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COSTLY AND INEFFECTIVE

WHY PENSION TAX RELIEFS SHOULD BE REFORMED

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SUMMARY

- Today's incentives to save for retirement are essentially financial. They comprise:
  - tax relief on contributions (cost: £26.1 billion in 2010-11)
  - a tax-exempt 25% lump sum at retirement (£2.5 bn)
  - NICs relief on employer contributions (£13 bn) and
  - tax relief on investment income (£6.8 bn).
- Over the last decade, relief on income tax and NICs has totalled £358.6 billion, (excluding tax foregone on the tax-exempt 25% lump sum).
- Over the same decade, the Treasury's cost of funding tax relief (i.e. the yield on gilts) averaged a real 3.9% per annum, yet the average real annual return on all UK pension funds was a paltry 2.9%, i.e. 1% per annum *less*. Thus, the return on the Treasury's co-investment with people saving for retirement, through the medium of tax relief, has been *negative* £17.5 billion. With most gilts being purchased by pension funds, this is partly explained by industry charges.
- These tax incentives are clearly flawed:
  - they are crude and mis-directed (primarily towards the wealthy)
  - they lack any emotional resonance and
  - they do little to encourage a savings culture amongst younger workers.
- The savings incentives framework should be radically realigned. This paper's nine proposals are listed overleaf, and include:
  - combining the annual contribution limits for ISAs and tax-relieved pension saving into a single limit of between £30,000 and £40,000 (saving between £1.8 bn and £600 mn annually, respectively). The full limit should be available for ISA saving;
  - shelving higher rate tax relief, thereby saving £7 billion annually but, as a partial *quid pro quo*, reinstating the 10p tax rebate on pension assets' dividends and interest income, at a cost of roughly £4 billion per year; and
  - replacing the 25% tax-free lump sum concession with a 5% "top-up" of the pension pot, paid prior to annuitisation. This would be cost neutral.

SUMMARY OF PROPOSALS

Proposal 1: The annual contribution limits for ISAs and tax-relieved pensions saving should be combined at between £30,000 and £40,000, with the full limit available for saving within an ISA. This combined limit could be used as a key cost control lever, with adjustments to it (driven by affordability) becoming a regular feature in the Budget.

Proposal 2: Higher rate tax relief should be abolished, the annual £7 billion saving being partly used to reinstate the 10p tax rebate on pension assets' dividends and interest income (costing some £4 billion). Alternatively, this would more than meet the cost of foregone tax on dividends and income, were the ISA subscription cap raised to £30,000 to £40,000.

Proposal 3: The Chancellor should consider replacing all income tax relief with a single flat rate of 25%, or even 30%. This would particularly incentivise low earners to save for retirement. Costs could be controlled by adjusting the annual contribution limit on which relief could be gained.

Proposal 4: The 25% tax-free concession on lump sum withdrawals at retirement should be replaced with a "top-up" of 5% of pension pot assets, paid prior to annuitisation.

Proposal 5: To be eligible to make any lump sum withdrawal at retirement, the individual should meet the Minimum Income Requirement of £20,000 a year (subject to trivial commutation rules).

Proposal 6: Salary sacrifice schemes are essentially a tax arbitrage at the Treasury's expense. As such, their cost should be reflected alongside income tax relief, to provide a clearer picture of the total cost of tax-based retirement saving incentives. A simplification step would be to ban them.

Proposal 7: The rate of tax relief on contributions to children's pensions should be increased to 30%, irrespective of the donor's marginal rate of income tax.

Proposal 8: Employers should be incentivised to encourage basic rate taxpaying employees to boost their pension contributions. This could take the form of a 5% distribution reward from the Treasury, paid in respect of employee contributions above 4% of band earnings, say.

Proposal 9: "Safe harbour" guidelines (not regulation) should be swiftly introduced (not least because of the onset of auto-enrolment), to exempt employers from class actions, provided it can be demonstrated that they were acting in good faith.

1. INTRODUCTION

Today's incentives to save for retirement are essentially financial, comprising tax relief on contributions, the tax-exempt 25% lump sum at retirement, and NICs relief on employer contributions. They are crude and mis-directed (primarily towards the wealthy), their effectiveness is woefully under-researched and they lack any emotional resonance. Behavioural traits, such as loss aversion and hyperbolic discounting, have far more influence on savings behaviour than financial rationale.

