probably less understanding of long-term financial affairs.

4.2 There is, perhaps, an unintentional conflation of the complexities of the current pension system behind the scenes with the straightforward process required of the saver at the point of saving. We discuss this in more detail in our answer to Q1 but there does seem to be a belief in the consultation document that there is a higher degree of complexity to the saver and therefore a greater degree of deterrence from this cause than is actually the case.

4.3 Another point not raised is the place of education in the pension process. It is a commonplace that the earlier a pension scheme is started, the better the outcome even on modest contributions. Even without any tax incentives, the power of compound interest is such that creating the pension saving habit right from the start of employment would probably be the most useful tool in making retirement a secure prospect. The conflicting pressures, however, in a worker's twenties on low or modest starting income of paying the rent, saving for the deposit on a house, paying off student loans, starting a family, combined with the infinitely remote notion of eventual retirement mean that a major campaign would be needed to overcome the immediate financial problems with a view of the world in 40 years time. The HMRC statistics[2] show a noticeable decline in contributions over the decade to 2012 in the 25 – 34 age band. **It is just this generation who should be especially encouraged to make pension provision.**

4.4 We have also taken an overall view of the pension system, combining both the desired simplicity of the savings input and the flexibility of the accumulation stage with the longer term attractions of the decumulation period, a step already partly taken by the pension reforms of earlier this year. We also concentrate on developing the Defined Contribution (DC) approach, give that the rapidly dwindling Defined Benefit (DB) will survive, if at all, only as a small appendix of pension saving. We do, however, recognise that DB will be with us for a long time to come, even if mostly in the public sector, and that this will be a source of complexity in any transitional period. But at all times we keep firmly in mind that the object of the exercise is the provision of sufficient income to maintain a dignified standard of living in the post-work stage of life, an aim which will often conflict with the more immediate savings and rainy-day needs during working life.

4.5 We will now address the questions individually.

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[1] HMRC. Personal pension statistics 27 Feb 2015

[2] Op. cit.

4.6 ***Question 1***

4.6.1 As mentioned above, we do not believe that there are any complexities in the present system for a basic rate taxpayer making contributions to either DB pensions schemes or to DC schemes. The process for the addition of tax relief whether by relief at source or by the scheme reclaiming the basic rate tax element from the Government does not require any involvement by the saver. The cost and effort needed to pay £100 into his pension is identical via either route and in fact minimal beyond reading a payslip for most employer-sponsored schemes or setting up a Direct Debit for the self-employed or for those making contributions outside their employer's payroll. The majority of taxpayers are basic rate (BR) and therefore there is nothing further to do, although the minority of BR taxpayers who complete a tax return, mainly the self-employed, should include the relevant figures there.

4.6.2 Many higher and additional rate taxpayers are already in self-assessment and therefore have merely the extra chore of completing one more box on their return once a year in order to claim the higher tax relief. Those who do not complete a tax return regularly may need to claim the relief separately but the very fact that they are higher earners suggests that they are unlikely to be baffled by the current system of giving tax relief at marginal rates. Similarly BR taxpayers are unlikely to be deterred from saving into a pension by the fact that the Government turns £80 into a £100 in some mysterious and entirely beneficial way.

4.6.3 More importantly, an extensive study by a combined team from Harvard and Copenhagen University[1] discovered that tax incentives in Denmark failed to make any significant impact on 85% of the savers and were exploited mainly by the 15% of financially-aware "active savers" in the higher-income bracket. We believe that the Danish findings can extrapolate to the comparable UK society.

4.7 ***Question 2***

4.7.1 Following on from our comments above, we feel that the question needs expanding beyond the implied tax incentive. If tax is not a primary incentive to save into a pension, then we must unearth what it is that drives such savings or conversely, what deters them.

4.7.2 The Danish research[2] noted that where a Government subsidy was offered to the "passive savers", there was actually a small increase in the overall savings rate, i.e. the savings were not simply shifted from one savings vehicle to another, as was the case with the "active savers". Likewise DWP research[3] showed that whereas before auto-enrolment up to 30% of eligible employees said they might opt out, in practice the overall figure showed only some 9% doing so. This might suggest that inertia could well be the major driving force in getting people to save into a pension, with perhaps the secondary incentive of a Government

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[1] Subsidies v. nudges Nov 2012

[2] Op.cit.

