Submission from the Association of Consulting Actuaries

Does the current suite of tax reliefs represent good value for money?

Pension tax relief

Pension tax relief is one of the largest reliefs and HMRC estimated[1] (noting that there are strong caveats about the accuracy of the numbers[2,3]) that in 2020-21 it cost £42.7 billion, made up of £22.9 billion for income tax relief and £19.8 billion for NIC relief. For comparison, principal private residence relief (i.e. no capital gains tax on private homes) cost around £28.4 billion[4], and exempting food from VAT cost around £20.7 billion.

The pension tax relief figure is inevitably large because of its broad coverage of the population, and the amount an individual needs to save (and needs to be encouraged to save) for an adequate whole-of-retired life income is large. We believe this relief is good value for money for the Treasury as by encouraging significant private pension provision it helps to offset the need for materially higher state pensions and other state aid.

1. It is **very widely distributed** across the population, and it benefits the vast majority of employees and pensioners. National Statistics / DWP: Pensioners Income Series[5]: Financial Year 2020-21 notes that three quarters of pensioners benefit from private pension income.

> "Private pension income was received by **74%** of pensioners in FYE 2021 – more than all previous years in the series"

Auto-enrolment into pension schemes means that in future an even greater proportion of the workforce will have the opportunity to retire with a workplace pension.

2. For the average pensioner, occupational pensions provide **more income** than the state pension. The same National Statistics / DWP: Pensioners Income Series: FY 2020-21 in the section on Sources of Pensioners' Income, notes that the median state pension received is £192 per week but the median occupational pension received is £198 per week. Personal pensions will increase this amount.

3. Pension tax relief is **good value for money** if the alternative of not supporting workplace pension provision would be that the government would have to provide additional state pension or additional benefits to make up the shortfall in pensioners' incomes. The government spent **£101 billion financing the state pension[6]** in 2020-21 to deliver median state pension incomes of £192 per week. This was **more than twice the amount deployed**

[1] Tax relief statistics (December 2021) – Section 6.1
https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs/estimated-cost-of-tax-reliefs-statistics
The statistics are current at the time of publishing this document. We understand that updated figures for 2020/21, and figures for 2021/22, will be published on 28 September 2022.
[2] HMRC also publish the pension tax relief estimate in a table known as Table 6. The notes to it state that "Costs are subject to large revisions and have a particularly wide margin of error."
[3] As examples, the method counts the cost of current tax relief for today's employees netting off the tax on current pensions for today's pensioners. However, with more employees now in pension schemes than in the past, it overstates tax relief to compare a larger current workforce's relief against a smaller pensioner population. The figure is also inappropriate as a measure of relief for year-by-year savings because it includes the tax relief on "deficit contributions" now being paid by employers into Defined Benefit Schemes ie contributions paid to make up funding gaps from past benefit accrual.
[4] Because capital gains tax rates are lower than equivalent income tax rates, this reduces the headline cost of Principal Private Residence relief compared to the cost if the relief had been measured relative to income tax rates.
[5] National Statistics / DWP: Pensioners Income Series: Financial Year 2020-21 – Section 5, Sources of Pensioners' Income
https://www.gov.uk/government/statistics/pensioners-incomes-series-financial-year-2020-to-2021/pensioners-incomes-series-financial-year-2020-to-2021#sources-of-pensioners-incomes
[6] Office for Budget Responsibility: Welfare Spending – Pensioner Benefits (Supplementary Tables: Table 3.7)
https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/welfare-spending-pensioner-benefits/

as pension tax relief, but that tax relief helped pensioners to receive a median amount of £198 per week of occupational pension[7].

The current structure of offering tax relief on pension contributions, while the person is working, but then taxing the pension received in retirement, also helps to **align tax receipts with public expenditure**. This is a practical benefit to the Treasury. Two of the largest items of public expenditure are state pensions and the NHS, and the cost of both is sensitive to the number of older people in the population. The Baby Boomer generation (born 1946 to 1964) is currently aged 58 to 76 and this population bulge will increase the number of older people and pensioners in the UK over the next decade. The taxes foregone by the Treasury in past years from encouraging pension saving via pension tax relief, when this large cohort was of working age but not imposing significant burdens on the state pension or the NHS, now comes back to the Treasury as tax on pensions in payment, at the time when the cohort moves through older ages and imposes on the cost of state pensions and the NHS. Long-term care costs for the very elderly are a further example of the same point.