The challenge is to design incentives that resonate with what matters to people, not least because the underlying objective is, unwittingly, to move them into the clutches of an industry that is widely distrusted. Furthermore, the products are often mind-numbingly complex because of, principally, their multi-various tax treatments. It is no surprise that consumers are bewildered, not least because product pricing signals are almost irrelevant. Unlike almost all other consumer decisions, the outcome of any purchasing decision is typically unknown until perhaps decades later.

Furthermore, the framework of saving incentives (as well as some aspects of the State Pension) is entangled with unrelated objectives (often political), notably wealth redistribution; this adds to complexity. Ideally, wealth redistribution should be confined to the income tax framework.

There is also a moral perspective to consider. We should, for example, question whether tax relief is an incentive (i.e. morally neutral) or a bribe, mindful that the Government would like people to save for retirement to help reduce the social welfare bill. But for people who are regularly servicing consumer loans or credit card debt (average APR of 18% per annum), saving is unlikely to be in their best interests. It would be better to repay such debt; basic rate taxpayers would effectively be generating a risk-free, pre-tax annualised return of 22%: "negadebt" (negative debt) saving.

2. TAX RELIEF

(a) Hugely costly

The state invests a huge amount in tax relief, primarily in the form of up-front income tax relief on employee and employer contributions (at a cost of £26.1 billion in 2010-11). NIC relief on employer contributions totalled a further £13.0 billion.[1] To put this into context, this is equivalent to the UK defence budget (£40 billion), and is 70% more than the Government spent on Transport in 2011-12 (£23 billion).[2] An additional £6.8 billion was spent on tax relief on investment income; the cost of relief in respect of capital gains realised by pension funds is deemed too difficult to estimate.

(b) What is the purpose of tax relief?

Before savaging tax relief, its purpose should be debated. The state's main motivation for encouraging savings is to mitigate future social security costs, necessary to alleviate pensioner poverty. Given that the effect of these costs is likely to increase with old age, the state has an incentive to encourage retirement savings ahead of discretionary (rainy day) savings with their ready access. But the current distribution of tax relief is heavily skewed towards the well-off; the 8% of taxpayers who earn more than £50,000 per annum receive almost 50% of all pensions tax relief.[3] Clearly, reducing pensioner poverty is not the result. Indeed, one

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[1] HMRC; *Registered pension schemes: cost of tax relief, Table Pen 6,* February 2012.

[2] HM Treasury; *Budget 2011.*

[3] HMRC; *Survey of Personal Incomes 2009-10*, Table 3.5, Income and deductions, 2012. (It is accepted that this distribution is not surprising given that the wealthy pay more into a pension and their relief is at higher rates of tax.)

could conclude that tax relief serves as a reverse form of wealth redistribution (the conventional approach being to favour the poor). Arguably, the wealthy do not need such an incentive to save, and even if it were deemed appropriate to reduce their tax burden, why not democratise the benefit by ending higher rate relief and simply cut the higher rate of income tax?

A thorough reappraisal of up-front tax relief is required (investment income should remain untaxed, and reinstating the 10p rebate is further discussed, below). *In extremis*, it could be abolished, the £26 billion annual saving being used to boost the basic State Pension (BSP, expected to cost some £63 billion in 2012-13) by roughly 40%. Such an approach would be beautifully simple and, crucially, politically appealing, the beneficiaries (future pensioners) outnumbering the recipients of tax relief. Furthermore, such a move would catalyse a virtuous circle, by dramatically reducing the annual bill for Pension Credit (more than £8 billion, annually, including Guarantee Credit). A saving in administration costs would also emerge, releasing yet more funds. Ending tax relief would also represent a significant simplification of our income-in-retirement framework, whilst removing a state-funded pit prop of what is, in parts, an ailing industry.

(c) The Treasury's perspective

(i) Higher rate tax relief is, usually, not taxation deferred

The proponents of higher rate relief (let us not forget that it a major lubricant of the industry) claim that tax is merely being deferred. The data does not support this assertion. The Treasury is effectively co-investing with recipients of higher rate relief, anticipating repayment through post-retirement income tax. But only one in seven of those who pay higher rate tax whilst working, go on to pay higher rate tax in retirement. From the Treasury's perspective, this is a bad deal; higher rate tax relief is a huge cost to the state, not an investment.

