Consultation on Pensions Tax Relief
Strengthening the Incentive to Save

I refer to the above mentioned consultation document issued to coincide with the summer Budget and I am responding to the invitation for comments on behalf of Wirral Council in its capacity as the Administering Authority for Merseyside Pension Fund (MPF).

Merseyside Pension Fund, which is part of the Local Government Pension Scheme (LGPS), is the 5th largest of the 89 funds with assets of £6bn. MPF undertakes the LGPS pension administration and investments on behalf of the five Merseyside district authorities and over 150 other employers on Merseyside and elsewhere throughout the UK. The Fund has over 125,000 active, deferred and pensioner members.

The Council concurs with many of the findings within the consultation paper regarding the decline of DB schemes and the benefits of auto-enrolment, but firmly believes that changes to the tax relief regime would be inconsistent with the primary objective to incentivise people to make adequate financial provision for retirement. We also strongly believe that any further change simultaneous to the fundamental changes around 'freedom and choice', the end of contracting-out and the limiting of tax free pension allowances, would result in further complexity and confusion for pension savers as well as for administrators.

The responses to the questions posed are as follows:

1. To what extent does the complexity of the current system undermine the incentive for individuals to save into a pension?

We agree with the opinion in paragraph 3.9 of the document that 'the current system is simple in principle' and we also feel that it is simple in practice. The issues concerning young people and 'lower income groups' failing to make adequate pension provision is not a consequence of perceived complexity in the system, but is largely as a result of an array of financial pressures. We would suggest that the optimum approach of encouraging these groups to save is to improve employment prospects and wages or to provide additional top-ups to pension plans. It would appear injudicious to make pension saving more expensive, by removing tax relief, at the time when people are young and/or of low income, with competing financial demands which will ultimately restrict pension savings.

2. Do respondents believe that a simpler system is likely to result in greater engagement with pension saving? If so, how could the system be simplified to strengthen the incentive for individuals to save into a pension?

In support of the above comment we do not believe that changes to tax relief will result in a simpler system. The perceived complexity of the tax system is not the key obstacle to pension saving as personal circumstances and current financial pressures balanced against unknown future financial commitments is a major barrier to an individual's capacity to make sufficient pension savings.

In order to strengthen the incentive to save, greater awareness of the value of tax relief should be promoted by expressing the amount of the tax relieved contributions on pension statements, and employer incentives should be widely communicated amongst employees. In addition it is necessary to restore peoples' confidence in the pension system by avoiding further radical change to allow a period of stability and greater understanding of the available pension products to nurture a culture of saving for retirement.

Indeed, if a single rate of tax relief was introduced which was set at a higher level than the basic rate of tax, we would see this as a potentially significant incentive for lower paid workers to make pension contributions and, thereby, encourage saving for their retirement. Provided it was not set substantially below the higher rate of tax relief (e.g. around 30%) it would be less likely to act as a disincentive to pension savings by higher rate tax payers.

3. Would an alternative system allow individuals to take greater personal responsibility for saving an adequate amount for retirement, particularly in the context of the shift to defined contribution pensions?

The consultation paper states that current contribution levels to DC are insufficient to maintain an adequate standard of living in retirement. The evidence cited, however, is from 2013, when the new system of work based pension saving was in its infancy. It may be sagacious to wait until 2018 when auto-enrolment has been fully rolled out to assess the position. If savings remain at minimum levels a targeted communication campaign would educate workers as to the optimum level of contributions necessary to realise expected pension income .The move to TEE would be counterproductive and exacerbate pressures on real wages leading to a reduction in pension savings as opposed to the intended outcome of increased pension provision and personal responsibility to ensure financial independence in retirement.

Also, looking at the figures in Chart 2A, the gross cost of registered pension scheme tax relief peaked in 2011/12, and is now falling slowly, despite auto-enrolment. The revisions to the annual allowances and lifetime allowances along with the impending tapering provisions although complex will ameliorate the inherent imbalances in favour of higher and additional rate taxpayers within the tax relief system and control the excessive costs to the Exchequer .

The introduction of a single rate of tax relief may encourage lower earners to save unlike the current system which gives a greater incentive to higher earners.

The complete removal of tax relieved pension contributions particularly for low and medium earners will act as a significant disincentive to savings with the cost of future pension and care provision falling on future tax payers.