What problems do tax reliefs cause?

A principal concern about pension tax relief is the complexity of the restrictions which surround it. A degree of complexity is inevitable, reflecting both the fact that pension schemes cater for many different employment and retirement patterns and HM Treasury's objective to control the use of the tax relief. However, given that the rules sometimes need to be complex, there is concern that there are insufficient government resources devoted to developing and maintaining the rules around pension schemes and pension tax relief. Rules are also poorly understood by the general public, and this also possibly dilutes the positive overall impact on incentives to save into pensions:

(a) Policy is implemented without necessarily having thought through the impact on real-world behaviours. An example is the tapered annual allowance, where concerns were raised when the taper was introduced. It has created significant problems regarding NHS doctors' pensions and it had to be amended when those problems began to affect important NHS services. Problems with poor design of legislation can also create opportunities for tax avoidance arrangements, which harm HM Treasury and the vast majority of taxpayers.

(b) The devil is often in the detail. Whilst the general principles of new legislation are well scrutinised, within Finance Bills that often span several hundred pages, there is significant scope for some of the more detailed technical aspects - with non-obvious or behavioural consequences - too often to pass with very little real scrutiny, and the effects become obvious only after implementation.[8]

(c) There appears to be limited spare resource, both within HMRC and HM Treasury, and in terms of parliamentary time, to maintain or amend existing legislation if problems are identified. For example, the pensions industry and HMRC are aware of long-standing issues in current pensions tax legislation, which can impede plans by pension trustees to safely secure members' pensions with insurance company annuities. However, there appears to be no spare resource within government to correct the problem.

[7] There is a mismatch between the state pension cost, which is the cost for current pensioners, and pension tax relief, which is about providing for future pensioners, but it is not possible to get precisely comparable figures for the two items. However, the principle holds good that the state pension is considerably more expensive, pound for pound, for the government to provide than using pension tax relief to encourage employers to provide good quality workplace pensions and workers to participate in these.

[8] We note that at the time that we are issuing this paper the impact of the Annual Allowance on NHS pensions for doctors is once again very much in the public eye. There are currently press reports that HM Treasury is considering changes to ease this impact by, for example, a) allowing more cash options as an alternative to pension provision, and (b) resolving technical issues in interactions between the AA legislation and the NHS scheme design which doctors complain create significant tax bills for them. Given that any change probably seems to be focussed solely on the NHS scheme, we do not address these reported proposals here. But this does demonstrate how much the devil is in the detail of such a complicated tax regime.

Going forward, we would prefer quality over quantity of legislation, even if it meant that legislation was slightly slower in arriving on the statute books, and we would prefer to see more resources devoted to creating and maintaining high quality tax laws. The complexity that already exists in pension tax also means that any possible changes that might be introduced could further complicate the system, making if difficult for existing pension savers (and their employers) to understand and navigate the changes, and may mean that any savings that are intended to be achieved might take years to feed through. Change also involves a cost of making the change, which needs to be considered.

Potential reforms

Current workers

For current employees and younger generations, we believe pensions tax relief should continue to form a bedrock of incentives to make long term private pension provisions. Policy developments over recent years, such as Automatic Enrolment have also been helpful to promote savings within these cohorts - and Lifetime ISAs have promoted savings in parallel.

However, especially for younger generations that already face significant competing savings needs from housing, student loan and other costs, there is a risk that recent negative economic shocks will undo this work if “resilience” needs arising from the pandemic, or current high inflation, further crowd out resources.

In particular, too many people currently do not have a cushion of adequate immediate-access savings that would cover unexpected costs ranging from a broken-down boiler or car through to unexpected redundancy and not having wages for a period until they find a new job. This makes it harder to persuade them to lock away significant savings until retirement and, to encourage these behaviours, these groups first need assurance around financial resilience for their current finances.