(ii) Tax relief: eroded by industry charges

The most damning aspect of tax relief is that over time it could be entirely consumed by industry charges. Consider a single contribution of £100 net, paid into a pension fund by a higher rate taxpayer. This is grossed up to £166.67p by 40% tax relief. Assume that the assets subsequently return 2.9% per annum (i.e. the average real annual return of UK pension funds over the last decade[4]), *after* deduction of an Annual Management Charge (AMC) of 1.5% per annum (which is typical). Every year thereafter, the industry deducts its AMC from the pension fund. Within 37 years, 40% of the total cumulative AMC exceeds the tax relief initially contributed by the Treasury.

Transaction charges add 0.7% per annum in costs, based upon UK pension funds' average portfolio turnover of 128% each year (i.e. holdings are kept for an average of just nine months).[5] The time required for 40% of the cumulative AMC to erode all of the tax relief then reduces to less than 29 years, i.e. less than the timeframe over which many people save for a pension.

[4] The CityUK; *Pension Markets 2012 report*, March 2012.

[5] SCM Private analysed 1,287 individual pension funds comprising £392.5 billion of assets; see *Research into dealing activity and costs of UK individual pension funds*, November 2011.

(iii) The industry is failing the Treasury

Over the last decade, the Treasury has provided tax relief totalling £262 billion (on contributions and investment income), plus another £96.6 billion in NIC relief (i.e. tax foregone) on employer contributions.[6] This will have been funded through gilts issuance, at a real cost, over the last decade, of 3.9% per annum; see Table 1 below.

Thus, the cost to the Treasury of financing tax relief is 1% *more* than the average annual real return on all UK pension funds over the same period. Table 2 shows how this 1% *per annum* "loss" on its "investment" has accumulated over the last decade, to total £17.5 billion.

In other words, over the last decade, the return on the Treasury's co-investment with people saving for retirement, through the medium of tax relief, has been a *negative* £17.5 billion. This is explained by two principal factors:

(i) pension fund returns have been dragged down by the poor performance of equities; and

(ii) industry charges, evidenced by the fact that many of the gilts issued to finance tax relief are held by pension funds (and increasingly so, in light of the trend in portfolio de-risking).

Certainly, a significant portion of the £17.5 billion has simply passed from the Treasury to the industry (and a similar conclusion is reached when considering other timeframes). Perhaps this is today's version of Keynesian economics.

(d) Generation Y's perspective

The word "pension" does not resonate with Generation Y. The lure of tax relief is insufficient to overcome the aspiration to own a home, the need to repay college debt and the financial myopia of the "spend-now" culture, as well as pension products' inflexibility. The Government's stance, opposing early access to pension funds prior to retirement, is regrettable, and the pension industry's support for this is short-sighted, and perhaps even suicidal. It risks the younger generation never engaging with retirement saving; indeed, the challenge is to encourage them to save at all.

[6] HMRC; *Registered pension schemes*, *Table Pen6,* February 2012.

Table 1: Real investment returns over different timeframes (% p.a.)

Asset class	2011	10 years	20 years	50 years	112 years
Shares (equities)	-7.8%	1.2%	4.8%	5.3%	4.9%
Gilts	15.8%	3.9%	5.9%	3.1%	1.3%
Corporate bonds	1.6%	1.6%	-	-	-
Index-linked gilts	14.4%	4.0%	5.0%	-	-
Cash	-4.1%	0.2%	2.1%	1.6%	0.9%

Source: Barclays Capital; *The Barclays Capital Equity Gilt Study 2012.*

Table 2: Tax relief: the cumulative cost to the Treasury (£, billion)

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10p	2010-11p	Total
Total tax relief	£17.6	£18.6	£20.4	£23.4	£26.9	£30.0	£30.7	£29.7	£31.8	£32.9	£262.0
NIC relief	£5.4	£6.2	£7.3	£8.4	£9.8	£10.4	£11.7	£11.5	£12.9	£13.0	£96.6
Cumulative total	£23.0	£47.8	£75.5	£107.3	£144.0	£184.4	£226.8	£268.0	£312.7	£358.6	-
1% of cumulative total	£0.2	£0.5	£0.8	£1.1	£1.4	£1.8	£2.3	£2.7	£3.1	£3.6	£17.5

Source: HMRC; *Registered pension schemes*, Table PEN6, February 2012

In the meantime, basic rate taxpayers are increasingly convinced that the lure of 20% tax relief on pension contributions is insufficient to overcome pensions' lack of flexibility. Immediate access to savings is, for most people, the first priority. Industry surveys[7] confirm people's preference for ISAs over pensions; ISAs are immensely popular (the brand is perhaps the only remaining trusted brand in the savings arena). In 2010-11, £53.9 billion was subscribed to more than 14 million ISA accounts, without the bribe of up-front tax relief, whereas some £22.9 billion of employee contributions went into occupational and personal pensions (excluding SIPPs).[8] Indeed, last year, for the first time, more was invested in Stocks and Shares ISAs (£15.8 billion, up 26% on the previous year) than personal pensions (£14.3 billion), in spite of the latter having the added attraction of up-front tax relief.

