

Effective incentives for savings - a consultation document

16 June 2010

1. Introduction

The Coalition Government is looking for a way to square a circle: the need to restore public finances whilst encouraging the personal sector to save.

To restore public finances, the government is looking for capital sums immediately to offset the accumulated public debt, but also to increase revenue and cut expenditure to tackle the annual deficit and prevent the stock of debt rising further.

Meanwhile, the Government also says it is committed to re-invigorating a savings culture. This would increase the resilience of the personal sector to future economic shocks and improve the level of retirement savings to ensure citizens have adequate funds for their longer retirements - thereby remaining active consumers and free of support from the state purse. But it also costs money, since most forms of saving and investing are boosted by a tax exemption, credit or relief.

The tax regime around pensions and savings has been used before both to raise revenue and to attempt to boost saving. The outgoing Labour government made a series of changes to the tax-privileged position of pensions and savings, starting with the changes to Advance Corporation Tax in 1997, through the introduction of ISAs and Child Trust Funds, and culminating in the last year with two sets of further changes to pensions aimed at raising cash. The latest changes breach the long-standing principle of the 'EET'¹ tax treatment of pension contributions, restricting the tax relief available to those on the highest incomes without any compensating reduction in the tax on pensions in payment. This has led naturally to speculation that further restrictions on tax relief are more likely and will be politically acceptable.

Progressive restrictions of relief over a period (so called 'salami slicing') could be attractive to the coalition government, looking to signal to the markets their continuing determination to control the fiscal deficit. The Liberal Democrats campaigned on a policy of restricting tax relief to the basic rate whilst the Conservatives, although not publically in favour of restriction of relief, did not rule out further changes.

So far, the coalition programme is silent on this topic but AEGON research in the wake of the last budget indicated that around 50% of people thought it was fairly or very likely that there would be further restrictions in the future².

Whilst pensions have been sailing against considerable headwinds, Labour's ISA policy has had better weather. Successive increases in the allowances and the recent confirmation of the permanence of ISAs in the savings landscape have all helped to make ISAs mainstream. However, it's worth noting that the ISA market remains small compared to pensions: in 2008/9, ISA subscriptions totalled £37bn - of which only £9bn

¹ EET refers to Exempt Exempt Taxed: describing the tax treatment of pensions where contributions and growth are tax privileged but tax is payable on the proceeds.

² Figures from YouGov plc. Total sample size was 2131 adults. Fieldwork was undertaken 24–26 March 2010. The survey was carried out online. The figures have been weighted and are representative of all GB adults (aged 18+).

was in stocks and shares ISAs - whereas in 2008, private pensions contributions totalled £82bn. And nearly one-fifth (18%) of those ISA subscribers are aged 65 or over³.

The changes to pensions have made ISAs appear relatively more attractive as savings vehicles. Their 'TEE'⁴ tax treatment is seen as less complex to understand and more flexible, and the costs to the public purse are deferred as the costs of the tax privileges are back-end loaded.

We thus have two competing structures of incentives with very different features and dynamics. When combined with the state national insurance and benefits system, this leaves even expert advisors with a very complex set of considerations when assessing strategies for longer-term savers.

But there is a pipeline filled with legislative change generated by the pension reform agenda set by the Turner Review. From 2012, there will be auto-enrolment of all employees into a qualifying pension scheme and contingent compulsion on employers to contribute to their employees' pensions. Alongside this, a new national pensions scheme, to be known as NEST, is being created to ensure all employees have access to a workplace pension arrangement.

Whilst there has been a broad consensus around the Turner reforms, the new political climate and economic imperatives have put a spotlight on areas of tension. The implementation of auto-enrolment and the development and operation of NEST are both significant costs. The contract to establish and run NEST is estimated by PADA to cost £600m over the next 10 years⁵ and the Treasury estimates the savings in tax-relief from the slower introduction of auto-enrolment at £2.4bn⁶.

There appears no appetite in the new government to reinstate the programme for implementation deferred by the Labour government in its last budget and the new pensions minister has now confirmed the review of NEST proposed by the Conservatives prior to the election is under way looking at both the scope of auto enrolment and the NEST administration contract.

