Strengthening the incentive to save: a consultation on pensions tax relief

Response by the Local Government Association

1. In **'Strengthening the incentive to save: a consultation on pensions tax relief'** the government invites proposals for reform of the current system of pensions tax relief. The current system provides exemption for contributions and exemption for growth but taxes retirement income or EET for short.

2. This response is made solely in respect of public service pensions and the Local Government Pension Scheme (LGPS) in particular. In that respect it covers only the impact on employee contributions as the vast majority of employers in those schemes are tax exempt and therefore receive no tax relief on their contributions.

3. The assessments made within this response of both the current situation and the alternatives relate only to the LGPS. The LGA is fully aware that the conclusions reached in this response would not translate to the wider pensions sector where employer tax relief and larger proportion of higher rate tax payers may render them inaccurate and inappropriate.

4. The response does not address the questions directly however it covers the issues within the questions by assessing both the current system and a number of alternatives against the principles set out in the consultation document namely they should be:-

   - Simple and transparent. The government believes that greater simplicity and transparency may encourage greater engagement with pension saving and strengthen the incentive for individuals to save into a pension.
   - Allow individuals to take personal responsibility for ensuring they have adequate savings for retirement. It should encourage people to save enough during their working lives to meet their aspirations for a sufficient standard of living in retirement.
   - Build on the early success of automatic enrolment in encouraging new people to save more.
   - Sustainable. Any proposal for reform should also be in line with the government's long-term fiscal strategy.

Summary of response

1. The current system provides tax relief on contributions of around **£189** per annum (£16 per month) for an average part-time scheme member and **£316** per annum (£26 per month) for an average full time member rising to **£4200** per annum (£350 per month) for a member paid £100,000 per annum . Tax

relief on contributions does not however provide any form of incentive for the lowest paid who are outside of tax.

2. The current system is broadly fiscally neutral in the LGPS costing around **£564m** in reliefs and bringing in around **£571m** per annum in tax on pensions. This may be an anomaly in the LGPS as only **5%** of LGPS scheme members are in the higher rate tax bands compared to **15%** in the workforce as a whole.

3. The current system is in the main relatively simple, however, the Annual and Lifetime allowances are administratively complex and resource heavy for little return. Less than **2%** of active members earn more than £50,000 per annum in danger of breaching them but bulk calculations and communications are required for all in order to find the few at risk.

4. Restricting tax relief to a flat rate of 20% could provide the option to remove the Annual Allowance and increase simplicity without having an impact on the net pay of the vast majority of members. This may not be true in other schemes with a much different balance between the numbers of members at different pay levels. Furthermore it would not address the lack of incentive for the lowest paid to join or remain in the scheme.

5. Straight TEE would result in tax windfall of up to **£530m** in the first year however this could be significantly reduced by mass opt outs of members who without the tax relief incentive no longer wish to use pension schemes to save.

6. Should the level of opt outs match recent survey results, introducing TEE could see contributions to the LGPS fall by half (a loss to the scheme of over **£3b** per annum) with resulting material impacts on cash-flows, asset liquidity and long term employer contributions.

7. TEE with incentives (T+EE) could provide the ability to use the savings from the removal of tax reliefs and limits to simplify and target the lower paid including those outside of tax.

8. Care would however need to be taken to ensure that such targeting does not dis-incentivise the middle and higher earners who although making up only 10% of the membership provide over **25%** of contributions.

9. The LGPS both in its membership profile and Defined Benefit (DB) structure is unlike the vast majority of schemes in the private sector, for that reason a different approach to incentives could in detail if not in principle be reasonably adopted.

The current EET system

10. The impact of the tax exemption on pension contributions of individual employees, including average part time (PT) and full time (FT) LGPS scheme members is shown in the table below:

Example 1 current EET system tax relief on contributions

	Ave P/T member	*Ave F/T member*				
Pay per annum	***£16,356***	***£24,312***	**£30,000**	**£50,000**	**£80,000**	**£100,000**
LGPS Cont rate %	*5.8*	*6.5*	6.5	8.5	9.9	10.5
Gross taxable pay	*£5,756.00*	*£13,712.00*	£19,400.00	£39,400.00	£69,400.00	£89,400.00
Gross tax	*£1,151.20*	*£2,742.40*	£3,880.00	£9,402.80	£21,402.80	£29,402.80
Contributions pa	*£948.65*	*£1,580.28*	£1,950.00	£4,250.00	£7,920.00	£10,500.00
Net Taxable pay	*£4,807.35*	*£12,131.72*	£17,450.00	£35,150.00	£61,480.00	£78,900.00
Net Tax	*£961.47*	*£2,426.34*	£3,490.00	£7,702.80	£18,234.80	£25,202.80
Tax relief	***£189.73***	***£316.06***	**£390.00**	**£1,700.00**	**£3,168.00**	**£4,200.00**

11. So for an average part time scheme member tax relief is worth **£189 per year** and **£316 per year** for an average full time scheme member.

