Reform postponed: what next for pension taxation?

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Summary

The European referendum has driven changes to the regime of pension taxation off the agenda for the foreseeable future, according to Treasury briefing. By drawing flak to the Pension ISA, a pointlessly high-risk and expensive reform, the Chancellor appears now to have lost the opportunity to introduce the one reform floated by the Treasury that was widely supported by pensions experts: flat-rate tax relief on contributions. Hopefully, it is only postponed.

The Treasury consultation[1] (whose conclusions were until just before the 2016 March Budget expected to form part of the Budget) was an opportunity to question all assumptions about the purpose, fairness, cost and effectiveness of the existing complex array of tax rules applying to different forms of pension saving. Fowler Drew has for a long time sought to contribute to the debate about pensions taxation from the points of view of: our 'day job' of performing the maths of saving in or out of pension for individuals in different situations; developing strategies for optimal decision making within the rules; charging to recover the cost of pension complexity; our own analysis of HMRC's data on the cost of tax relief; our past differences of opinion with many so-called 'think tanks' about the data itself or how to interpret it; and, finally, insights (after careers spent in both occupational and personal pensions) into the economic and social purpose of tax incentives to retirement provision.

These viewpoints are drawn together in this research paper. Its key conclusions, no less valid after the postponement of changes in this Budget and now with a longer shelf life, are as follows.

1. Whether measured in budgetary terms or equity, Defined Contribution (DC) schemes are not the main target. Defined Benefit (DB) schemes account for the vast majority of the implied budgetary cost of pension incentives.
2. Because DB and DC are so different in principle, there is no need for a complex framework that seeks imperfectly to equalise the fiscal treatment of each: tax them differently and scrap all that complexity.
3. When tax incentives are correctly linked to the principle of risk taking, it becomes logical to tax the product of investment risk more heavily for DB (where individuals are indifferent to risk and sponsors face perverse risk incentives) than for DC (where risk is essential to the logic of saving both for individuals and for society as a whole). That change could be simply implemented by taxing cash lump sums from DB. Tax free cash should remain uncapped for DC schemes because it was the only certain part of the maths of the bargain that encouraged individuals to take long-term risk with their savings and voluntarily make them inaccessible for any purpose other than retirement.

[1] 'Strengthening the incentives to save' HM Treasury July 2015

4 The way the budgetary cost of DB schemes has typically been presented is flawed. The cost of tax relief is much smaller than that calculated notionally by HMRC, as if all contributions would otherwise have been paid and taxed as salary. It also contains the seeds of its own reversal as the notional cost has been boosted by contributions made to plug valuation shortfalls that are the product of very low discount rates. DB is dying out and the notional budgetary problem will shrink with it.

5 Scrap all the allowances. The cost of tax relief has already been capped by an increasingly complex set of annual allowances biting on contributions and lifetime allowances biting on benefits. As things stand, on 5th April we will see the Lifetime Allowance further reduced from the current level of £1.25m to £1m (50% below the level originally introduced 10 years ago) and the introduction of a tapered annual allowance for those with taxable incomes in excess of £150,000. Both of these changes add further complexity to a pension system already suffocating under layer upon layer of legislation. This complexity is presumably expensive for HMRC to operate and is certainly expensive for individuals, a cost only benefiting advisers like ourselves. It is widely viewed by savers as arbitrary and cynical. A flat rate of tax relief on contributions allows the Chancellor the luxury of scrapping the entire regime. The rate is self-policing: people are mistrustful of pensions and will not tie money up in a pension scheme if it is risks being taxed at close to, let alone more than, the rate on the earnings from which it originates.

6 The flat rate of relief applied to contributions only affects the mathematics of saving in or out of pensions at the point of each decision. There is therefore no need to fix the rate: it can change on budgetary considerations including emerging data about the effects of auto-enrolment and the switch from DB to DC as well as the effects of the regime changes suggested here.

7 The overall revenue effects of replacing DC allowances with a flat rate of relief are uncertain but the realistic bounds do not look very important. Only reducing tax free cash entitlements will make any immediate significant difference to revenues.

8 The measures proposed are redistributive but it is only taxing DB benefits, such as by restricting tax free cash, that will impact the wealthiest retirees, as they are already likely to pay tax on pension income at higher rates. The main contributors to the gap between notional relief given to current savers and actual tax recovered from current retirees have always been the affluent not the rich. It is Middle England who drop to a lower tax rate when they retire. Many are also earning enough when making pension contributions to be sheltering a lower rate of NI when saving. Most basic rate tax payers while earning will remain basic rate payers in retirement.

9 The previous Government introduced even more favourable tax treatment of death benefits that only helps people with large protected pots. This was perverse and should be reversed if the Chancellor wants these changes to increase the recovery of tax reliefs and wants to make the benefits of tax relief fairer.