Whilst ISAs offer ready access, they are increasingly being considered as part of retirement saving. Furthermore, ISA withdrawals are tax-free (unlike income derived from a pension), and it is in retirement, when incomes are lower, that people need a lower tax burden.

Consequently, the annual contribution limits for tax relief on ISAs and pensions saving should be combined, with the full limit available for saving within an ISA. Furthermore, the annual contribution limit on which relief could be gained (currently £50,000 for pensions, irrelevant to 99.5% of the population) should be reduced, perhaps to £30,000, and certainly no more than £40,000, *including* ISA investment. This would reduce the up-front cost of these financial incentives by between £1.8 billion per annum and £600 million per annum respectively (which would be marginally eroded by a small additional, on-going, cost of ISA-derived income being tax-free). Note that investment limits for tax-advantaged products should be simple, round numbers, rather than, for example, the ISA limit for the 2012-13 tax year of £11,280.

A combined tax-advantaged investment limit of £40,000 could become a key cost control lever, with adjustments to it (driven by affordability) being a regular feature in the Budget. Any unused allowance could perhaps be "carried forward" on a rolling three year basis.

Proposal 1: The annual contribution limits for ISAs and tax-relieved pensions saving should be combined at between £30,000 and £40,000, with the full limit available for saving within an ISA. This combined limit could be used as a key cost control lever, with adjustments to it (driven by affordability) becoming a regular feature in the Budget.

Subsequently, up-front tax relief could be whittled away entirely (remember mortgage interest relief?) as the next generation places an increasing emphasis on ISAs for their retirement income, ideally built upon a bedrock of income certainty provided by a higher State Pension (as envisaged in a DWP's green paper[9]). The pensions industry would then need to refocus on delivering high quality asset management of (long-term) savings, the word "pension" having been consigned to history.

[7] For example, more people (38%) view cash savings (including ISAs) as a better route to a reasonable standard of living in retirement than personal pensions (30%). Source: Scottish Widows, *UK Pensions Report 2009,* June 2009.

[8] HMRC; *Individual savings accounts,* Table 9.4, 2011; and *Pension Trends*, Chapter 8, Pension contributions, Table 8.3, 2011.

[9] DWP: *A state pension for the 21st century*, April 2011.

(e) The end of tax relief: gently does it

(i) End higher rate tax relief

The immediate abolition of all tax relief on pension contributions would not be politically pragmatic; a multi-step process is required, starting with putting an end to higher (and additional) rate relief. Limiting tax relief to 20% would save the Treasury around £7 billion per year; to be clear, this is an annual saving, repeating itself year after year. In return for the removal of higher rate relief, there are a number of *quid pro quos* that the Government could consider offering, including:

- **reinstating the 10p tax rebate on pension assets' dividends and interest income** (at a cost of roughly £4 billion per year); i.e. such income should be *truly* tax-free for pension funds.[10] Retaining additional income within pension pots would ensure that the positive power of compounding benefits the individual, rather than the Treasury; and
- **dramatically increasing the annual ISA subscription cap, to £30,000 to £40,000, say**, as per Proposal 1. The cost to the Treasury would be limited to taxation foregone on dividends and income within the ISA wrapper.

Given that prevailing interest rates and dividend yields are currently so low, now would be a relatively cheap time to implement both these proposals. Furthermore, although the cost would increase with rising interest rates, this would probably coincide with a strengthening economy; affordability would be less of an issue.

Proposal 2: Higher rate tax relief should be abolished, the annual £7 billion saving being partly used to reinstate the 10p tax rebate on pension assets' dividends and interest income (costing some £4 billion). Alternatively, this would more than meet the cost of foregone tax on dividends and income, were the ISA subscription cap raised to £30,000 to £40,000.