2. Criticisms of the current system

There is now no shortage of proposals to make further reforms to our long-term savings landscape. And there are a number of critiques of the current system – on grounds of complexity, lack of flexibility or deadweight costs.

³ Source: Office for National Statistics

⁴ TEE is Taxed Exempt Exempt: ISA contributions are made after income tax is deducted but growth and proceeds are tax privileged.

⁵ Financial Times, 3 March 2010.

⁶ p173 & Footnote 4, p174, Pre-Budget Report 2009

Means testing under auto-enrolment

One of the consistent points of criticism of the Turner reforms is the potential interaction between modest savings generated by auto enrolment of lower earners and reduction in those same earners' means-tested benefits. The primary critique here is that the widespread application of means testing to benefits undermines incentives to save. Furthermore, attempts to engineer out the steepest 'cliff edges' have made the whole system fearsomely complex.

But the response has been that moving to a State Pension that is both universal and generous is both unacceptably costly and would carry a high deadweight cost. As such, it is poor value for the taxpayer. And in the case of auto-enrolment, the presence of an employer contribution reduces this risk to a minority of the target market (principally amongst those in their 50's who will be renting in retirement)⁷.

Pensions and ISAs

Other criticisms focus on the complexity created by the competing Pensions and ISA regimes. These arguments point to the success of the ISA regime and the contrasting poor public regard for pensions. They also comment on the relatively low cost to the exchequer of the TEE system when compared to EET pensions and observe that, for many, a £10,200 pa contribution is more than sufficient for the majority of savers - representing around 40% of national average earnings. Some have gone as far as suggesting bringing together all savings into an ISA-style regime, and limiting or targeting tax relief for pensions so that those who can afford to save anyway are not subsidised by those who can't.

Others highlight that pensions are designed specifically to secure incomes for retirement. In order to achieve this policy goal, more restrictions need to be placed around pensions to ensure deferral of consumption - for up to 40 years - and that this has, rightly, to be rewarded with a larger and more certain incentive. An EET regime mitigates political risk (i.e. the risk that politicians change the rules before they retire) as the saver is given the tax relief on the way in. In an EET regime, the value of the tax relief increases through time and relies on a continuance of the regime, in the case of retirement savings for potentially 40 or more years. No politician can realistically make such a promise.

Others observe that pensions are prevalent in the workplace setting, and incentives have to persuade corporate benefits managers and their advisors, not just retail customers. Supporters of workplace pensions would point to the boost that the 'A' day simplifications gave, and note that these have subsequently been rescinded or undermined. And that the salami slicing of relief and incentives is reaching a tipping point where pensions can no longer be the near universal component of the benefits package.

⁷ See the PPI's paper, "Are Personal Accounts Suitable for All?"

Progressive tax relief for pensions

Another debate is around the generosity of tax relief for pensions. How can it be in the public interest to give greater incentives to higher-rate taxpayers who already have the means to save substantially for their retirement? Others would argue that this is to misunderstand the nature of the tax privileges on pensions. Tax relief is tax deferred as the proceeds (after the tax-free lump sum) are taxed at their marginal rate. Therefore, those receiving significant relief at the higher rate on the way in, will be paying higher rate tax on the way out. Removal of higher rate relief, they argue, would result in double taxation for those individuals for the difference between standard and higher rate relief. And, in any case, as more of the baby boom moves into the retirement phase, the tax take from pensions payments, at the higher rate of tax increases accordingly. Higher rate tax relief is no 'free lunch'.

Others would say that the tax-free lump sum is a significant factor here, allowing one quarter of the fund to avoid tax. This benefits the higher-rate tax payer disproportionately. And that many who earn at the higher rate have ample opportunity to arrange their affairs so that they minimise higher rate tax in retirement through the use of drawdown rather than annuities.

And the debate on tax in versus tax out is not limited to higher-rate tax payers. If the coalition achieves its aim to raise the personal tax threshold to £10,000 pa basic rate tax payers could be receiving a significant proportion of their tax deferred funds tax-free.

Pre-retirement access to pension funds

Questions are also being asked about the need for increasing flexibility in accessing saved pensions funds both at and prior to retirement. ISAs place fewer restrictions on access.