1 Why provide tax relief?

Good pension legislation needs to connect with first principles. Incentivising pension contributions has generally had two intentions:

1 increasing the level of savings and

2 increasing the output of savings through productive investment.

The aim was both to improve the welfare of individuals and to increase the growth of the economy and hence the welfare of society as a whole.

In terms of individual welfare, more generous State Pensions have reduced the motive for tax-incentivised private provision. The ISA regime competes directly with pensions as a stimulus to savings levels. So also, indirectly, does the accumulation of housing equity. All three options come with some form of tax privilege relative to the treatment applicable to directly-held financial assets. Public policy concerns about the adequacy of savings levels need to take account of the competition between them, differences in the welfare each delivers (including flexibility) and behavioural biases ('bricks and mortar' versus 'pensions'). Finally, savings preferences are directly affected by the interaction at lower levels of household income of savings and benefits. Tax incentives specifically for pension savings, and their expected impact, cannot be viewed in isolation.

In terms of the outcomes of saving, the 'growth dividend' from encouraging long-term productive investment was an important justification for giving tax relief on pension contributions. Recovered by treating pensions in payment as taxable income, it should eventually 'pay for itself' and so prevent permanent transfers from one generation to the next. Public policy thinking about this also needs to recognise how much has changed in the investment of retirement savings. Before the Thatcher Government fired the starting gun for democratising retirement savings, most schemes were occupational and generally only the self-employed had personal pension contracts. Both were organised institutionally, with professional management by banks or insurance companies, along broadly the same lines familiar to us today as 'balanced management'. Two subsequent developments have had impacts on investment strategy that cut across the original aims.

- New international rules for accounting for pension liabilities in occupational DB schemes have disincentivised risk taking, by redefining the sponsor's utility so it now values maximising the stability of discounted asset values, and hence contributions, instead of maximising expected long-term investment outcomes and minimising contributions. DB schemes now serve to help finance Government borrowing more than the productive economy.
- The growth of personal pensions, where asset allocation is the choice of the individual, has weakened the commitment to long-term productive investment. Typical risk tolerance is lower but also more skittish and therefore more vulnerable to return destruction from selling low and buying high.

The cost to investment returns of democratising pension investment has at least been offset by two other political initiatives: i) using regulation to bear down on high industry charges for personal pension plans and ii) removing the default in DC schemes to purchasing an annuity and encouraging drawdown.

- Early pension contracts carried costs that offset much if not all of any expected risk premium (the reward to taking equity risk compared with holding fixed income investments that are the equivalent of buying a deferred annuity).[2] The experience of UK financial services suggests that product providers have always been able to charge up to the full amount of any tax relief, such that relief acts not as an incentive to people to buy products so much as an incentive to agents to sell them products. This sales impetus may help satisfy the objective of improving individual welfare (without it people would have carried much less life assurance, for instance) but does not contribute to societal welfare or intergenerational equity in the form of a growth dividend, unless we count the growth of financial services themselves.

- Prior to the latest pension freedom legislation, an annuity was the default means of taking benefits for the vast majority of personal pension plan holders. With very few opting to shop around for the best annuity rate, a lack of competitive pressure kept profit margins high and rates lower than they ought to have been, even allowing for the fact that gilt yields are at record low levels. With the removal of GAD limits, far greater numbers are now opting to take pension benefits via drawdown.[3]

Our own view of the growth dividend as a justification for tax incentives to saving is skeptical, to say the least. We nonetheless doubt a similarly skeptical Treasury would risk scrapping relief altogether. The political aim is probably more risk averse: to reduce the overall cost of the current regime and address the unequal distribution of tax relief. The two issues are linked since it is the unequal allocation of tax relief that is widely seen as leading to the tax leakage which is held up as the main contributor to cost.

2 What does it cost?

i) Relief on contributions

The popular narrative for critics of the current regime can be set out quite easily. At present basic rate taxpayers (who account for 87% of all tax payers) make 50% of all pension contributions but receive only 30% of the tax relief granted, whilst higher rate taxpayers (12% of all tax payers) pay 40% of contributions and receive 50% of the relief. Additional rate taxpayers (the remaining 1%) pay just 10% of contributions but receive 20% of the relief.[4]

ii) Tax on pensions in payment

The narrative is often limited to the relief at point of contributions, ignoring the recovery of relief after the accumulation period, which is when the growth dividend should show up. Commentators who understand the deferral (or 'loan') nature of relief realise that the actual value of these reliefs will hinge on the rate of tax an individual will pay in retirement, which they do not know at the point of each contribution.