A further reason for ending higher rate tax relief is that for many higher earners it is, in reality, an extension of their tax planning arrangements, rather than being primarily considered as an incentive to save.

(ii) A higher flat rate for tax relief?

A flat rate of tax relief, of 25% or even 30%, irrespective of the saver's marginal rate of income tax, could be considered as an alternative to 20% for everyone, if it were deemed appropriate to further incentivise low earners. Costs could be controlled by adjusting the annual contribution limit on which relief could be gained. Irrespective of the level of any flat rate for tax relief, it should not be less than the maximum rate of income tax that pensioners could face, thereby retaining high earners' interest in saving within a pension product.[11]

Proposal 3: The Chancellor should consider replacing all income tax relief with a single flat rate of 25%, or even 30%. This would particularly incentivise low earners to save for retirement. Costs could be controlled by adjusting the annual contribution limit on which relief could be gained.

[10] In 1997 Gordon Brown scrapped the 10p rebate on dividends, thereby effectively imposing a 10p income tax on what were supposedly non-income tax paying bodies, notably pension funds. Estimates vary as to how much the Treasury has subsequently benefitted, with a corresponding reduction in the value of retirement funds; figures vary between £150 billion and £225 billion, to the detriment of millions of savers and pensioners.

[11] Note that today's savers are making a leap of faith that in future, the basic rate of income tax will remain at 20%, but today's level is a historic low (ignoring the previous Government's very short term dalliance with 10%). Tax relief at 20% and pensioner income tax capped at 20% could be marketed as "20:20 vision".

As an aside, it is acknowledged that a flat rate of tax relief in excess of the standard rate of income tax would comingle wealth redistribution with a saving incentive, at the price of additional complexity. There are other permutations for the future of tax relief, which would save the Treasury a lot of money without materially reducing most people's incentive to save for retirement. These are more fully discussed in a prior paper.[12]

(iii) Re-characterise tax relief?

More than three-quarters of non-pension savers are ignorant of the contribution from tax relief.[13] Given this, tax relief should be re-characterised to aid communication. A number of alternatives have been suggested, including:

- **a matched savings scheme,** whereby for every £1 added to a pension pot, the state puts in a fixed additional amount, irrespective of the saver's marginal rate of income tax.[14] This would be more progressive than the current system, and the state's contribution to each individual could be capped to control the total cost;

- **a "no-lose lottery",** such as guaranteeing people a 50p return (which would then be automatically added to their savings) on their £1 "ticket" (the ticket price being retained within the asset pot)[15]; and

- **a persistency bonus** to tackle short-termism. Initially set at zero, the bonus would grow over time as funds are left *in situ*, thereby encouraging people to save for the long term.

[12] Michael Johnson; *Simplification is the key,* CPS, June 2010.

[13] A Standard Life survey (March 2012) found that 77% of people aged 18 to 65 who do not currently save for retirement are oblivious that for every £4 they invest in a pension, the government contributes at least another £1 in tax relief.

[14] Proposed in the Social Market Foundation's' report *Savings on a shoestring: a whole new approach to savings policy*, July 2011.

[15] Based on an idea from Ros Altmann, Saga Director-General.

3. OTHER INCENTIVES

(a) The 25% tax-free lump sum: replace it with a pre-annuitisation reward

Another tempting target for the Treasury is pension savings' 25% tax-free lump sum (at retirement), costing some £2.5 billion per annum in foregone income tax. Encouraging the withdrawal of a tax-free lump sum is a bizarre way of encouraging people to build up a pot of assets to subsequently provide a regular annual pension income. Furthermore, to Generation Y, the prospect of 25% of some distant, uncertain return being free of tax is unlikely to change behaviour in respect of saving within a pensions framework. As an incentive for long-term saving, it is wholly ineffective.

Given that the objective for retirement saving is to supplement the basic State Pension, perhaps the expense of the lump sum tax concession should be reallocated to increasing people's annuities? A 5% pre-annuitisation "reward" (or "top-up") of the pension pot would, for basic rate taxpayers, be equivalent in value to the lump sum tax concession (which today saves them 20% income tax on 25% of the pension pot, i.e. 5%).[16] This would be of much more lasting benefit, to most people, than the 25% lump sum's tax concession.

> **Proposal 4**: The 25% tax-free concession on lump sum withdrawals at retirement should be replaced with a "top-up" of 5% of pension pot assets, paid prior to annuitisation.

