Response to HMT consultation:

Strengthening the incentive to save

The Money Charity is the UK's leading financial capability charity.

We believe that being on top of your money means you are more in control of your life, your finances and your debts, reducing stress and hardship. And that being on top of your money increases your wellbeing, helps you achieve your goals and live a happier more positive life as a result.

Our vision is for everyone to be on top of their money as a part of everyday life. So, we empower people across the UK to build the skills, knowledge, attitudes and behaviours, to make the most of their money throughout their lives.

We believe financially capable people are on top of and make the most of their money in five key areas:

- Planning (including budgeting)
- Saving
- Debt
- Financial services products
- Everyday money (including wages, cash, bank accounts)

Introduction

1. We welcome the opportunity to respond to this consultation, and support its stated aims – to strengthen the incentive to save and create a pension taxation system that is *'lasting and that stands the test of time.'*
2. Although the move to automatic enrolment has increased the number and proportion of workers contributing to their pension pots, much of the increase has been in the number contributing at the lowest rates. If contribution rates are in the low single digits, savers will reach retirement unable to convert their pension pots into an adequate income. So this highlights the need for adults to be properly incentivised to save.
3. Faith that the system lasts the test of time is absolutely crucial. In order for savers to be able to make good financial decisions, they need to know what the system will look like over the long term - and know that the decisions that they make today will have at least somewhat predictable outcomes.
4. Our recommendations, filled out in more detail below, are that the principle of tax relief on accumulation (EET) ought to be maintained in order to keep the up-front incentive to save and the sense that savers are keeping their own money rather than receiving a benefit. In order to foster a saving habit early in life, this should be added to with an additional incentive for low income, often younger people, who are currently not additionally incentivised at the same rate as higher income, usually older people. Where savings need to be made, this should happen through further restrictions to the lifetime and annual allowances.

Q1. To what extent does the complexity of the current system undermine the incentive for individuals to save into a pension?

5. The current system is characterised by providing exemption from tax when saving and on investment income, with pensions taxable only upon drawdown (EET). This has the notable plus of providing benefits that are visible up front, strengthening the incentive to save by visibly giving people more than they put in to their pots from the outset. The disincentive to save – taxation during drawdown – is far enough away for most savers to not to act as a deterrent today.
6. We would encourage that any change to the system retains this up-front reward in order to continue to incentivise saving.
7. However, the language of tax relief is not well understood except by the financially capable. Most consumers do not fully understand the tax system itself. So relief of that tax, with the added detail of annual and lifetime

allowances appears opaque to most people. This is exacerbated by complications in the tax system such as the tax free allowance and national insurance. Those exempt from tax due to low earnings might expect an incentive to save, and national insurance is still paid on pension contributions, so is not completely exempt from any type of taxation. Unless and until the tax system is simplified, a system for incentivising pension saving based on tax relief will always be difficult for people to understand.

8. We would encourage a change in the language used to describe tax relief. It should be made explicit that the government is in effect topping-up pension payments by 20%, 40% or 45% up to the annual limit. This language would be far easier for the consumer to understand.
9. Given the relatively low understanding of pension tax relief, we would encourage a concerted public education campaign to explain what the system can provide. This should explain that you can keep your money, and that you can get the most out of the taxman, giving meaningful examples of what this would mean for people's finances.

Q2. 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?

10. The proposals to replace EET with a TEE system similar to an ISA, even with top-ups for the first few thousand pounds of post-tax contribution, will bring forward the disincentive to save for your pension. Unless this is more than made up for by top-ups (in order to make up the lost revenue from no longer taxing drawdown it likely will not be) this will reduce the incentive to save.
11. Despite its problems of regressiveness and increasing cost, tax exemption has two great psychological advantages over government top-ups:
    a. People feel like they are keeping their own money rather than receiving a benefit from government. This appeals to the sense people have of self-reliance and financial capability.
    b. The recent experience with tax credits where thresholds were reduced and withdrawal rates increased shows that in a situation where top-ups are seen as being given by the government rather than an individual keeping their earnings, they are easily subject to changes. Top-ups will not be trusted and this uncertainty will undercut long term financial planning. If people believe that top-ups will not remain steady during their careers, they will not be able to make sound financial decisions.

12. The problem of higher rate and additional rate taxpayers having their pension contributions subsidised at 40% and 45% while basic rate taxpayers are incentivised with a lower 20% has often been commented upon as a key problem with the tax relief. On top of this, as tax free allowances are increased to £12,500, those on lower incomes will have no additional incentive whatsoever to save.
13. We would encourage the government to use some of the money saved by reducing annual and lifetime allowances to provide an additional incentive to save, separate from tax relief, for those currently not paying tax due to low incomes and those paying the basic rate.
14. As income is usually lowest at the beginning of a person's career – the very time when saving will have the greatest long term payoff – incentivising lower income people to put money away will foster the savings habit earlier in life. This will both leave future pensioners better off in retirement and improve lifelong financial capability.

Q3 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?