It is argued that providing access to pension funds (possibly limited to specific emergencies) prior to retirement would increase pension savers' comfort in contributing. The ability to access these funds in specific cases of ill health or long-term unemployment could be a significant safety net, and deal with some of the objections to locking money away until retirement. References are made to legislation in other countries (for example, in the US) to support these arguments. The key debate is between those who argue that access increases the appeal, and hence take up, of retirement savings and those who see no strong evidence to support this and are concerned that such access would only result in people most in need of retirement funds whittling them away, through such early access, prior to retirement.

The PPI has explored these issues in their paper 'Would allowing early access to pension savings increase retirement incomes?' in November 2008⁸ and the SMF recently

⁸<http://www.pensionspolicyinstitute.org.uk/default.asp?p=12&publication=04&pagesize=999&>

launched 'Early access to Pension Saving' in March 2010⁹. The coalition agreement promises to explore the potential for early access.

Annuity and constraints on using funds in retirement

Another area of debate has been around liberalising the arrangements for the use of funds after retirement. Here the debate is around how far the regulations should force people to use annuities to secure their incomes in retirement. Currently, the tax system is designed to drive all people to take an income from their remaining pension fund at age 75. The coalition has made a commitment to remove the obligation to annuitise at 75 but have yet to spell out what requirement, if any, there will be to provide a level of secured income sufficient to prevent the individual falling back on the state.

AEGON's views

AEGON believes that we must build a strong savings culture going forward. This needs to be built on consistent and well-understood incentives - constant tinkering with allowances and tax relief sows confusion and uncertainty.

We believe that restricting auto-enrolment to those earning over £10,000 pa and aged 55 or under would be a practical step to restrict the impact of means testing under auto-enrolment. We are unconvinced that early access to pension funds would significantly increase the take-up and contributions to pensions but are more concerned that it could result in more people reaching retirement reliant on state benefits.

AEGON believes that the law has not kept pace with the changing nature of retirement and the increased needs for flexibility in managing assets in retirement. However, the abolition of age 75 annuitisation legislation without new measures to ensure that consumers understand the importance of guaranteed incomes in later retirement with strong prompts to secure these, we think would be unwise.

Prior to the recent election, we set out our views on these topics in our Pensions Manifesto¹⁰ and called for a one-off review of incentives – not just direct incentives, but behavioural approaches – to create a framework that encourages long-term asset accumulation.

We have since expanded on this by publishing a joint 'White Paper' discussion document, 'Saving Britain'¹¹, outlining practical proposals based on how people think and behave in today's world.

A new approach

As the discussion above shows, there is a complex web of inter-related issues and initiatives on the policy agenda.

⁹http://www.smf.co.uk/early_access_to_pension_saving.html

¹⁰ <http://dms.aegonse.co.uk/download/d380136f16fd77eb3be78a20852a5015>

¹¹ <http://dms.aegonse.co.uk/download/907a532a6375495fc1631c186a172795>

AEGON believes that a new approach is required to help resolve the potential conflicts. We need better understanding of how best to design traditional economic and behavioural incentives to achieve outcomes that:

- Get more people saving more for longer – especially with their retirement in mind;
- Represents good value for the taxpayer;
- Results in support being allocated fairly with regard to needs;
- Creates a simpler system for savers, advisers and administrators to navigate;
- Goes with the grain of people's actual behaviours - or provides effective mechanisms to overcome unhelpful biases; and
- Works in the wider context of the legislative and regulatory environment.

It is our belief that the best incentives are those designed on a behavioural basis.

3. Proposed project approach

To explore these questions further, AEGON UK is proposing to undertake a significant research project as our contribution to the debate.

The objectives of the research are:

- Identify, scope and explore a set of alternative policies for savings incentives
- Identify and explore the likely behaviour changes these policies would stimulate and explore taxpayers' reactions to the proposals in order to gain insight into likely political and behavioural outcomes
- Model and scale the financial impact of these alternative policies in the short and longer term on the public purse, household finances and the long-term savings industry.