12. Total tax relief on contributions for members of the LGPS is estimated at less than **£536m** per annum, reflecting the fact that only **5%** of the 1.7m LGPS active members are in the 40% tax band and around **100,000** scheme members pay no tax at all. This balance between a very large majority of lower and lower middle pay members against a tiny minority of high paid members will have a significant impact on the assessment of various flat rate and TEE options below.

13. Tax relief is limited by both the Annual Allowance (currently a maximum increase in pension build-up of £40,000 each year) and the Lifetime Allowance (currently planned to move to a maximum total pension pot of £1m).

14. In order to trigger the Annual Allowance limit a scheme member would (assuming a 10% pay rise and full use of reliefs from previous years) need something like the following combinations of pay and service:-

Example 2 current EET system Annual allowance limit on tax relief

Annual pay	£30,000	£50,000	£80,000	£100,000	£150,000
Years in scheme	41	25	25	25	25
Pay increase	£3,000.00	£5,000.00	£8,000.00	£10,000.00	£15,000.00
Increase in pension pot	£40,163.27	£40,816.33	£65,306.12	£81,632.65	£122,448.98
Taxable increase	**£163.27**	**£816.33**	**£25,306.12**	**£41,632.65**	**£82,448.98**

15. As less than **40,000** scheme members receive pay above **£50k** this is an issue for a small proportion (around 2%) of the membership. According to a recent survey of LGPS funds only **225 (around 0.013%)** members have seen an impact on their tax as a result of annual allowance limits. Nevertheless it is both a complicated and important issue for those scheme members and takes up a disproportionate amount of time and effort by employers and scheme administrators.

16. In order for a scheme member to exceed the Lifetime Allowance they would need to be anticipating a pension in excess of **£50,000** per annum. Less than **2,000** of the 1.4m LGPS pensions currently in payment are in excess of that figure. Of those in active membership a combination of an average pay of £60,000, an accrual rate of 1/49th and 40 years membership would be required to reach the limit. However in order to provide the necessary information to scheme members, annual calculations and comparative data have to be produced for all 1.6m scheme members which as with the Annual Allowance produces a significant administrative overhead for very little result.

17. Income tax is then payable on pensions when they are due as per the following examples:-

Example 3 current EET system tax payable on pension

	Average PT member	*Average FT member*			
Annual LGPS pension	*£4,500.00*	*£7,000.00*	£15,000.00	£25,000.00	£50,000.00
plus basic State Pension	*£6,029.40*	*£6,029.40*	£6,029.40	£6,029.40	£6,029.40
taxable pay	*£0.00*	*£2,429.40*	£10,429.40	£20,429.40	£45,429.40
tax	***£0.00***	***£485.88***	**£2,085.88**	**£4,085.88**	**11,814.52**

18. The estimated total tax paid on LGPS pensions is **£571m** per annum roughly the same amount as the relief provided on employee contributions.

19. However a further relief comes into play on retirement which provides for 25% of the value of the pension pot to be taken as tax free cash. If this happens then only 75% of the potential pension pot is subject to tax. Making some very prudent assumptions (i.e. that all 60,000 new pensioners each year take full

tax free cash and that all receive the FT average pension of £7,000 per annum) the cost of this relief is **£28m** per annum. This gives a total relief cost of **£564m** per annum.

20. In other words the current system is more or less **fiscally neutral**.

21. With regard to the principles the current system is:

- Relatively simple apart from the complexity (for little return) of the Annual and Lifetime allowances.
- Encourages saving for the majority but does little for those at the lower end of the pay scales who receive little or no tax relief.
- Provides little encouragement for those at the lower end of the pay scales to join the scheme.
- Is sustainable as it balances the amount of relief given on contributions with the tax collected from pensions

Alternative 1 - EET with single rate of relief at 20% with the removal of Annual Allowance

22. Moving to a single rate of relief of 20% would have very little impact on the vast majority of LGPS members **(95%)** who do not fall in the higher rate tax band as shown below:-

Example 4 single 20% rate of tax relief on contributions

	Ave P/T	*Ave F/T*				
Pay per annum	***£16,356***	***£24,312***	**£30,000**	**£50,000**	**£80,000**	**£100,000**
LGPS Cont rate %	*5.8*	*6.5*	6.5	8.5	9.9	10.5
Contributions pa	*£948.65*	*£1,580.28*	£1,950.00	£4,250.00	£7,920.00	£10,500.00
Tax relief	***£189.73***	***£316.06***	**£390.00**	**£850.00**	**£1,584.00**	**£2,100.00**
Difference	*£0.00*	*£0.00*	£0.00	-£850.00	-£1,584.00	-£2,100.00

23. The total cost of tax relief on contributions for LGPS members under this system would fall from £536m to **£470m** per annum.

