Conservative proposal to increase support for pension saving

Description of the proposal
The Conservatives have announced that, if elected, they would cut taxes by £4.0 billion in 2007–08. Of this they have allocated £1.7 billion to increasing support for individual contributions to private funded pension schemes where these contributions attract relief at the basic rate of income tax. Currently each 78p contributed by non-higher rate taxpaying individuals (i.e. basic rate taxpayers, starting rate taxpayers and non income taxpayers) to private pensions attracts relief of 22p. The Conservatives proposal would add another 10p Government contribution to each 78p of individual contribution, but only when they are made to funded private pension schemes.

Under the Conservatives’ proposal contributions made on individuals’ behalf by employers, those that attract higher rate relief, and those made to unfunded public sector pension schemes, would not qualify for the additional support.

Q1. Who would win from this policy?
Individuals who contribute to private pensions that qualify for this support, and who are not higher rate income taxpayers, would be gainers from this policy. The Conservatives estimate that around 10 million individuals are in this position. These individuals would receive more financial support for their personal contributions to their pensions than they would under current arrangements for tax relief. This means that the same amount of private pension saving would achieve a larger amount of pension wealth.

Some of the individuals who receive this support might not have contributed as much, or at all, to a qualifying pension in the absence of the policy. The fact that these individuals would have chosen to change their behaviour suggests that they have only done so because they are made better off. Hence one can argue that all individuals who do not pay income tax at the higher rate and who would contribute to qualifying pensions after the reform, would have been made better off by this policy change. (In addition those higher rate taxpayers who contribute more to a funded pension than the amount by which their income exceeds the higher rate threshold also receive basic rate relief on part of their pension contribution and therefore this part of their pension saving would be eligible for increased support.)

Q2. Who would lose from this policy?
There would be no losers from this policy. One potential group of losers could have been higher-rate taxpayers making individual contributions to personal or stakeholder pensions. At present the tax system operates in a way such that these individuals automatically receive basic-rate tax relief on their personal contributions to their pension, and claim back the balance of (higher-rate) relief that they are due at the year end. Were this policy to operate in such a way that higher rate income taxpayers automatically received basic rate tax relief plus 10% on their individual contributions, then these individuals would have less money to claim back at the year end. Since the money that is claimed back at the year end can be used as an individual chooses, but payments that are automatically credited are locked into a pension fund, this reduction in money claimed back would leave individuals with less resources to spend on buying goods and services. In order to free up extra resources to spend, some higher-rate taxpayers might in
this situation choose to cut their pension contributions (and so qualify for less tax relief). The Conservatives have said that they will design the policy in a way that avoids these individuals losing. While no details have been released for how this might be achieved, designing the scheme in this way could lead to extra complexity in the administration of personal and stakeholder pensions. Regardless of this point, the policy might also create administrative difficulties for the administration of defined benefit pension schemes.

**Q3. How much would the policy cost?**

The Conservatives have allocated £1.7 billion to pay for this policy, and believe that they have costed it “prudently”. The policy is targeted on contributions made to funded pension schemes which attract relief at the basic rate of income tax. This targeting, and the paucity of available information on pension contributions, makes it difficult to cost this policy accurately.

By making a number of assumptions the Conservatives estimate that if individuals do not change their behaviour the policy would cost £1.0 billion a year to implement. The assumptions made do not seem unreasonable. Rough calculations using figures from the Inland Revenue suggest that the total income of non-higher rate taxpayers is around £440 billion. The Conservatives £1.0 billion costing is consistent with around 2½% of this income being paid by individuals into funded pension schemes, which does not seem unreasonable.1

The cost would also depend on the extent to which those individuals affected by the policy would respond to the increased incentive to contribute to a private pension. This is extremely difficult to estimate in advance, but the Conservatives have allocated an additional £0.7 billion, which on the basis of the £1.0 billion estimate outlined above, would allow for a potential 20% increase in pension contributions. This would be a large increase in contributions and a smaller increase in contributions would reduce the cost of the policy (see question 5 below).

**Q4. What would be the effect on defined benefit pensions?**

The policy would make a given pension promise cheaper to deliver. Hence it would strengthen the position of funded defined benefit pension schemes, and hence could lead to some individuals receiving higher pension income in retirement than would be the case in the absence of the policy.