4. Would an alternative system allow individuals to plan better for how they use their savings in retirement?

This question suggests that individuals will have a better understanding of how they are going to live in retirement, if they do not have to take into account taxation of pension benefits. The current tax system requires an understanding of gross and net income and a continuation of a consistent tax system into retirement should not impede retirement planning.

However, it may benefit future financial planning by raising greater awareness that although the state pension is paid gross of tax, it is actually liable to income tax through the interaction with other earned pension income.

In light of the new flexibilities introduced under freedom and choice provisions, the current system where taxation applies as funds are withdrawn and taken as income or capital, enables tax to operate as a natural brake on an individual over-spending early in retirement, as people seek to reduce their tax bills. Removing this natural break could lead to individuals exhausting all pension assets earlier resulting in a poorer pensioner population, with greater reliance on welfare benefits than government expectations.

The proposal of an ISA-style pension would lead to many individuals likely to save in other vehicles rather than pensions, which would give them more freedom to access the money, but means that less may be put aside for retirement as there is no incentive for people to lock away their savings.

In general, individuals prefer a current reward over the promise of a future one even if the overall benefit is no different in value which would suggest that less would be saved under an ISA-style system than the current system.

5. Should the government consider differential treatment for defined benefit and defined contribution pensions? If so, how should each be treated?

As the LGPS is a funded statutory scheme, we are specifically interested in DB pensions and the necessity to maintain scheme participation to avoid a rapid acceleration of the maturity of the membership. The abolition of contracting out in 2016 will have significant implications on members' affordability to contribute to the scheme with the potential removal of tax relieved contributions compounding the problem and increasing opt outs, putting further cash flow pressures on the scheme. This will affect investment strategies with a move away from return seeking into defensive assets potentially culminating in increased employer contributions and a direct adverse impact on local taxpayers.

There is no obvious rationale to treating DB and DC pensions differently for tax purposes (other than linking the life time allowance for DC arrangements to contributions rather than values to prevent penalising positive investment returns), as different treatment would lead to greater complexity and confusion specifically in circumstances where people move from DB to DC arrangements and vice versa during their working lives.

6. What administrative barriers exist to reforming the system of pensions tax, particularly in the context of automatic enrolment? How could these best be overcome?

The change to a TEE system (Taxable Exempt Exempt) from an administrative perspective would increase operational costs as pension schemes would have to segregate 'old pensions' from 'new pensions' to ensure that only savings that benefited from up front tax relief get taxed when benefits become payable.

Perhaps, if there is to be a change to TEE, sustainability would be best served if the new regime only applied to new pensions being taken out from a certain date.

If individuals find the LGPS less attractive due to the removal of tax relief, they will opt out, then they will be reinstated every three years under auto-enrolment, and then they will opt out again. This will create further administration costs and utilise scarce resources at both employer and pension scheme level.

The option to introduce a single rate of tax relief is administratively more difficult to operate than awarding tax relief at an individual's marginal rate of income tax. It would be difficult to operate Net Pay Arrangements with a single rate of tax relief and would require employers to use alternate arrangements and incur costly changes to their payroll software.

7. How should employer pension contributions be treated under any reform of pensions tax relief?

Employers in the public sector acknowledge the value of providing quality pension schemes to avoid future reliance on welfare benefits and as pay is generally lower than in the private sector, the provision of a pension scheme is recognised as deferred pay. To enable employers to encourage a culture of saving it is imperative that the any loss of revenue from the removal of the national insurance rebate is recycled back to employers.

8. How can the government make sure that any reform of pensions tax relief is sustainable for the future?

The key concern of moving to TEE system is the fact that it may well not be sustainable as individuals may have less confidence in trusting future governments to honour promises on maintaining the tax-free nature of pension pay outs. The constant change in pension legislation may also provide doubt that future governments would not keep the promise of today's policy makers and tax pensions in payment.

It is probable that if pensions start to be taxed like ISA that most people would prefer the flexibility and better reputation of an ISA over a pension product with a detrimental outcome on auto-enrolment.

In conclusion, while we understand that tax relief on pensions costs a significant amount of money, in order to catalyse a broad-based saving culture, specifically among those on low to middle incomes, a single rate of tax relief is likely to incentivise savings. The removal of upfront tax relief will signify the end of pensions if people do not receive any direct benefit from contributing to pension schemes

Although the change to a TEE model will realise immediate gain for the Exchequer, it will undermine peoples' confidence, and place greater pressure on individual finances, resulting in people opting out of pension saving and ultimately store up a larger burden on the state.

Yours sincerely

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