24. These savings would more than cover the cost of removing the complexity (and disincentive to save more) resulting from the Annual Allowance. The Lifetime allowance could be retained to place an overall cap on the amount of relief any individual can benefit from.

25. The tax take from pensioners would be unaffected.

26. With regard to the principles this alternative:-

- Simplifies by removing the complexity and uncertainty (for little return) of the Annual Allowance
- Encourages further saving by those who would have been previously limited by the Annual Allowance. However it does nothing new for those at the lower end of the pay scales and is a potential disincentive for those 5% at the higher end of the scale to contribute.
- Provides no new encouragement for those at the lower end of the pay scales to join the scheme.
- Is sustainable as it balances the amount of relief given on contributions with the tax collected from pensions

Alternative 2 - A straight TEE (Taxed, Exempt, Exempt) system

27. This alternative would remove the tax relief on contributions and replace it with a tax exemption for pensions in payment.

28. The result of this change would be felt by all active members who currently receive relief (some **1.5m** members) as seen in the example below:-

Example 5 TEE system – no tax relief on contributions

	Ave P/T	*Ave F/T*				
Pay per annum	***£16,356***	***£24,312***	**£30,000**	**£50,000**	**£80,000**	**£100,000**
LGPS Cont rate %	*5.8*	*6.5*	6.5	8.5	9.9	10.5
Contributions pa	*£948.65*	*£1,580.28*	£1,950.00	£4,250.00	£7,920.00	£10,500.00
Tax relief	***£0.00***	***£0.00***	**£0.00**	**£0.00**	**£0.00**	**£0.00**
Tax relief lost	*-£189.73*	*-£316.06*	-£390.00	-£1,700.00	-£3,168.00	-£4,200.00

29. The loss of relief would range from **£189** per annum (£16 per month) to over **£4200 per annum** (£350 per month).This would provide a significant disincentive to pension saving. The removal of the Annual and Lifetime allowances would be of benefit in terms of simplicity, but given the very few members who are affected, such a move would be far outweighed by the loss of tax relief to all.

30. The gain to government from removing the reliefs would be **£536m** per annum. There would of course be no loss to those who pay no income tax. These members would in most cases also see no benefit from the exemption of pension income from tax as the amounts would probably be below their individual allowance.

31. As existing pensions would have to continue to be taxed (as they accrued under EET) the cost for exemption would be limited to new pensions and only in respect of benefits accrued after the introduction of TEE. The average LGPS full time scheme member accrues a pension of £500 each year. Assuming 60,000 new pensioners each year the cost of exemption would be around **£6m** in year one (i.e. each pensioner has one year of benefits accrued after the introduction of TEE) rising to around **£300m** per annum in approximately 12 years.

32. As the loss to members would be immediate while the benefits would be slow to materialise a move to TEE could provide a significant disincentive to save using a pension. A recent survey of 2,300 pension investors undertaken by Hargraves Lansdown showed that 45% would reduce or stop savings in their pensions under TEE and that this rose to 60% if the responses were limited to those under 40.

33. Should such reductions in pension savings materialise the tax gain would be significantly reduced, possibly by half to **£270m**. More importantly there would be a similar reduction in employee and employer contributions to the LGPS. Currently contributions into the LGPS amount to **£8.6b** while benefits payable are **£8.5b**. A halving of contributions would have a material effect on cash-flows resulting in the forced sale of scheme assets and subsequent impact on employer contributions.

34. With regard to the principles this alternative:-

- Simplifies the system by removing all tax reliefs on pension contributions but would add back some complexity as two different systems would have to apply to pensions in payment until EET accrued benefits fall away
- Discourages further pension saving as the benefits are all in the future while losses are immediate.
- Provides no encouragement for new members to join the scheme.
- Would provide a net gain to government although the amount might be less than anticipated and would be medium term in nature
- More importantly it could result in significant cash-flow reductions for the LGPS with material impacts on funding and employer contributions.

Alternative 3 - TEE with incentives (a T+EE system)

35. This alternative aims to maintain the simplicity of TEE but by adding back some incentive. It seeks to maintain the encouragement to save using pensions and furthermore aims to address the lack of incentive at the lower end in the current or flat rate systems.

36. In this system contributions tax relief, Annual and Lifetime allowances are all removed but all or part of the savings used to add back an incentive for employees to join or remain in the pension scheme.

37. For example a 20p in the pound incentive could be provided which would have in most cases the same effect as a flat rate 20% relief but would extend the incentive to those who pay no tax increasing the cost by £10m to **£480m.** However, unless the base contribution rate was reduced the actual effect would be more money into the pension scheme rather than offsetting the loss of tax relief.