We see this work as being in two streams:

- A **consumer research stream** to explore the likely nature and scale of changes in consumer behaviour in response to the policy options. We envisage this will involve primary deliberative consumer research and discussions with employers and advisors, to explore the likely outcomes from policy changes, which will then be fed into the modelling of the financial impacts.
- A **modelling stream** to scale the potential impact of these against a current baseline. Its objective would be to show the overall impact on personal, public and savings industry finances of policy alternatives but with sufficient granularity to identify potential winners and loser groups within consumers and businesses. This would enable us to postulate that if the government does 'x', the impact is 'y'.

The timeline we envisage is as follows:

Stage	Timings
Consultation Period	Early Quarter 3
Consumer research, modelling and analysis	Quarter 3 and Quarter 4
Final report	Quarter 1, 2011

Changing policy background

We are proposing this approach in the content of the policy environment in early June 2010. As noted above, this environment is fast moving with the new government forming policy and many interested parties contributing to the debate.

Whilst this approach represents AEGON's best judgement of how to contribute to the debate, we are very aware that this approach may need to be modified or even abandoned in the light of future changes, including to the policy environment. This consultation therefore sets out our current thinking, but does not bind us to this specific programme.

We would, of course, keep interested parties informed of any changes to our plans.

4. Policy options

To put a structure on this multi-dimensional debate, we have defined three broad areas of optionality. These are:

1. Tax treatment of private savings, pension contributions, accumulating funds and withdrawals or payments of funds
2. Structure of state pensions and benefits - and their interaction with private savings
3. Flexibility of access to funds at different life stages

Using these as a framework and building on some of the emerging policy proposals over recent months, we have drafted different policy options in each area that permit a mix and match approach to exploring policy packages to address the points of debate. These are set out in Appendix 1.

The "tax treatment" area is about the accumulation phase: it looks at a variety of options to reform incentives to encourage those most needing to increase their savings to do so. Options include current proposals to limit pensions tax relief for higher earners, but also the alternative of increasing relief for lower earners and also a more radical change to harmonise the tax treatment of pensions and ISAs. Of course, any changes in accumulation should have a direct link to the "access" options below when overall packages are assembled. Not all combinations of accumulation and access

options are logical, because, as discussed earlier, tax relief is actually tax deferred. So to be fair, the rate of taxation on pensions in payment, it can be argued, should broadly mirror the level of relief at the point of contribution.

The “structure of state pensions” dimension looks at ways to reduce the impact of the offset of modest levels of pensions and savings against benefits entitlement. These ideas have been recently refreshed with separate policy papers from the NAPF, CPS and from Baroness Hollis proposing integration of the two state pensions, along with other measures, to achieve this aim.

“Flexibility of access” looks at ways of introducing access to pension funds prior to retirement, but also ways of increasing flexibility in using pensions and other savings at and in retirement (which is where the current discussion on the “age 75” rule comes in). In terms of access pre-retirement, we’ve tried to capture a point on the scale between the current restrictions and total flexibility, as well as the two ends. This is a one-off advance from the pensions commencement lump sum, without limitation on purpose or reason.

5. Draft scenarios

From all the possible permutations, we have assembled 3 draft scenarios from the options set out in Appendix 1. We are putting these forward for consultation prior to conducting primary research and modelling. These scenarios would all be set against a base case reflecting the status quo as at the election.

The first scenario seeks to capture what the outcome might be should the current round of proposals that are being considered by the new government all come to pass. This would combine:

- a contribution cap on pensions tax relief
- BSP up rated with earnings, and
- new flexibility on access both before and after retirement.

In the table in appendix 1, this would combine Options 1B and 2B and then add Options 3A and 3B.

The second scenario is a radical option to unify all tax-privileged savings into a single TEE environment and achieves a higher level of State Pension by deferring payment to age 75. This combines Options 1D and 2C with Options 3C and 3D.

The final scenario is a much more limited approach that looks to take small steps to simplify savings incentives by applying a unified rate of pensions tax relief with more generous pension disregards to mitigate means testing. It also allows early access to pensions.

6. Consultation

AEGON is seeking responses to our consultation document from those with an interest in this area of policy.