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[2] For instance, a historically 'normal' equity risk premium of 3% pa in real terms would be fully absorbed by a typical pre-RDR actively-managed fund Total Expense Ratio of 1.7% pa and total transaction costs of 1.3% pa (implying a turnover rate of around 50%)

[3] The value offered by an annuity can be tested by calculating how long the same capital sum would last if it were invested in a maturity-matched ladder of gilts held in a drawdown portfolio to provide identical cash flows. This identifies the added value in the form of incremental longevity risk covered, as the annuity will provide income to any age. To the extent insurance companies now hold high-yielding corporate bonds rather than gilts, annuities ought to come out better on this test than they do. Our calculations have for a long time suggested that an annuity provides incremental longevity insurance only beyond the late 90s. We are unable to tell whether this shockingly poor value has been due entirely to excessive profits or partly to inefficient industrial processes for converting portfolio cash flows into product cash flows

[4] Pension Policy Institute, July 2013

With the vast majority of basic rate taxpayers continuing to pay basic rate tax in retirement, it is only the availability of a 25% tax free lump sum that prevents the pension regime being anything other for them than an exercise in tax deferral. However, for the large numbers of higher rate taxpayers who will revert to paying basic rate tax in retirement[5], the rewards for pension investment are far greater and it is this tax-rate arbitrage that critics point to as being a major cost of the current regime. The Treasury appears to buy into the same narrative, hence the desire for reform.

iii) Tax free cash

The Treasury has nonetheless shown itself reluctant hitherto to attack tax free cash. Since pension reforms first started to address the cost of tax relief in the Pensions Act 2006, an attack on tax free cash has been one of the most frequent concerns of clients of financial advisers, to the point where an offered rationale for conserving this element of the tax regime struggles to outweigh fear of the possible consequences of being caught out by its removal or capping, without opportunities to take evasive action. For everyone too young to take pension benefits, they have no scope for evasion but for older clients it looms as one of those decisions with a very high opportunity cost. The run-up to this Budget was no exception with speculation in, for instance, the Daily Telegraph.

The fact that no government since 2006 has decided to act on tax free cash is frustrating to opponents of tax relief who do not see the entirety of the picture in terms of how average tax rates will determine individual tax payers' relative advantage.

For instance, the fact that tax free cash amounts in excess of £150,000 only account for 2% of the total but account for 24% of the total relief arising from tax free cash makes the regime appear extraordinarily generous. [6] Yet it is precisely these wealthier retirees who can expect to pay higher rate (if not also additional rate) tax in retirement. For them the maths of saving in rather than out of a pension are similar to the much greater number who will remain basic rate payers. Because they would not drop a tax rate between earning and drawing a pension, without tax free cash they would pay back the relief with interest at a rate equivalent to the gross roll-up (or tax-deferred growth rate) earned by their investments. Had they had perfect foresight, these are not loan terms they would have accepted, given that they were giving up access to their capital – including making themselves vulnerable to cynical governments who might take advantage of that restricted access.

3 The costs are misleading

Where do the numbers come from that everyone is relying on to support this narrative? The main source is HMRC itself, in a set of tabulated estimates with explanatory text, labelled PENS 1 to 6. PENS 6 is the source of the estimates for the amount of relief, year by year, and for the amount of tax collected. The latest data, to 2014/15, was published on 26th February 2016.

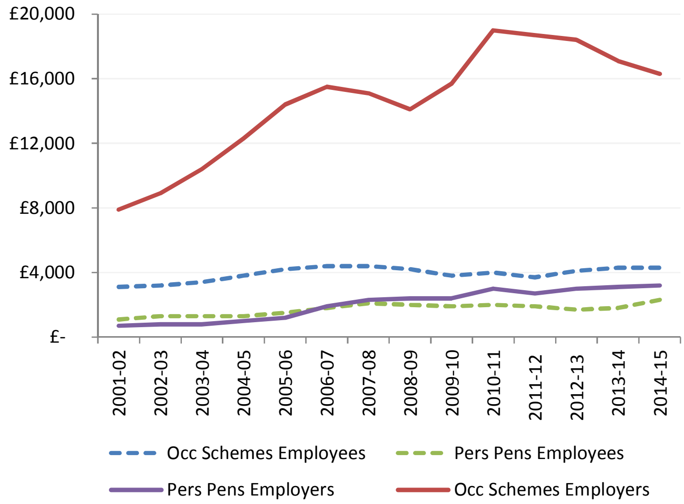
Though everyone is using the same source data, we do not think that it is being interpreted the same way and believe the assumptions are not being questioned properly. The result is that the net cost of the current regime is being greatly exaggerated and that future projections are not considering the way it will decline without any additional initiatives.

[5] HMRC data on income bands does not match tax thresholds so estimates of the proportion dropping out of the higher-rate band (such as Centre for Policy Studies' estimate of 85%) are speculative and ignore the size of any change in average effective tax rates
[6] For example Centre for Policy Studies (several different reports including Retirement Savings Incentives, 2016)

Gross costs

In Fig.1 we show HMRC's calculations of the annual cost of tax relief on contributions into registered schemes and their evolution since 2001/2 which is the earliest data. We have kept their four categories: schemes written under occupational rules that are in turn divided into employers' and employees' contributions; personal pension plans similarly divided between employers' and employees' contributions. For each type of scheme, the employees' relief is shown by a broken line.