[3] Attitudes to pensions: the 2012 survey

subsidy, currently delivered in the UK as tax relief on contributions. This method of subsidising pensions is, of course, mostly beneficial to higher-rate taxpayers who receive 75% of the total relief.[1]

4.7.3 The low opt-out rate from auto-enrolment points towards people understanding the desirability of having pension income to look forward to while highlighting the faintly regrettable need to serve the opportunity up on a plate in order to encourage them to do something about it. There is certainly simplicity, for employees at least, in the automatic assumption that pension provision is part of the job, just as NIC are taken for granted (another form of compulsory pension provision). What auto-enrolment lacks, however, is the incentive to save enough for retirement, rather than the present and intended increased amounts. Education at the start of pension saving needs two prongs, one to show the desired amounts required at retirement to provide sufficient support for the state pension for an adequate lifestyle, and the other to demonstrate the input necessary during working life to achieve that target. We elaborate on this point in our answer to Q3. Carrots rather than sticks should be waved. Auto-enrolment should provide regular – annual? – statements showing not only what the saver has contributed but also the Government subsidy in whatever form plus a forecast predicting the likely outcome at retirement if present levels of savings are maintained. This could encourage greater personal control over levels of savings if individuals can see clearly where they stand and where they wish to be.

4.7.4 Whatever savings route is taken, whether existing employer schemes, auto-enrolment or personal pension, then any Government subvention can be best offered simply and also better targeted at the low paid in the form of a flat-rate tax relief of, say, 33.3%. While this would have a significant impact on the higher rate savers who gain under the current system, it would not be a complete leveller of all savers since the rich will inevitably stash away more than the poor and will consequently receive top-up in the same ratio. (Doubtless Governments would be keen to apply an annual cap to avoid an open-ended drain on the public purse. This would, of course, be of no relevance or interest to the vast majority who between them earn the national average wage of some £26,000.) The connection, however, between the amount contributed and the state top-up would be much clearer if annual statements showed savers' contributions and Government additions separately and in aggregate. This should form part of the fundamental education programme which must inform any drive to incentivise pensions saving. Such clarity would be especially valuable in enticing the less financially aware or capable into staying inside a pension scheme. For sure, flat-rate tax relief would offer enormous savings to the Treasury who at the moment "top-up" by tax relief the contributions of higher and additional rate taxpayers by nearly 1:1.5 or more. **It would also render unnecessary the complex structure of lifetime allowances, annual allowances, tapering allowances, individual protection and the uncertainty of the ultimate valuation of both DB & DC pensions pots.**

[1] PPI: Tax relief pension saving in the UK, July 2013

4.7.5 Such subsidy would also have the benefit of applying equally to the employed and self-employed in that the support goes to the amount saved regardless of the scale of earnings or tax due. Pensions would be removed entirely from self-assessment returns and indeed remove some higher rate taxpayers from self-assessment if the sole requirement of their return is to adjust tax relief on pension contributions. There would be no need to change the simple systems already in place for employers to deduct at source or for the self-employed and personal pension savers to set up direct debits or pay periodic lump sums.

4.8 ***Question 3***

4.8.1 Responsibility requires two necessary conditions. First, an understanding of the matter and secondly, capability to act on that knowledge. In the matter of pensions the former demands not so much as a grasp of the technical workings of the accumulation, investment and decumulation processes, but rather a realisation that retirement has to be funded and that the flat rate state pension alone is going to fall far short of the income needed for an adequate retirement. The abolition of various forms of state second pension and contracting in or out has removed a considerable cushion of extra income for future pensioners, hitherto funded semi-automatically by deductions from pay at source. Savers must understand that this income at the least must be replaced and preferably topped-up. **Education – a word glaringly absent from the consultation paper – has to play a key role in getting this idea across**, especially to the young who generally both lack money and a realistic understanding of the far-distant world of post-work. Education must not only spell out that they must put money aside now for their (much) later years but also demonstrate that the effect of compound interest means that delaying starting paying into a pension scheme by ten years requires contributions of nearly double to achieve the same final pot. Simple charts showing the long-term benefits of, say, £50 a month saved from age 25, plus, of course the Government top-up of perhaps £25 should supply an attractive carrot.

4.8.2 The second condition, of course, can only be fulfilled if the would-be saver has any spare money after paying for food and shelter, repaying loans and debts and saving for immediate needs like the deposit for a house or starting a family. Pension schemes must therefore be better geared towards accepting low start contributions (cf the old-style low-start endowment policies), especially from those in their twenties, and make it easy to increase or index the contributions. Some set too high a minimum monthly or lump sum contribution for the low paid. This is detrimental to those on low wages, zero hour contracts or part-timers. We have noted above the serious decline in contributions by this generation. In the case of company and auto-enrolment schemes, this process happens automatically with pay rises but for those paddling their own canoe, the processes need to be made attractive or semi-automatic to prevent savers sticking to their original £50 a month for the rest of their working life. In particular we put forward for consideration the proposal that younger savers should receive a greater Government top-up, e.g. at age 30 a further percentage bonus could be added to the sum already saved. A savings habit started early is more likely to be continued during working life.