15. A 2012 ONS study found that more people believed that individuals ought to be responsible providing for themselves in retirement than previously. And a falling proportion of the population thought the state should have a role in telling people how much to save[1]. This shows that people have become more comfortable with the idea of personal responsibility. Tax relief is a policy that appeals to this growing sense, allowing savers to imagine that they are saving their own hard-earned money, rather than receiving a benefit.
16. If an alternative system that shifts entirely from the concept of tax relief to one where some post-tax contributions are topped up, the psychological benefit of keeping your own income will be lost.
17. The shift to automatic enrolment has the effect of undermining personal responsibility. Given that many of the newly enrolled employees are saving at rates that will not leave them a suitable income in retirement, we encourage the government to study those who are contributing through automatic enrolment and look into ways to incentivise contribution at higher rates amongst this cohort.
18. The pension is a unique product designed to provide income in retirement and EET reflects that. Treating pensions as an ISA will make it seem like any other savings vehicle, and people may begin to regard it as such.

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193372/rrep813.pdf

Q4 Would an alternative system allow individuals to plan better for how they use their savings in retirement?

19. Most people do not believe that the pensions system that exists today will exist throughout their career. A 2012 study by the ONS found that attitudes to pensions are often characterised by complexity, fear, denial and uncertainty[2].

20. In 2012, 38% of people did not believe that there would be a state pension when they retire and a further 20% did not know. This degree of uncertainty in the financial and political sustainability of the pension system needs to be addressed in order to allow individuals to plan better.

21. The *'pension freedoms'* represented a huge change in the way that people use their pension savings. If those saving in defined contribution pensions had known that there would be other choices but an annuity, they may have planned alternative investment vehicles to provide retirement income.

22. If other changes of a similar scale are made, such as significant alterations to the state pension or a shift in the taxation of pensions to a TEE system, these must be seen a sustainable, both politically and financially.

23. If this consultation results in a major change to pension taxation, it will represent the second large change to pensions in less than five years. People save into pension pots for 30 – 40 years. For today's 25 year old, if this rate and scale of change continues, it means that they will retire into a completely unrecognisable pensions environment, and any long term planning will simply be a matter of putting money away and hoping for the best.

24. In the case of a major change, it should to be unveiled as a "generational settlement" for pensions that is financially secure and supported by people from all sides of policy making.

Q5 Should the government consider differential treatment for defined benefit and defined contribution pensions? If so, how should each be treated?

25. We see no justification for treating different types of pensions differently. If the taxation of pensions moves from EET to TEE, this places the treasury in a difficult position. Defined benefit pensions cannot be taxed during accumulation, and can only be taxed during drawdown.

26. In the past few decades, people have pursued careers characterised less by staying with a single employer for long stretches and more by moving from job to job. This change will leave a lot of people with mixed pensions. The danger of taxing drawdown from separate pensions deferentially is that some pension income will be taxable and some will not, adding to complexity. If pensions are

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193372/rrep813.pdf

made tax exempt during drawdown, a way of taxing defined benefit pensions should be introduced so that consumers are make simple calculations of their income.

Q6 What administrative barriers exist to reforming the system of pensions tax, particularly in the context of automatic enrolment? How could these best be overcome?

27. The Money Charity has no comment to make on the administration of the pensions system.

Q7 How should employer pension contributions be treated under any reform of pensions tax relief?

28. While, as mentioned in the consultation paper, the importance of tax relief in incentivising individual savings has been questioned, employers will tend to make much more economically rational decisions about compensation packages, so a form of tax relief ought to remain.
29. If the taxation system does shift to one where post tax savings are topped up by the government up to a threshold of a few thousand pounds of contribution, the employer contribution ought not to be part of this threshold. Individuals ought to be incentivised to save individually regardless of the contribution that their employers are making.
30. One of the objects of any system of pension taxation is to encourage high levels of saving. In order to do this, any new system should incentivise both the employer and the individual. People should understand that they, their employer and the tax system contributes, and it should be the case that the more they put in, the more they should get from the other two parties.

Q8 How can the government make sure that any reform of pensions tax relief is sustainable for the future?

31. Taxing pensions at drawdown provides an automatic stabiliser for demographic changes. If pension tax is taken from those who are not working, rather than those that are, the treasury does not suffer the same fall in tax receipts that would be expected from a decreasing ratio of working age people. Taxing pensions during accumulation may bring forward revenue and allow the Chancellor to achieve a balanced budget in this parliament, but if this is done at the expense of long term fiscal sustainability, no one will have any faith that pension taxation will not change again.
32. The uncertainty people have about pensions is based on the experience that people coming up to retirement now have of less generous provision than the previous generation. The common assumption is that this process will

continue with successive cohorts being worse off. It may not be politically expedient, but the way to create a system that people trust not to gradually deteriorate is to make the difficult decisions up-front. If subsidy through tax relief or any alternative system is to fall significantly, this should be made clear now so people do not retain the expectation of continually worsening pensions.

33. The reform of taxation must also be politically sustainable. This is why we call for the retention of the tax relief principle. Tax relief, whereby savers are allowed to keep their own money, is more difficult for a future government to change than a top up rate, levels and thresholds of which can and will be shifted regularly to suite the fiscal and political climate.
34. We would also recommend that any change is made with bipartisan support so that future changes in government do not necessarily result in uncertainty about the pension taxation regime.