Many would agree that retaining the £2.5 billion per year within people's annuities would be a

[16] *Tax by Design (the Mirrlees Review); Chapter 14, Reforming the Taxation of Savings*, September 2011.

much better use for it than simply returning it to the Treasury (by simply ending the 25% tax-free concession). Payment of the "top-up" would be delayed if annuitisation were postponed (perhaps because the £20,000 Minimum Income Requirement (MIR) had been exceeded).[17]

(b) The Minimum Income Requirement should be extended to lump sums

Retaining the 25% lump sum within the pension pot would enable people to buy a larger lifetime annuity, i.e. a 25% larger pension than otherwise. Furthermore, research by Prudential shows that 79% of pensioners drawing a company or private pension in 2011 took a lump sum from their fund at retirement… and 10% regret doing so. People are increasingly questioning the wisdom of having taken the lump sum and spending it (perhaps frivolously), not appreciating, at the time, the corrosive impact that this would have on their retirement income.

Given this, it would make sense to also apply the MIR to taking income via flexible drawdown.

> **Proposal 5**: To be eligible to make any lump sum withdrawal at retirement, the individual should meet the Minimum Income Requirement of £20,000 a year (subject to trivial commutation rules).

(c) Salary sacrifice: an arbitrage at the Treasury's expense

Salary sacrifice schemes are offered by employers as a means to save on National Insurance Contributions (NICs), both for employer and employee. Some employers then pay all or part of their NICs saving into the pension plan, thereby increasing contributions. The structure's popularity is rising; 55% of companies offer it, either automatically or as an option for employees (43% in 2009).[18]

Essentially, instead of an employee paying his own contributions, they are paid on his behalf by the employer, the employee's pay being reduced by the same amount. Thus, the employee swaps some of his gross pay for pension contributions; less gross pay means that he (and the employer) pays less NICs and, in addition, some employees will fall into a lower income tax band.

Consequently the Treasury is foregoing NICs and income tax revenue; salary sacrifice schemes should be reported alongside tax relief, to provide a more accurate picture of the cost of incentivising pension saving. Indeed, it would be better if all tax-based retirement savings incentives were consolidated into a single mechanism, the cost of which could then be properly controlled.

> **Proposal 6:** Salary sacrifice schemes are essentially a tax arbitrage at the Treasury's expense. As such, their cost should be reflected alongside income tax relief, to provide a clearer picture of the total cost of tax-based retirement saving incentives. A simplification step would be to ban them.

(d) Employee share ownership schemes

There are four different types of HMRC Approved Share Plans[19] providing tax-efficient savings

[17] The MIR is the amount of secured pension income that a member must have for life, to draw an income via flexible drawdown. The £20,000 requirement is to be reviewed by the Government in the 2015-2016 tax year. Income payments that count towards the MIR include the basic State Pension, State Second Pension (S2P), lifetime annuities and scheme pensions.

[18] *Source*: Punter Southall Group; *DC pensions in the UK workplace: corporate DC survey results*, March 2010.

[19] Save as you Earn (SAYE) Savings-Related Share Option Scheme ("Sharesave"), Share Incentive Plans (SIP), Company Share Option Plans (CSOP) and Enterprise Management Incentives (EMI).

mechanisms. They encourage medium- and long-term saving amongst many low and middle income earners[20] but, collectively, provide administrators with a minefield of complexity. The Treasury has, quite rightly, requested that the Office of Tax Simplification (OTS) look at simplifying the Share Plan tax arrangements, reporting to ministers in 2012.

(e) Incentives that resonate with behaviour

(i) Acknowledge that people value certainty

Tax relief is a reward for completing an activity, but it does not lead to any certain outcome. Perhaps tax relief should be replaced with an incentive that provides certainty, in what would otherwise be a DC (i.e. uncertain) pension pot? For example, the annual £21 billion currently directed to income tax relief on employee contributions could, instead, be used to subsidise the purchase of deferred annuities from the Treasury, i.e. certain income commencing at retirement. If done on an unfunded basis, the Treasury would enjoy an immediate cashflow benefit; this would also end the erosion of invested tax relief, care of annual industry charges.