We would welcome your views on:

1. Whether we have captured the main areas of debate and characterised these in a useful way
2. the policy options and scenarios that it would be most helpful to take to modelling and consumer research
3. What output you believe would be most helpful as evidence to progress the debate

Please address your responses to francis.mcgee@aegon.co.uk to be received by Friday, 30 July.

AEGON, in association with the Pensions Policy Institute, will also be holding events with invited interested parties during the consultation period to promote debate and take views.

AEGON UK, June 2010

Savings Incentives – Possible Future Fiscal and Legislative Regime Options

1. TAX TREATMENT OF SAVINGS (choose one)	Current Position	Option A Single rate of Pensions Relief	Option B Combined ISA and Pensions contribution limit	Option C Harmonisation of Pension and ISA regimes	Option D Single savings regime
Tax Relief on Pensions Contributions	Relief is at the marginal rate of income tax ^{12,13}	Single rate of 30% on all future pensions contributions	Relief at marginal rate	No tax relief on contributions	No tax relief on contributions
Contributions Limit	Per annum: 100% of salary or £255,000 ¹⁴ whichever is lower Lifetime allowance: £1.8m ¹⁵	No change	Single annual contribution limit for tax-incentivised savings of £45,000 of which, a maximum contribution to pensions savings of £35,000 No lifetime limit	No per annum contributions limit £2m lifetime limit	No per annum contributions limit £2m lifetime limit

¹² It was announced in the 2009 Budget that from April 2011 people with an income over £150,000 will be restricted from claiming full tax relief on their pension contributions. The restriction will be tapered, so that tax relief will be at the basic rate of tax for those earning above £180,000. This means that people earning above these levels will have to pay some tax on their pension contributions and those made on their behalf by their employer.

¹³ Note that tax relief is granted on the first £3,600 of contributions for non-tax payers

¹⁴ Fixed until 2015/16

¹⁵ Fixed until 2015/16

Tax relief on fund growth	For pensions and ISAs the roll-up of funds invested in bonds, property and cash is tax-free. Dividend income from equities is taxed at the Corporation Tax rate.	No change	No change	As for ISA funds	As for ISA funds
Transitional arrangements	Not applicable	No proposals	No proposals	15% one-off tax on all current pensions assets phased over 3 years (20% on annuity funds). DB pensions assessed on 20x basis.	All existing savings accounts and investment products can be converted for inclusion. 15% one-off tax on all current pensions assets phased over 3 years (20% on annuity funds). DB pensions assessed on 20x basis

2. STATE PENSIONS (choose one)		Option A Targeted increases in disregards	Option B Merger of BSP and S2P	Option C Universal increase in level of Basic State Pension above poverty line from age 75	
State Pensions	Full BSP 2010/11 is £97.65 for a single person and £156.15 for a married couple. Pension guarantee credit levels are £132.60 and £202.40 respectively. SPA will gradually increase to 68 by 2050.	Introduce pension income disregard of £12pw (in 2007 terms), indexed with earnings SPA proposals as currently	Increase BSP to Pensions Credit level at age 75 and index with earnings Abolish S2P SPA proposals as currently	Merge BSP and S2P to increase pension entitlement to Pensions Credit level and then index with earnings SPA proposals as currently	

3. FLEXIBILITY OF ACCESS		Option A Early access to Pensions Commencement Lump Sum (PCLS)	Option B Minimised Annuitisation Requirement	Option C ISA Annuities	Option D Early access to employee contributions
Pre-retirement access to pension funds	No withdrawal of funds except on death.	One-off 25% withdrawal tax-free to be deducted in times of hardship from subsequent PCLS entitlement. Larger withdrawals allowed but taxed at highest marginal rate	No change	No change	Access to all funds contributed by employee rather than employer at any point
Annuitisation of Pension Funds	Funds remaining at age 75 must be used to purchase a lifetime annuity or Alternatively Secured Pension	No change	No compulsory annuitisation required provided have secured minimum income of 40% median income from a combination of state pensions, lifetime annuities or guaranteed private pensions	No change	No change
Tax on Pensions in Payment	Pensions in payment taxed at marginal rate of income tax.	No change	No change	Annuities payments purchased from ISA funds are tax free	No change