One option would be to allow more flexibility for people to dip into retirement savings before retirement to meet urgent essential expenditure. This might also be consistent with approaches taken in some other countries[9], which allow limited early access to retirement savings, but would arguably reflect a significant change in the societal view of the “purpose” of long-term savings, as distinct from a pure retirement only vehicle.

However, to a degree we believe these behaviours are already consistent with current practices under “freedom and choice” which, for example have allowed those aged over 55 to flex their working patterns and resilience needs since the pandemic. Under Freedom and Choice, tax is paid when individuals access their funds and we would suggest that any limited extension to earlier ages (if this is to be considered) is taxed in an appropriately consistent way.

Behavioural effects would also be important to understand and model, and one view is that if provided with the certainty that long term savings can be accessed, if needed in defined circumstances, individuals will in general feel comfortable saving at higher levels than they otherwise would (i.e. knowing that their resilience needs could be met from this source). If modelling suggests that overall, such policies would lead to an aggregate increase in overall savings for future generations (and with appropriate safeguards to avoid unnecessary use), we view that this could help to “square the circle” of many of today’s competing savings needs. For example, in ACA’s 2021 survey[10], 73% of respondents believed that aggregate savings would increase if there was greater flexibility.

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[9] Examples include Australia and New Zealand.
https://www.ato.gov.au/individuals/super/withdrawing-and-using-your-super/early-access-to-your-super/
https://www.ird.govt.nz/kiwisaver/kiwisaver-individuals/getting-my-kiwisaver-funds-early/getting-my-kiwisaver-funds-for-significant-financial-hardship

[10] https://aca.org.uk/pensions-key-reforms-still-needed-to-avoid-crisis/

The alternative view is that current day to day spending challenges should be tackled through other (non-pensions) policy mechanisms and that calls to relax the rules that currently restrict access to pension savings would simply defer the day of reckoning rather than address the more fundamental current problems.

This is a powerful argument, and we believe that getting the best value for the public purse from the tax relief provided for pension schemes requires a parallel exercise to help people to have both sufficient income to cover the basic cost of living and a suitable "rainy day fund" for financial resilience, alongside accruing pension savings. One could argue that the very low levels of opt-out from Auto Enrolment suggest that there is little need to make changes, such as early access, to attract contributions. Initial findings from a recent and still running trial on auto-save, i.e. an opt-out payroll saving approach that sets employees up with a simple instant-access savings account and a modest monthly saving contribution directly from their pay, suggest that this might meaningfully boost employee financial resilience.[11]

This will facilitate all sections of the population to save for retirement and not simply the wealthier sections. Whether this should be done within the existing structures of retirement funds or should be done by enhancing people's abilities to save using existing (non-retirement) savings accounts is a debate to which we would be happy to contribute further.

Older pensioners

We would also add that there are similar pressures on pensions around financing the cost of later life care and nursing care for the very elderly. Pension provision must be considered holistically along with difficult questions about the best way to finance care costs.

To the extent that pension schemes are asked to shoulder some or most of the costs this would have consequences around the cost of pension tax relief and on the tax limits on pension contributions and benefits.

Annual and lifetime allowance limits on pension tax relief

The cost of pension tax relief has been controlled in recent years by cutting both the annual allowance on contributions and the lifetime allowance. Had the lifetime allowance in 2011/12 been increased with CPI then today it would be worth more than twice the current actual level of the lifetime allowance, which is just over £1 million. However, with the allowance frozen at its current level until April 2026 and with inflation running far above its 2% pa target level, these limits now affect an increasing group of people well beyond the very richest in society.

For pension tax relief to be effective, people need confidence that the regime will be stable and that they can make the long-term commitment over decades to build up a secure retirement income. Especially given their now wider population coverage, both limits, but particularly the lifetime allowance, should be restored to a more appropriate level with automatic annual indexing built in and respected, and we would urge cross-party commitment to stability of the pension tax regime.

[11] https://www.nestinsight.org.uk/autosave-trial-early-findings/

About the Association of Consulting Actuaries

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of private sector defined benefit pension schemes. Members also advise thousands of smaller pension arrangements and individuals (many in self-employment) as well as advising life and general insurers.

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