**Q5. Would the policy lead to increased pension saving?**

One aim of this proposed policy might be to increase the amount of funds flowing into funded private pensions. The increased support to pension saving would have two effects on incentives to save in a pension which work in opposite directions. Were it to be introduced the reform would increase the amount of pension wealth that could be bought by each pound of personal income allocated to pension saving; this substitution effect would increase the incentive to save in a private (funded) pension. On the other hand the reform would also mean that an individual could achieve the same final private pension wealth by allocating less of their personal income to pension saving; this (lifetime) income effect would tend to decrease personal saving in private funded pensions. While these competing effects mean that it is unclear how individual contributions to qualifying pensions would respond to this policy, the extra government contributions would mean that total contributions to qualifying pensions would almost certainly not be reduced, and would probably be increased, were this policy to be introduced.

The reform would also increase the attractiveness of contributing to a qualifying pension to non higher rate taxpayers who do not currently save in this way: the reform would make such contributions more attractive relative to spending on current consumption and also relative to other forms of saving. To the extent that the reform resulted in people
shifting wealth that would otherwise have been saved in other assets, personal contributions that attract the support would not actually be new saving, although they could still represent new pension saving if the money would otherwise have flowed into non-pension assets. Although funds that were reshuffled in qualifying pensions rather than being saved elsewhere would not be new savings, they would still attract financial support and so – provided the Government support is more costly than any reliefs that would have been due for other forms of saving – increase the cost of this policy. Furthermore funds that were reshuffled from non-qualifying to qualifying pensions would not even be new pension saving – for example a basic rate taxpaying teacher who instead of purchasing added years in her unfunded final salary scheme chose instead to make a contribution to a stakeholder pension would simply be shuffling saving from one form of pension to another.

The Conservatives have estimated that this policy would imply a £1.0 billion cost of extra support for existing contributions to funded pensions, which implies that there are currently around £7.8 billion of such contributions attracting £2.2 billion of tax relief. Under the assumption that this is correct, table 1 illustrates the annual cost of this policy, and its impact on balances in funded private pensions, for a range of scenarios concerning how the level of individual contributions would be affected by the new financial support. One way to summarise the information in the table is that under the policy envisaged, an extra £1 billion of individual contributions to qualifying pensions would lead to an extra £410 million^2 of state support for these contributions and so an extra £1.41bn of deposits into qualifying pensions to be added to the £1 billion of extra state financial support paid for current contributions.

In more detail, the first row of the Table indicates that if no new savers were attracted to qualifying pensions, and if current savers aimed to keep their total pension contributions at the level they would have achieved without the new support, then this implies a cut of slightly more than nine per cent (from £7.8 billion to around £7.1 billion) in individual contributions to qualifying pensions. The fourth row of the table (highlighted in bold) corresponds to the Conservative’s main costing of the policy. This envisages a total of £1.7 billion of new individual contributions to qualifying pensions due to this policy, which may come from existing contributors increasing payments, or from savers who are new to qualifying pensions. With such a response the total cost of financial support to contributions to qualifying pensions would be increased by £1.7 billion, and there would be a total of £3.4 billion per annum of new funds flowing into qualifying pensions. This costing implies an increase in personal contributions of slightly over 20%. This seems quite a strong response, which suggests that the costing provided is quite cautious (i.e. high), although a lower costing would correspond to less success in attracting funds to funded private pensions. Furthermore, the response could be quite strong if the policy generates the kind of reshuffling of assets discussed in the previous paragraph. The possibility of a strong response explains why we have included a row in the table to show the implications if the policy were to increase individual contributions by 30%.
Table 1: Funds flowing into funded private pensions under Conservative plans

<table>
<thead>
<tr>
<th>Change in individual contributions to qualifying pensions</th>
<th>New individual contributions</th>
<th>Financial support for new contributions (at 32%)</th>
<th>New financial support for current contributions</th>
<th>Implied total cost of policy</th>
<th>Implied total new funds in qualifying pensions</th>
</tr>
</thead>
<tbody>
<tr>
<td>−9.1%</td>
<td>−0.71</td>
<td>−0.29</td>
<td>1.00</td>
<td>0.71</td>
<td>0.00</td>
</tr>
<tr>
<td>0%</td>
<td>0.00</td>
<td>0.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>10% has to be noted</td>
<td>0.78</td>
<td>0.32</td>
<td>1.00</td>
<td>1.32</td>
<td>2.10</td>
</tr>
<tr>
<td>Conservatives’ assumption ≈ 22%</td>
<td>1.71</td>
<td>0.70</td>
<td>1.00</td>
<td>1.70</td>
<td>3.41</td>
</tr>
<tr>
<td>30%</td>
<td>2.34</td>
<td>0.96</td>
<td>1.00</td>
<td>1.96</td>
<td>4.30</td>
</tr>
</tbody>
</table>

Q6. Would the policy lead to increased national saving?