Fig. 1 HMRC cost estimates for relief on contributions 2001/2 to 2014/15 £ million



We can see immediately that the largest contribution to the cost estimate is employer contributions to occupational pension schemes. Though these include DC plans that are written under occupational scheme rules (but not group personal pensions), the vast majority of occupational schemes are still DB. Several points call to be made here.

- HMRC assume that if the contribution had not been made the money would have been received by an employee as taxable remuneration. As a purely notional exercise this may have some justification but it does not help budgetary planning or public debate. The fact that virtually all DB schemes are now closed to new members and that public sector schemes have reduced accrual rates shows that the equivalence assumed by HMRC is wholly unrealistic. Employers are far from indifferent between pension and salary. They would not even have made the pension commitments they made had there been from outset the same requirement as now to fund them on the basis of near-certainty of outcome rather than on the original 'aspirational' basis of earning mean historic returns on investment.
- The cost line implies continued growth for most of the period. Though companies had the power to stop the growth of accruals they were unable to prevent statutory increases in contributions to plug funding deficits.
- The level of employer contribution to a DB scheme is a function of accounting rules applicable to the funding of liabilities for accrued contractual rights to future pension payments. The accounting rules make the funding status highly sensitive both to volatility in the market value of the assets and to changes in the market interest rates or yields used to discount future liabilities. It is primarily falling real and nominal interest rates, rather than the price behavior of risk assets, that have led to large accounting deficits in UK DB schemes. Funding requirements have also risen in line with increases in assumed longevity. The result is that employers have been compelled to make exceptional contributions to top up their pension funds, money that

would never have been paid as remuneration. In some cases employees have also had to increase their contractual contributions.

- To stop funding ratios deteriorating further, many DB scheme sponsors have de-risked their asset portfolios so that they are less sensitive to variance in discount rates (by hedging some of the liabilities perfectly) and to asset volatility (less of the return-seeking assets that are imperfect hedges for liabilities are now held in the form of equities). These schemes' contribution levels are now less likely to change (up or down) as a function of external influences on the funding status. Clearly, therefore, the global acceptance of more robust ways of accounting for pension liabilities has completely cut across the economic justification of tax incentives for pension funds in the form of encouragement to long-term productive investment.
- Funds that have not heavily hedged (or not yet) are presumably hoping for a return to more normal fixed interest yields and so to profit from an improvement in funding ratios and a reduction in the cost of contributions. Very few funds have given up all exposure to this factor so it is reasonable to assume that a return to more normal interest rates will reduce contributions (other than for time-based accruals) and therefore HMRC's notional cost of tax relief.

We can also observe in Fig. 1 that the offset to declining DB schemes is growth in employers' contributions to personal pension schemes as they move to DC schemes. This will continue to grow even if the DB effect weakens because of the new growth impulse from auto-enrolment.

Finally, we can see that HMRC's cost estimates for employees' contributions to DC schemes have shown no growth since 2007/8. This demonstrates the effects of several waves of tightening of the restrictions on contributions via both annual and lifetime allowances. With a further wave coming in April 2016 the Treasury should expect this to decline without doing anything else.

Investment income

In our estimates of the gross cost of tax relief we have chosen to exclude HMRC's estimates of the tax foregone by not taxing investment income in the fund. Averaging £5.5b pa (assuming basic rate tax would have applied), this implied cost is significant. It is also misleading. To be consistent with HMRC's assumption that pension contributions would otherwise have been paid as salary and notionally saved, it should be expected (given the average size of individual savings) that investment income and capital gains would both be fully or largely sheltered by a combination of allowances and use of other tax-favoured wrappers including ISAs.

Costs apportioned by incentives

The problem with HMRC's cost estimates, apart from the validity of the underlying assumptions, is that they do not allow us to consider the cost in terms of the value as an incentive. This is information the Treasury needs if it is to consider the cost-effectiveness of the tax regime. Contributions that are contractual in nature cannot respond to tax incentives in the way that discretionary contributions do and if they are not responsive the benefits they are intended to provide may not be valued.