Example 6 - T+EE 20% without reduction in base contribution

	Ave P/T	*Ave F/T*				
Pay per annum	***£16,356***	***£24,312***	**£30,000**	**£50,000**	**£80,000**	**£100,000**
LGPS Cont rate %	*5.8*	*6.5*	6.5	8.5	9.9	10.5
Contributions pa	*£948.65*	*£1,580.28*	£1,950.00	£4,250.00	£7,920.00	£10,500.00
20% incentive	***£189.73***	***£316.06***	**£390.00**	**£850.00**	**£1,584.00**	**£2,100.00**
Total contributions	*£1,138.38*	*£1,896.34*	£2,340.00	£5,100.00	£9,504.00	£12,600.00

38. The average full time member would still lose £316 per annum from net pay but would see the same go into the scheme in increased contributions. In order to match the net effect of a 20% flat rate the base contribution rate would have to be reduced by the same amount as shown below:-

Example 7 - T+EE 20% with reduction in base contribution

T+EE				0%	20%	
	Ave P/T	*Ave F/T*				
Pay per annum	***£16,356***	***£24,312***	**£30,000**	**£50,000**	**£80,000**	**£100,000**
LGPS Cont rate %	*4.8*	*5.5*	*5.5*	*7*	*8.5*	*9*
Contributions pa	*£785.09*	*£1,337.16*	£1,650.00	£3,500.00	£6,800.00	£9,000.00
20% incentive	**£157.02**	**£267.43**	**£330.00**	**£700.00**	**£1,360.00**	**£1,800.00**
Total contributions	£942.11	£1,604.59	£1,980.00	£4,200.00	£8,160.00	£10,800.00

39. Alternatively the incentive could be targeted at the lower end of the pay scales for example by introducing a 30p in the pound incentive rate up to a pay ceiling of £30,000 with no incentive beyond that point. This would differ from a Defined Contribution (DC) T+EE system where the limit could be an annual pension build amount similar to the principle used for Annual allowances. This option is shown below (with resulting reductions in base contribution rates under £30,000):-

Example 8 - limited T+EE 30% with reduction in base contribution

	Ave P/T	*Ave F/T*				
Pay per annum	***£16,356***	***£24,312***	**£30,000**	**£50,000**	**£80,000**	**£100,000**
LGPS Cont rate %	*4.5*	*5*	*5*	*8.5*	*9.9*	*10.5*
Contributions pa	*£736.02*	*£1,215.60*	£1,500.00	£4,250.00	£7,920.00	£10,500.00
30% incentive	**£220.81**	**£364.68**	**£450.00**			
Total contributions	£956.83	£1,580.28	£1,950.00	£4,250.00	£7,920.00	£10,500.00

40. The total cost of a 30p in the pound incentive to £30,000 would be around **£520m** per annum which is roughly £20m per annum less than the current system. Targeting in this way should encourage those at the lower end (who also tend to be younger on average) to join or remain in the scheme.

41. This option may however have the opposite effect on those higher up the pay scales. In this respect an important statistic is that those earning over £30,000 make up just over **10%** of the membership but pay over **25%** of the total employee contributions.

42. With regard to the principles this alternative:-

- Simplifies the system by removing all reliefs but would include some complexity as two different systems would have to apply to pensions in payment until EET accrued benefits fall away
- Encourages further saving by the adding back of incentives which would include those who currently do not benefit from tax relief
- Could be targeted to encourage the lower paid to join the scheme.
- Could provide a small net gain to government but would be at least fiscally neutral
- Would require care in communication in targeting the incentive to avoid mass opt outs of higher paid staff who pay a disproportionate amount of contributions

A different system for the public sector

43. The public service pension schemes makes up the majority of active membership in open Defined Benefit (DB) pension schemes (over 5m as opposed to 2.7m in private schemes).

44. The membership of those schemes and in particular the LGPS differs from the private sector with the most significant factor being the number of members subject to higher rates of tax.

45. Furthermore any incentive for pension saving either through tax relief or direct would be funded from the same source as the employer contributions and employee payroll from which contributions are derived for those schemes.

46. For those reasons we consider a different system, in detail, if not principle could reasonably be adopted for public sector schemes. For example the exclusion of PSP benefits from annual allowance assessments or the use of a pay limit in a T+EE system rather than a pension build up limit.

Conclusion

47. The current system has much to commend it (in particular for the LGPS its fiscal neutrality) but fails to provide much, if any, incentive for those at the lower end of the pay scales. The Annual and Lifetime allowances are complex and resource hungry while providing very little in return to the government in the form of additional tax.

48. If an alternative system was to be introduced then either an EET flat rate relief without the Annual Allowance or some form of targeted T+EE would be preferred.

Head of Pensions
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