The last column of Table 1 indicates how much extra money might flow into qualifying pensions under different assumptions about the responses of private savers to this potential policy. However, not all of this could be considered as new national saving. Part of it represents state financial contributions. If this policy were not introduced then these contributions would not need to be paid and the funds could instead be used to reduce the national debt. Furthermore, even the new individual contributions could not all be seen as new national savings if some of these contributions would in the absence of the policy be saved in other assets. Since there exist assets that are quite close substitutes for private pensions, this reshuffling could be quite strong and the contribution of this policy to national saving could be correspondingly small.

Q7. What does all this mean for ensuring adequate pensions?

Even if the policy does not add a huge amount to national saving, it might add rather more to total pension saving. It could therefore help some individuals to ensure that they have adequate provision for their retirement, but certain provisos must be noted. First, if the policy were not introduced and instead national debt were reduced, then this could free extra resources for future spending on state pensions to ensure adequate provision. Extra private provision through saving now may be preferred if this offers a better guarantee of future pension incomes than current policy promises. On the other hand, future policy changes could erode future private pension incomes, for example by taxing them more heavily than currently expected. Second, it may be that many of the individuals who would end up with a little extra pension provision because of this policy would have ensured themselves reasonably good retirement incomes even in the absence of the policy.

Q8. Would the policy create an incentive to convert employer contributions into employee contributions?

At present, employer contributions to pensions are financially more favoured than employee contributions because they are exempt from employee national insurance contributions (the main rate of which is 11%) and employer national insurance contributions (the main rate of which is 12.8%). Those individuals affected by the policy would see an increase in the attractiveness of making individual pension contributions relative to having contributions paid on their behalf by their employer (perhaps as part of a salary sacrifice arrangement). However, the new support would not completely offset the advantages of employer contributions that are due to the system of national insurance contributions. Therefore we might not expect to see a big shift from employer contributions towards employee contributions due to this policy.
Q9. This is a very complicated policy – can we expect individuals to understand it and respond to it?

Basic rate taxpaying individuals would not need to understand all the complexities in order to understand that they would receive additional support worth an extra 10% (of their personal gross contribution) under the Conservatives policy. Moreover those advising individuals on their pension decisions should be able to understand the policy. An alternative, but very similar, policy that the Conservatives might want to consider would be to make individual contributions to private pensions exempt from employee national insurance contributions. This might have advantages in terms of greater simplicity, although the overall cost of this alternative policy could be somewhat different from the cost of the current proposal.  

ENDS

Notes to editors:

1. Table 2.5 of Inland Revenue Statistics (http://www.inlandrevenue.gov.uk/stats/income_tax/table2-5.xls) shows that individuals with incomes below £30,000 a year have a total income above the personal allowance of £366 billion. Adding in half of the income above the personal allowance of those with incomes between £30,000 and £50,000 (to approximate those with incomes below the higher rate threshold) gives a total income above the personal allowance of those earning below the higher rate threshold of £439 billion. To support all of this income by 10% would cost £44 billion. Hence for the Conservatives costing to be correct 1/44th of this income must constitute individual contributions to private pensions (i.e. 2.3%). Another problem with this estimate is that it includes contributions from higher rate taxpayers which only attract relief at the basic rate of income tax.

2. This is 1 billion * (32/78).

3. Those individuals whose earnings are above the Upper Earnings Limit currently pay employee national insurance contributions at a rate of 1%, and employer contributions to a pension paid on their behalf receive relief at that rate. While this relief on employer contributions would not be worth as much as the 10% support available on individual contributions (to funded pension schemes which attract basic rate relief) under the Conservatives proposal, these employer contributions do also attract relief from employer national insurance contributions at a rate of 12.8%. Therefore the employer and the employee could still both be financially better off if the employer continued to make the contribution as long as part of the saved employers national insurance was transferred to the employee.

4. The main rate of employee NI is 11% which is higher than the 10% support proposed by the Conservatives. Moreover those higher earners (who pay employee NI at a rate of 1%) would also benefit from the change. This would be at least partially offset by the fact that those earning above the UEL but who receive basic rate relief on some of their pension contributions would receive support of 1% instead of 10%. In addition those earning below the LEL, and those not in paid work, would not benefit from this alternative policy.