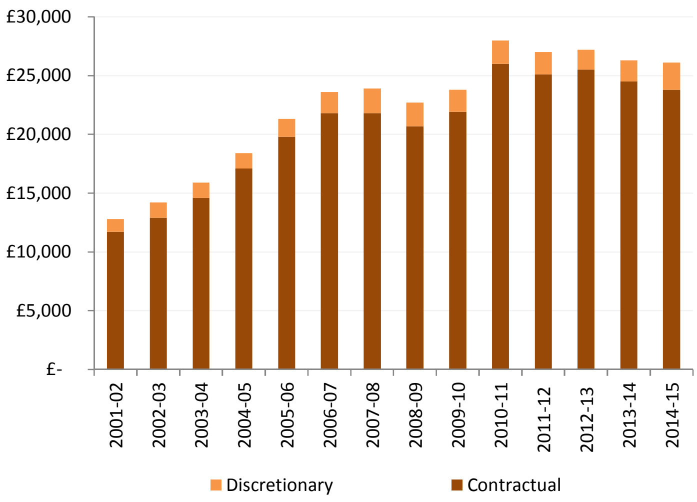
- Employers' contributions are normally contractual. Employers are indifferent between salary and pension for corporate tax purposes but are not indifferent between them when it comes to employer National Insurance. They are generally indifferent today to the welfare benefits of members, even if occupational schemes' origins were often paternalistic, but they do respond to competitive pressures in the employment market of which pension provision may be a part and they do also respond to opportunities to game the tax system to pay remuneration in forms that are more valuable to the employee, such as because it may avoid employee

National Insurance (tax-favoured forms of remuneration will be cheaper if both parties share the tax subsidy).

- Employees' contributions to DC schemes are normally contractual but most personal pension contributions are discretionary. The choices are generally dependent on the maths of saving in one form or another, which are largely shaped by the tax treatment, and are not thrown out by extraneous factors, except for when the dominant incentive is matching contributions by an employer.

To separate HMRC's cost estimates so they fit this difference in the way tax incentives are valued as part of a decision-making process, in Fig. 2 we have resorted the HMRC data. We have treated all employer contributions (DB and DC) as contractual and all employee DC contributions as discretionary except for those made under scheme rules.[7]

Fig. 2 Cost estimates sorted by contractual and discretionary £ million



Even allowing for the fact that the budgetary cost of relief for employer contributions is overstated, the proportion represented by contributions where tax decisions do not even affect choices is perhaps around 80-85%.

National Insurance

One of the data items provided by HMRC is an estimate of the cost of relief in the form of employers' and employees' National Insurance (NI). This single figure is mainly accounted for by contractual contributions as personal pensions are typically made from pay after suffering NI. On that basis, NI foregone represents more of the cost estimate than income tax foregone.

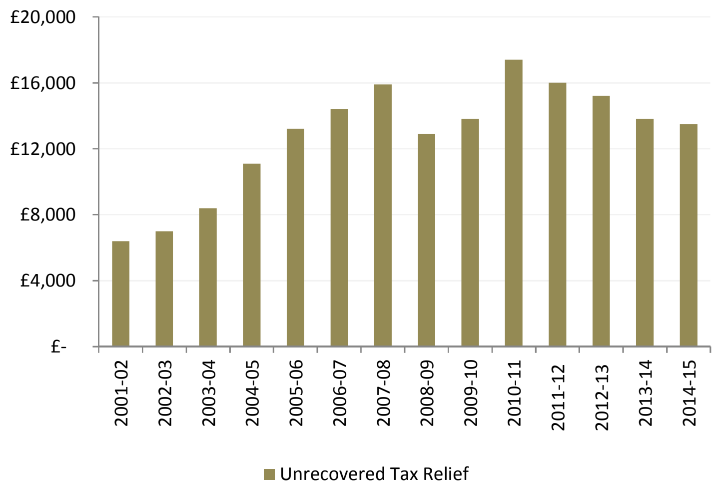
Notwithstanding our observations about the lack of realism about these estimates for DB schemes, it is clear that the Treasury could usefully focus on the role of NI in any reforms that are aimed at reducing the overall cost of relief and increasing equity with personal pensions.

If the cost estimates of tax relief on contributions and their growth trend are misleading, the gap each year between relief given and tax recovered from pensions in payment is even more misleading.

[7] A small proportion of employee contributions to scheme pensions is accounted for by NEST, NOW: Pensions and other non-insurance company auto-enrolment solutions which we treat as essentially contractual in nature and may be influenced by matching employer contributions

In Fig. 3 we show the gap each year between the HMRC estimates of the cost of relief on contributions (notional) and the amounts of tax received on pensions in payment (which we assume are both hard and reliable numbers).

Fig. 3 HMRC estimates for unrecovered tax relief ('leakage') £ million



Our belief is that the main driver of the apparent growth in unrecovered tax relief up to 2007/8 was the emergence of accounting shortfalls in DB schemes. No other factor is of a size that could justify the gap. Given the lags between accounting shortfalls and corrective contributions, it also fits the profile of a fall and renewed rise after the financial crisis of 2008/9.

Even allowing for the overstatement of the tax cost in DB schemes, their size also means that any significant budget contribution needs to focus on the ways in which DB contributions cost the Treasury most money but make the least impact as an incentive.

Even in DC schemes where the value of tax-favoured pension schemes is a mathematical calculation, the Treasury needs to be aware that there must be some gap for there to be any incentive at all, as otherwise it implies people will have made the wrong calculation.

