

Consultation Response:

“Strengthening the incentive to save - a consultation on pensions tax relief”

To: HM Treasury

By: The Intergenerational Foundation

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The Intergenerational Foundation (www.if.org.uk) is an independent think tank researching fairness between generations. IF believes policy should be fair to all – the old, the young and those to come.

Introduction:

IF welcomes any review that reduces unfairness towards a younger generation which is generally poorer than the previous generation. IF will welcome any outcome which addresses the problem of an older generation who are likely to receive significantly more generous pensions than their children.

Any new system should be fair to younger generations

A new tax system based on tax relief for pensions’ savings when they are drawn down, rather than upfront when they are paid in, is much less generous to younger savers (this is illustrated in Appendix 1) and therefore:

- 1. The government should compensate younger workers for offering them a significantly less attractive pensions deal;**
- 2. Any new regime needs to give some additional incentive to encourage pensions saving, particularly for younger savers.**

Under the current system, savers receive a huge benefit from the 25% tax-free withdrawal after the age of 55. **If this tax relief is to be retained for past contributions there should be some compensating allowance for younger pension savers.** There is a strong argument too that the 25% allowance should be capped at a fixed amount, such as £50,000 per individual. This would help to counteract the fact that the current system has been particularly generous to high earners, and would be more in line with how another allowances work, such as the personal allowance on income or the capital gains tax allowance.

Incentives need to move people away from dependence on the state pension

The costs of the state pension are unsustainable and its costs will have to be curtailed in future years. The UK state pension is, by European standards, very low, so there is little scope for containing the costs through reducing the level of the pension. State pension costs cannot be reduced except by raising the state retirement age (which is being done) and reducing the number of claimants.

The OBR predicts there will be 1.3 million people aged over 100 in 50 years' time. This increase in longevity, while welcome, means that the State Pension will become increasingly expensive to continue funding. Therefore it is particularly important that there are effective incentives for individual saving so that, in due course, the state pension could be means-tested if necessary.

Any change to the timing of taxation should be used to reduce borrowings

The future tax revenues that governments will collect as the pensions people are saving towards today are paid out represent a significant off-balance sheet asset. A new ISA-style pension system that promises tax-free withdrawals is clearly less attractive to future governments as they will not receive this tax take. Instead governments will receive more money up front in immediate tax receipts. This should be used to reduce the National Debt – the financial obligation being passed on to future generations.

Recycle some of the savings into up-front incentives for younger savers

A scheme where the government matches contributions, up to a fixed annual limit, could provide a strong incentive for people to save and could be comfortably financed out of the savings from moving away from the generous current EET system. The government suggestion to put in £1 for every £2 saved could work well, so that the employee might put in, for example, £3,500 each year, the employer £3,500, and the government matches that with an extra £3,500. Such a scheme could apply to all workers or, in view of the generosity of the past schemes, could be limited to those under 35 or those with less than 15 years contributions' under the old scheme.

If you would like to learn more about the work of the Intergenerational Foundation please contact:

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Appendix

The following tables illustrate two hypothetical scenarios: one in which money is saved under the existing rules, and one where it is saved after tax, like with an ISA. In each case the annual amount saved is assumed to be £4,000 and the return on investments is 5%.

In the existing system the tax rate is assumed to be 15% because a saver will usually pay tax in years when their marginal tax rate is much lower (after they stop earning) AND they will not pay tax on 25% of the fund. So $\frac{3}{4}$ of 20% is assumed, so the pension recipient under the existing system will have an average tax rate of 15%.

In contrast, under a new ISA-type system the saver will have paid tax and national insurance at their marginal rate during their working life which will typically be significantly higher, and they will of course not have received anything equivalent to the tax-free lump sum (tax is assumed to be 35%).

Comparing these figures one can see that under the old system the same annual savings would after 30 years be worth £237,000, whereas under a new ISA-type system the same savings would only be worth only £181,000.

As an aside, these figures show how important the investment income is so that even at a 5% annual return in both cases the income exceeds the value of the invested capital. So the exemption from tax of the income on pensions savings is critical - the central "E" in both the old system and the new (EET and TEE).

Scenario 1 (existing system)

EET Outcomes (£)

EET	Money in (gross)	Tax free income	Year end total
Year 1	4,000	200	4,200
2	4,000	410	8,610
3	4,000	631	13,241
4	4,000	862	18,103
5	4,000	1,105	23,208
6	4,000	1,360	28,568
7	4,000	1,628	34,196
8	4,000	1,910	40,106
9	4,000	2,205	46,312
10	4,000	2,516	52,827
11	4,000	2,841	59,669
12	4,000	3,183	66,852
13	4,000	3,543	74,395
14	4,000	3,920	82,314
15	4,000	4,316	90,630
16	4,000	4,731	99,361
17	4,000	5,168	108,530
18	4,000	5,626	118,156
19	4,000	6,108	128,264
20	4,000	6,613	138,877
21	4,000	7,144	150,021
22	4,000	7,701	161,722
23	4,000	8,286	174,008
24	4,000	8,900	186,908
25	4,000	9,545	200,454
26	4,000	10,223	214,677
27	4,000	10,934	229,610
28	4,000	11,681	245,291
29	4,000	12,465	261,755
30	4,000	13,288	279,043
Totals	120,000	159,043	
Tax of 20% on 75%			41,856
Net after-tax EET value			237,187

Scenario 2 (possible new ISA-style system)

TEE outcomes (£)

TEE	Money in (gross)	Net of tax at 35%	Tax free income	Year end total
Year 1	4,000	2,600	130	2,730
2	4,000	2,600	267	5,597
3	4,000	2,600	410	8,606
4	4,000	2,600	560	11,767
5	4,000	2,600	718	15,085
6	4,000	2,600	884	18,569
7	4,000	2,600	1,058	22,228
8	4,000	2,600	1,241	26,069
9	4,000	2,600	1,433	30,103
10	4,000	2,600	1,635	34,338
11	4,000	2,600	1,847	38,785
12	4,000	2,600	2,069	43,454
13	4,000	2,600	2,303	48,356
14	4,000	2,600	2,548	53,504
15	4,000	2,600	2,805	58,909
16	4,000	2,600	3,075	64,585
17	4,000	2,600	3,359	70,544
18	4,000	2,600	3,657	76,801
19	4,000	2,600	3,970	83,371
20	4,000	2,600	4,299	90,270
21	4,000	2,600	4,644	97,514
22	4,000	2,600	5,006	105,119
23	4,000	2,600	5,386	113,105
24	4,000	2,600	5,785	121,490
25	4,000	2,600	6,205	130,295
26	4,000	2,600	6,645	139,540
27	4,000	2,600	7,107	149,247
28	4,000	2,600	7,592	159,439
29	4,000	2,600	8,102	170,141
30	4,000	2,600	8,637	181,378
Totals	120,000	78,000	103,378	
Tax 0%				0
Net after-tax TEE value equals				181,378