(ii) Harness the emotional power of family

The current spend on tax relief could be redeployed towards incentives that span the generations. Leaving something for children (and grandchildren) is a powerful motivator, so why not permit pension assets to be bequeathed free of Inheritance Tax (IHT) limits and the seven year rule? Provided that the assets could only go into the recipients' pension savings, this would encourage a *controlled* trickle-down of wealth through the generations, and reinforce a sense of personal ownership of pension savings. This would, however, only benefit the relatively rich, i.e. those with estates in excess of the IHT threshold.[21]

A more egalitarian approach to combining a financial incentive with an emotional one would be to extend the current arrangement whereby parents can make contributions to a child's pension, up to £2,880 per year (i.e. below the £3,000 annual gift limit for inheritance tax), topped up by 20% tax relief, to £3,600. The investments then grow free from income and capital gains tax.

Irrespective of the donor's marginal rate of income tax, why not increase the tax relief rate to 30%, say? The additional cost could be easily met by eliminating all higher rate tax relief (as proposed above). This would represent a potentially significant step towards redressing the looming generational injustice, as well as enabling the recipient to harness the positive power of compounding over a very large timeframe (although few children would appreciate this at the time!).

Proposal 7: The rate of tax relief on contributions to children's pensions should be increased to 30%, irrespective of the donor's marginal rate of income tax.

Policy makers interested in cross-generational incentives should consider that Generation Y could be the first generation to experience a deterioration in their quality of life, relative to their parents (baby boomers and Generation X[22]). This trend, acknowledged by the politician David Willetts[23], could be accompanied by the emergence of inter-generational antagonism,

[20] A third of employees saving in an SAYE scheme, for example, earn less than £21,000. *Source*: ifs ProShare.

[21] £325,000 for 2012-13.

[22] Baby boomer were born between 1946 and 1964, Generation X from the early 1960s through to the early 1980s.

[23] David Willetts; *The Pinch: How the Baby Boomers Took Their Children's Future – And How They Can Give it Back*, 2010.

as well as disillusionment amongst the young (having grown up adjacent to their (affluent) parents, thinking that all will be well).

Policymakers should bear in mind that when seeking to encourage people to save, the optimal messengers are people they respect; often older family members (rather than politicians, say). In the meantime, we are already seeing a marked increase in grandparents making financial commitments to support Generations Y and Z (people born since the early- to mid-1990s, also known as the Internet Generation).

4. EMPLOYERS MATTER: INCENTIVISE THEM

(a) NICs relief on employers' contributions: retain it

Employers' contributions perform a crucial role in supporting occupational pension schemes, and encouraging people to save. But the biggest source of decline in pension saving, between the early 1980s and 2000, was a contraction in (private sector) employer pension contributions. Subsequent increases were largely due to the need to reduce scheme deficits in respect of benefits already accrued, rather than future accruals.

But, recently, a new impetus for employers to increase their engagement with pensions has emerged. It stems from the growing realisation that employees' lack of future retirement income will become the employers' problem too. The average annual amount paid from DB pension schemes will peak in 2012, at £7,100, but fall thereafter, to £2,400 by 2060, a consequence of only 10% of DB schemes still being open.[24] This decline of DB provision in favour of DC is moving the deleterious consequences of the industry's inefficiencies and conflicts of interest from employer to employee. Consequently, a growing elderly workforce will become unable to retire (and cannot be forced to, the Default Retirement Age having been scrapped). This will exert a financial cost on employers, which could (belatedly) trigger a resurgence in schemes offering more than just pure DC provision. Cash balance pension funds, for example, could become the model for future provision, usually providing an improvement over DC schemes; Morrisons, the supermarket chain, launched such a scheme in early 2012.[25]

There is little doubt that policies which encourage greater employer engagement with pensions will increase employee pension savings. Consequently, NICs relief should be retained; indeed, perhaps employers should be *further* incentivised to support retirement saving?

(b) A distribution reward?

Although employers may be reluctant stakeholders in the retirement savings arena, their engagement is hugely beneficial to society. In 2009 they contributed £36.3 billion to funded occupational pension schemes and £9.7 billion to personal pensions (employees contributed £6.6 billion and £9.3 billion, respectively).[26] Emotionally, however, employers have been disengaging from pensions for decades; witness the demise of DB schemes. But the advent of auto-enrolment moves employers (consciously, or not) into the

[24] DWP; *Evolution of Pensioners' Income from Defined Benefit schemes*, March 2012.

[25] Cash balance schemes accumulate contributions in employees' retirement accounts, the employer providing an assured rate of return until retirement. At retirement, the "cash balance" is passed to the retiree who then, typically, uses it to purchase an annuity at the prevailing market rate. Employees assume their own longevity risk thereafter, arguably the most significant component of the total risk.