4 The way forward

EET or TEE?

The Treasury's consultation paper sought opinions on whether the Government's objectives could be better met by switching to the same regime as ISAs: investment out of taxed income (T), exempt roll-up of income and gains (E) and exempt gains when consumed (E). This reverses the sequence of pension savings which are effectively made gross (E), roll up tax free (E) but are then treated as taxable income when consumed (T).

We are not competent to assess the economic impacts of altering the timing of cash flows under a revised regime. We note the NIESR report commissioned by the Association of British Insurers (ABI) was highly critical of a switch to TEE but we were surprised by some of the assumptions about dependencies that its modelling relied on. Clearly, though, it is a reform that introduces both heavy costs (in operating two regimes for many decades) and economic risks (given that its effects cannot be well understood).

If we accept that people need an incentive to lock money away, and to take appropriate levels of risk, then some form of government top up would also be required, in which case the Pension ISA effect is much the same as moving to a flat rate of relief but without the same risks and costs.

The rate at which the top up was set would depend partly on whether benefits continue to be taxable or are paid tax free. If benefits remain taxable the size of the top up needs to be larger.

Flat rate relief

Limiting the rate of tax relief as a percentage of contributions has the advantage of appearing to meet the objectives of reducing the budgetary cost and making the system fairer and more efficient by shifting incentives to those that most need them. Because all the relief applicable to DC contributions will be physically paid into the fund (whereas currently only an amount of relief equivalent to the basic rate is added to the fund with relief at the higher rate recovered via the self-assessment tax return), the flat rate relief can be more simply and accurately described as a credit, or bonus or matching payment. The naming of the relief could contribute to its effect as an incentive.

We nonetheless do not expect this initiative to make an appreciable difference to the budgetary forecasts. Depending on the rate of tax relief, which has been widely canvassed hitherto in terms of a range of possibilities as wide as 25% to 33%, it will not necessarily save the Government more than the existing framework with its planned reduction from 6th April 2016 in both annual and lifetime allowances. Nor will estimates of the revenue effects carry much weight.

As we have noted above, the value of incentives that genuinely drive DC choices is highly dependent on changes in average tax rates between accumulation and decumulation, which themselves depend largely on unknown future employment earnings and investment returns as well as unknown future tax rates and thresholds. We have seen that where expectations are most modest, basic rate relief is not much of an incentive. Where expectations are greatest, including in later stages of accumulation when there is more certainty about the size of the pot and the income from it, the existing framework of allowances and tax bans effectively negates any tax incentive.

Simplification

Logically, therefore, the overwhelming merit of the flat rate incentive is that it should allow the Chancellor to dispense with much of the existing framework of allowances designed to reduce the cost of DC schemes, as long as the maths of the decision make it largely self-policing. Given the costs and intense unpopularity of the existing framework, this simplification would be a real gain for the Chancellor.

The DC framework has in turn spawned an equivalent framework for DB schemes where contribution choices are not decisions of the member but a function of salary changes and the accrual of pension rights over time. Since exact equivalence is never going to be achievable, this is also widely viewed as arbitrary and unfair.

We examine each of these in turn.

1. DC Annual Allowance

Without changes in the March 2016 Budget, on 5th April the annual allowance remains at £40,000 but with a new tapered annual allowance for those with total taxable incomes in excess of £150,000 potentially back to £10,000. The latter adds a new order of complexity by making the taper a function of total income from all sources, not just pensionable earnings. We can assume that anticipation of the change will have led to contributions and tax relief being brought forward into 2015/16. We can also assume that in the majority of cases individuals able to contribute at this rate into a personal pension will already be affected by their having previously sought 'protection' to guard against over-contributing and a tax charge of 55%, or to calculations of the risk of breaching the new standard Lifetime Allowance which is also due to change from 5th April (from £1.25m to £1m). The likely revenue effects of the taper appear in practice relatively small but were perhaps less important for the Chancellor than the appearance given that the two new measures together make a further step in ensuring tax relief mainly works to the advantage of 'working families' who most need them.

We can more easily estimate the scale of revenue effects of setting a flat-rate of relief, which is part of its appeal for individuals, their advisers and the Treasury itself. In Table 1 we replicate a simple, linear approach to calculating the point at which relief becomes its own brake on contributions, similar to what we might expect advisers or online planning software to provide individuals to guide discretionary decisions about saving within or outside a pension fund. This example is based on an assumed rate of relief of 30% of gross contributions.