4.9 ***Question 4***

4.9.1 It is not obvious that this question is relevant to the main theme of this consultation. If it refers to the method of decumulation of retirement savings, then that has already been addressed by the pension reforms of this year. If it is simply asking what people want to spend their savings on, for instance a Lamborghini or supporting a donkey sanctuary, then the question is covered by Q3 "saving an adequate amount for retirement". For most people the need is to accumulate enough money to enable them to lead something a bit better than mere survival for the rest of their days and therefore the question comes back to "**how do we encourage people to save enough for retirement**", not just "how do we encourage them to save for retirement".

4.10 ***Question 5***

4.10.1 There is no obvious reason why the different outcomes of DB and DC schemes should mean that the input benefits should be different. If Government wishes to provide incentives to save for retirement, then those incentives should be the same for everyone contributing to an approved scheme.

4.11 ***Question 6*** – No comment

4.12 ***Question 7***

4.12.1 There could be a case made for requiring employers with their own company pension schemes to make contributions in line with those made under auto-enrolment as a minimum. It is very noticeable that employer contributions to DC schemes are much lower than those they make to DB schemes,[1] although that may be in part because of the greater commitment of DB employers to the benefits given. Since employer contributions are an added cost on top of salaries, it would seem fair that exemption from NIC would, if not incentivise employers, at least not penalise them for their further expenditure.

4.13 ***Question 8***

4.13.1 If the current system is to be reformed at all, it should encourage individual responsibility by offering a product that is trusted as a financial vehicle in accumulation and flexible at the point of decumulation. A major step has been taken this year on the second point but there is a long way to go in restoring trust in pensions, too often regarded as a poor value way of delivering the desired income in retirement and locking away savings until some remote time. There is, however, a trusted financial vehicle in the form of ISAs which have proved very successful. It is important, in the context of this possible reform, to examine why ISAs have been so successful – and see if that has lessons for the pensions reforms.

4.13.2 We think that ISAs are seen as:

[1] ONS: Pension trends 2013

- Simple
- Transparent
- Under the saver's control
- Accessible
- Safe

4.13.3 In their present form ISAs would lack the essential condition that retirement income should be inaccessible until a certain age but the possibility of a 'pensions ISA' may be worth investigating, perhaps developed separately on the lines of Help to Buy ISAs. There would be a greater sense of ownership than with pension schemes, greater understanding and perhaps greater confidence.

4.13.4 Even if the current EET basis is maintained, the 'pensions ISA' concept still has merit: saving into the pensions ISA would attract a top up through tax relief; there would have to be controls to the extent that withdrawing funds from the ISA before a statutory pension age would cause a withdrawal of the top-up by the government.

4.13.5 The saver would have the choice during their working lives as to how much they would put into which segment of their ISA according to their needs at the time. Perhaps this places too much faith in people being able to balance their immediate needs against their future needs, but the annual statement would show very clearly how much they held in each part and also the amount of Government subvention to the retirement pot. We are, after all, trying to get people to take personal responsibility. Auto-enrolment has shown encouraging results so far in engagement but the main problem is in trying to get people to save enough for retirement and early enough rather than whether they save at all. The transparency of an ISA plus the knowledge that all drawings would be free of tax could provide the incentive needed.

4.14 We should, however, add an answer to a question not asked: **it is of the highest importance that certainty and stability are offered to the would-be savers**. So many changes have taken place over the last decade in pensions legislation that savers must feel sure that what they are saving into and the future benefits will not be further manipulated by Governments to come. We have emphasised the importance of education and communication in any changes to pension saving. Of equal importance is trust in the system, especially a system offering such long-range benefits. This means that there must be guarantees (as far as possible under our form of government) that the future benefits already secured by contributions will remain in place even if changes further down the line, almost inevitable, make for more uncertain or lower outcomes. Savers today have seen during their working lifetimes the constant changes to Retirement annuity contracts and personal pensions, final and average salary schemes, contracting in and out, SERPS and State Second Pensions, survivors benefits and the forthcoming major change to the State pension. They have seen in recent years the constant changes in tax policy with authorised and unauthorised payments, with Lifetime allowances yo-yoing up and down, annual allowances shrinking, the Government hit on investments in pension schemes, the constant undercurrent of threats to the tax-free lump sum. All these undermine faith and trust in providing for retirement. **Any**

reforms must recognise that lack of trust can disincentivise just as much as carrots can incentivise.

4.15 The sense of control over their retirement savings in both what they put in and what they can do when they take it out combined with the transparency of their own “superISA” would encourage greater personal responsibility for autarky in later life. One company[1] reports that so far since pensions reform in April while 8% were taking out an annuity and 15% went for UFPLS, an overwhelming 77% were choosing to remain invested in the markets via drawdown. If savers can trust the Government not to undermine their retirement savings and Government can trust the savers to handle their savings responsibly, then there is a strong foundation for developing a sustainable pension system.

LITRG
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[1] Hargreaves Lansdown: Pensions freedom. The first 100 days 15 July 2015