[26] ONS; *Pension Trends Chapter 8: Pension contributions*, *Table 8.13*, September 2011.

distribution arena, essentially acting as agents of the state, particularly in respect of those whom the industry finds hard to reach.

Today, the only explicit incentive for employers to participate in pensions is NICs relief on their contributions (£13 billion in 2010-11). It would makes sense for the state to harness the strong relationship between employee and employer (something that the industry rarely enjoys with consumers), and reward employers who succeed in encouraging their employees to increase their pension contributions.

An initiative such as this requires a cautious approach. It should be focused only on basic rate taxpayers (who are more likely to fall into the category of those who "save something, but not enough"), with the incentive paid in respect of employee contributions above 4% of band earnings, say.

> **Proposal 8**: Employers should be incentivised to encourage basic rate taxpaying employees to boost their pension contributions. This could take the form of a 5% distribution reward from the Treasury, paid in respect of employee contributions above 4% of band earnings, say.

If, for example, such an incentive were to increase by 50% the amount that employees contributed to funded schemes (i.e. an extra £7.9 billion), it would cost an additional £1.58 billion in tax relief (at 20%) and £395 million in reward payments, annually. Contrast this with the £15 billion paid in tax relief to those earning over £50,000 per year: clearly, redistributing higher rate (personal) tax relief in favour of employer incentives would be a much more effective use of Treasury funds. And perhaps some of the more enlightened employers would forward their distribution rewards to their employees' pension pots?

The industry would benefit from such an initiative because it should help it cut its marketing and distribution costs (one advantage of auto-enrolment).

(c) Protecting employers: a "safe harbour"

In the US, a "safe harbour" principle exempts trustees, employers and governance committees from class actions, if it can be demonstrated that they were acting in the best interests of members. Prior to safe harbours being introduced (December 2007), employers were increasingly reluctant to discuss pensions with their employees. Many deemed it too risky (which also provided them with a ready excuse not to do it).

A safe harbour arrangement in the UK is a pre-requisite to increasing employer engagement with pensions. It may also precipitate the use of more appropriate investment options (less defensive, more imaginative). Employers are unlikely to promote saving amongst employees unless they have clear guidelines (*not* regulation) within which they can safely operate. These should include the distinction between "advice" and "information", and what constitutes a "qualified" default fund.

> **Proposal 9**: "Safe harbour" guidelines (not regulation) should be swiftly introduced (not least because of the onset of auto-enrolment), to exempt employers from class actions, provided it can be demonstrated that they were acting in good faith.

(d) Other initiatives

(i) Scheme membership: flexibility for employers

Employers used to be allowed to make it a condition of employment that employees had to participate in the company pension scheme. Regretfully, this right was revoked in 1988, when the then prevailing political ethos was to encourage personal provision. Well-intentioned employers should be at liberty to require scheme membership, unless the employee can demonstrate that they already have adequate pension arrangements. That said, employers are allowed to write scheme membership into new recruits' contract of employment (occupational schemes and contract-based workplace pension schemes).

(ii) Pressure the management?

In the US, some senior executives can only receive employer contributions after they can demonstrate "substantial" employee engagement with the company's 401k Plan. The intention is to incentivise management to improve employee engagement with retirement saving.

The UK could amend this approach by denying tax relief to management unless employee engagement in NEST, for example, exceeds 70%. In practice this is unlikely to be productive, and could create resentment. Not all employers will participate in NEST, and it would have no impact on executives whose pension assets have already reached the £1.5 million lifetime allowance.

5. CONCLUSION

Today's tax-based incentives to save for retirement are hugely expensive and, worse, ineffectively deployed. Skewed towards the wealthy, they do far less than they should to minimise pensioner poverty. Furthermore, they do little to catalyse a savings culture amongst younger workers, thereby exacerbating the looming generational inequality.

The savings incentives framework should be restructured, which will require a preparedness to confront deeply-entrenched vested interests within the savings industry. Prior to that, the Treasury should thoroughly research the effectiveness of tax relief, measured against the objectives of catalysing a savings culture and achieving value for money. The latter could be assessed against expected future tax receipts from pensioners (including consumption-related taxes). In parallel, the Treasury should determine what proportion of tax relief is ultimately captured by the industry, rather than savers. Its findings should be put into the public domain, to facilitate meaningful debate.

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