Table 1 Tax advantage of pension contributions assuming relief at a flat rate of 30%

1	2	3	4	5	6	7	8
Age for Start of Contributions	Flat Rate of Annual Contribution	Fund Size at SPA	Gross Sustainable Draw	Taxable Amount	Headroom for Higher Rate	Total Relief Given	Total Tax Collected
25	£7,500	£1,065,000	£47,925	£35,944	£415	£94,500	£127,241
30	£10,000	£1,067,000	£48,015	£36,011	£348	£111,000	£127,480
35	£13,500	£1,067,000	£48,015	£36,011	£348	£129,600	£127,480
40	£18,500	£1,061,000	£47,745	£35,809	£550	£149,850	£126,763
45	£26,000	£1,051,000	£47,295	£35,471	£888	£171,600	£125,568

Assumptions

State Pension Age (SPA): 67
Life expectancy from State Pension Age: 17.7 years
Real investment growth rate: 5% pa
Sustainable real draw rate in retirement: 4.5% pa of fund at start of draw
State Pension, allowances and tax thresholds constant in real terms
Draw is on top of total State Pensions assumed to be equal to the Personal Allowance
Taxable Amount is after deduction of 25% PCLS ('tax free cash')
Flat-rate relief at 30%
Pension taxed at 20%

Column 1 in Table 1 shows the age at which assumed flat real rates of contribution start. Column 2 shows the rate of flat real contributions, starting at the age assumed in Column 1, calculated to lead to an amount of taxable income in retirement that keeps a basic rate payer below the higher rate. The 'headroom' test in Column 6 serves as a check of the optimality of the solved for rate. Column 3 outputs the estimated mean size of the pot at the State Pension Age (SPA), assumed to be 67. All figures are in real terms, after inflation.

The key assumption is that retirement benefits will be taken in the form of pension drawdown, sitting on top of State Pension benefits. Draw is assumed to start at the SPA. Both could be adding to other sources of income in retirement but the investment income from the pension pot is assumed to form part of the real 'total return', ie capital growth with income reinvested. The drawdown assumption is fundamental to the logic that capital does not need and cannot afford to retire (or stop taking economic risk) when we do, a logic understood better in the Treasury than by many commentators, some financial advisers and our regulators who have all contributed in the past to an unhealthy bias to taking benefits in the form of an annuity. This is therefore also consistent with the belief throughout this paper that the logic of tax incentives to retirement saving is linked to the concept of risk taking and a growth dividend.

The assumed mean real total return on the pension fund assets in accumulation is 5% pa. On the basis of historical real returns, this is higher than if savers had held a balanced asset allocation throughout the period of accumulation (with more bonds and less equities). It assumes a largely equity-based approach for most of the period of accumulation. To earn net returns of 5% investors need to keep their advice and implementation costs at least as low as 1%, otherwise the growth dividend will be eroded.

Based on the assumed approach to asset allocation, with derisking arising mostly in the decumulation phase, we have allowed for a sustainable rate of draw from the portfolio of 4.5% pa in retirement. By sustainable we mean not running out of capital (including on the assumption of longer than mean longevity) and being able to maintain the draw in real terms by increasing the starting rate in line with actual inflation.[8]

We note that all of these solutions based on optimising on tax rates produce portfolio values at SPA around £1m, which is also the new Lifetime Allowance level.

Columns 7 and 8 tell us the expected gains and losses to each party, individual and HMRC, based on these assumptions. Note above all that the balance of advantage for individuals with a flat rate of 30% only attaches to high rates of short-period saving or fairly modest savings rates sustained for very long periods. The highest gain adds up to less than £50,000 cumulatively per individual. Even this advantage would swing back to HMRC with a longer life assumption than 85. This illustrates how the growth dividend works from the point of view of HMRC or (better put) different generations of tax payers. Such small orders of magnitude for expected gains and losses, which may anyway disappear with averaging within each cohort of savers, are trivial compared with the benefits of simplification.

The data suggest that a 30% rate ought not to be appealing for very low savers who can instead make use of ISAs and annual investment-income and capital-gains allowances to avoid paying more in taxes than in a pension account. It is not necessarily a weakness in the incentive regime to leave pensions poorly competitive at the low end as long as there are offsetting tax efficiencies. It is after all at the low end of the earnings spectrum that personal welfare may be better served by flexibility as other savings priorities with shorter horizons (debt repayment, house deposits, family raising) may have higher utility than retirement income. Note that all our contribution assumptions are above the level at which utility is dominated by the interaction of savings and benefits, where even auto-enrolment may be an irrational choice.

As noted earlier, even assuming easy access to decision tools, we do not need all savers to become really efficient maximisers of expected after-tax wealth as long as sub-optimal choices cancel out with averaging.

2. DC Lifetime Allowance

This is the most hated aspect of the 2006 reforms, hated for its arbitrary nature (with tax consequences dependent on factors outside the investor's control) and for its inconsistency (progressive changes to levels that have ranged between from £2m and £1m, with inflation indexation variously promised and then removed). The tax charge for a breach, set at 55%, is also seen as punitive, disproportionate given the lack of control and its lottery nature, and

[8] The sustainable draw rate should be derived from more complex 'stochastic' models but we have tried to emulate a simple model or rule of thumb that would appear plausible to many financial advisers.

disproportionate relative to either income tax rates or (as may be more appropriate) IHT. How this complexity and inconsistency sits in the public's mind is inseparable from the fact that once someone has tied up capital in a pension fund they are a sitting duck for rapacious governments. It is fanciful to ignore the impact on savings choices.

As things stand, on 5th April the Lifetime Allowance will be further reduced from the current level of £1.25m to £1m (50% below the level originally introduced 10 years ago) and the introduction of a tapered annual allowance for those with taxable incomes in excess of £150,000. Both of these changes add further complexity to a pension system which was already suffocating under layer upon layer of legislation.

Complexity and the impression given that 'here be bear traps' have increased the need for advice, not even from tax accountants but rather a far smaller population of qualified pension advisers. The regulatory requirements financial advisers operate under make it hazardous to give any advice without holistic analysis of the client's circumstances and financial position, further driving up the cost of avoiding the bear traps. We have already noted that the product of the nation's savings has been rescued from the weight of self-defeating product costs but it makes no sense then to replace this with the heavy weight of advice costs.

We see no need for any of this unproductive activity and cost under a flat-rate regime. Whenever new lifetime allowance limits are imposed those at risk of breach have been offered the opportunity to protect themselves. One of the conditions of protection is that no further contributions can be made but only a flat rate of relief in excess of 30% would offer any reward for further contributions if we assume that those with protection stand little chance of avoiding higher rate tax on draw.

3. The equivalent DB regime

Changes to annual and lifetime allowances are complex when applied to DC pensions but when applied to DB schemes become completely arbitrary. Witness the change in the annual allowance multiplier from 10 to 16. Attempts to apply DC rules to DB schemes now contain numerous traps for the unwary to the extent that even pension advisers shy away from giving advice to members with a combination of DB and DC benefits.

Lifetime allowance charges on DB schemes can be reduced by opting to commute pension for tax free cash. Commutation factors vary between schemes and with time so the cost of tax relief is not even applied equally between schemes. As an incentive, it works mainly to encourage sponsors to be less generous with commutation factors than they would otherwise have needed to be, which will perversely reduce future tax recovery on the reduced pension payments.

The view throughout this paper is that it is a pointless exercise to try to make the very small DC sector applicable to the much larger DB sector. It just creates its own inequities and randomness and does not address the ways in which DB pensions perform differently from DC as incentives, and even perhaps how public-sector and private DB schemes are different from each other.

Dealing with the appropriate way to tax DB benefits, or possibly also NI on contributions, seems a better way to deal with the Treasury's challenges of both fairness and cost-effectiveness of incentives.

5 Reforming the taxation of death benefits

Judged against objectives for pensions tax of reducing the cost and increasing fairness, the Coalition Government's decision to exclude residual DC pension funds at death from the 55% 'pension recovery charge' was perverse.

It made sense to address the anomaly that the long-standing cut-off for death benefits being paid free of any tax was age 75 rather than death at a much earlier age when there were still likely to be dependents. It could also be argued that encouraging people to spread their drawdown so that their spending was sustainable, without risk of running out of funds, was illogically negated by retaining a tax penalty for dying with undrawn pension residue.[9] But the Government went much further than this by allowing residual or undrawn pension amounts to be passed on untaxed at death to children or grandchildren of the member, with taxation deferred until the point (not restricted) at which the beneficiary chose to encash the funds when tax would be paid at his or her own marginal rate. The eventual tax recovery was therefore likely to be deferred or at a lower rate than the original plan holder's marginal rate (or both), contributing further to the leakage between annual relief and tax recovered.

Since the people most able to benefit from this were those with more accumulated capital than they needed for their own lifetime spending and all or much of that surplus sitting in pension accounts, it tended to increase the bias in the tax regime towards wealthy savers. Like the increase in the nil-rate band to £1m solely to include residential property, it is as a political initiative with a focused constituency and no justification in terms of economic performance.

Both the original tax leakage due to the 75 cut-off and the increment created by the new privilege can be plugged by getting rid of tax free death benefits altogether, lowering the age limit by reference to dependents (eg the State Pension Age or lower), or placing a limit on them (perhaps a special nil rate band for pension funds). Rather than a pension-specific rate for the notional recovery of relief given earlier, otherwise redundant as a consequence of the simplification changes proposed here, we suggest the residue be brought into the estate for tax purposes or charged at the same rate as IHT.

If the current generous tax treatment of pension death benefits was addressed, many of those deferring pension draw might opt to begin taking taxable benefits.

[9] Sustainable draw is not the same as a sustainable spending rate and the benefits of pension freedom are maximised by separating the two, optimising the draw from pensions on tax planning and optimising spending on sustainability. This is a luxury for affluent savers benefiting from continuous financial advice.