PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

PENSION TAX REFORMS: IMPLICATIONS FOR SAVERS

JULY 2021

PLSA ANALYSIS OF PPI MODELLING
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INTRODUCTION

During the past year, there has been much speculation in the media that the Government may be looking at reforming pensions tax relief as a source of additional revenue to help to pay for the costs of the pandemic or to support the cost of changes to social care.

In response to this speculation, the PLSA has produced two reports. The first, 'Five Principles for Pension Taxation'[1] assessed a number of potential reforms against its five principles.

Principles for Pension Taxation

- ***Promotes adequacy***: provides financial support and incentivises saving for retirement.
- ***Encourages the right behaviours***: helps savers make the right decisions about retirement saving.
- ***Fair***: helps everyone – the employed, the self-employed - save for retirement.
- ***Simple to adopt & administer***: avoids unreasonable transition and on-going costs for employers and schemes.
- ***Enduring & sustainable***: designed to avoid repeated change and so builds confidence in long-term saving.

The assessment suggested that neither the current system, nor any of the seven options for reform widely discussed, meet all of our five Principles for Pensions Taxation. However, the current system satisfies more of the principles than any other option. The lowest scoring option is TEE; it meets only one of the five principles for reform and fails four of them. The other options only satisfy one or two of the principles, although some do also achieve some neutral scores.

We concluded that, rather than embarking on a major reform of pensions tax relief, there is more value in addressing some of the more specific and technical shortcomings of the current system. For example, the inequalities created for low income savers due to the differences in tax administration systems used by different pension schemes - the net pay / RAS issue.

In this report, we explore in more detail how four of the reforms would affect different workers with different levels of income and in different schemes: a change from EET taxation of pensions to TEE and a change to a single rate of tax relief set at 20%, 25% or 30%.

[1] https://www.plsa.co.uk/Policy-and-Research/Document-library/Five-principles-for-pension-taxation

EXECUTIVE SUMMARY

The modelling was produced by PPI and subsequently analysed by Jackie Wells for the PLSA. It was designed to reveal the impact of different pension tax reforms, specifically, a move from EET to TEE[2] or a flat rate of tax relief (at 20%, 25% and 30%)[3] on different individuals. The individuals were chosen specifically to illustrate the impact of different tax reforms on individuals with earnings in different tax bands.

The first section of this report provides further details of the modelling and the assumptions used. The report then goes on to highlight the impact of the reforms on the different individuals, showing the effect on private pension income, total retirement income, retirement replacement rates and the PLSA's retirement living standards.

Limiting pension contribution income tax relief to basic rate (currently 20%), will result in few winners and many losers.

At a single rate of 20%, most basic rate taxpayers (those earning between £12,571 and £50,270[4]) will see no change to their pension contributions or tax bill. However, this may not be the case if their earnings are close to the basic rate band. Those earning just below the higher rate (£50,270) throughout their career may pay between £12,000 (in an A/E DC Scheme) and £119,000 (DB CARE Scheme) in extra tax or reduced pension contribution or benefits.

All higher rate taxpayers (those earning between £50,271 and £150,000) or additional rate taxpayers (earning over £150,000) will pay more tax for every year that they remain at that income. For some, particularly those in DB schemes, there would be very substantial tax bills to pay and, for their schemes, a decision to make as to whether to allow the tax bills to be paid by the scheme in return for lower benefits at retirement. The modelling suggests that a higher rate taxpayer who earns at the 90th percentile (i.e. at age 22 earning £29,000 per year and at age 68 earning £64,000 per year) would have to pay between £34,500 (in an A/E DC scheme) and £205,700 (in DB CARE Scheme) in extra tax over a working lifetime, reducing their pension contribution or benefits.

Setting a single rate of income tax relief at somewhere between basic and higher rates (25%) yields a different result. Basic rate taxpayers generally benefit from improved pension contributions or benefits - their private pension is boosted by between 5% and 8% depending upon scheme type. However, higher rate taxpayers still pay more tax with the result that they receive lower pensions in retirement or reduce their take-home pay during their working life. At 25%, the extra tax a higher rate taxpayer who earns at the 90th percentile of earnings would have to pay would be between £26,300 (in an A/E DC scheme) and £150,400 (in a DB CARE scheme). At a 25% single rate their pre-tax private pension income is reduced by 16%.

However, even at these higher rates, there is a much smaller impact on total retirement income (state pension and private pension) and replacement rate, due in large part to the dominance of the state pension in the retirement incomes of most of the individuals we have modelled.

[2] TEE is where income tax is fully applied to all contributions but investment returns and income in retirement are both exempt from tax. The current system is EET where tax is exempt on contributions, exempt on investment returns and taxed when taken in retirement.

[3] Individuals currently receive tax relief at their marginal rate of tax. A flat rate of tax relief would mean that all individuals receive the same level of tax relief – not matter what income tax level they are paying.

[4] At the current tax year 6 April 2021 to 5 April 2022.

The table below considers the impact of reforms on individuals' target replacement rates. In its 2004 report[5], the Pensions Commission proposed target replacement rates for different levels of earnings. For example, for someone earning between £17,500 and £25,000 their target replacement rate is 67%.

As shown in the table, none of the reforms modelled lift any of our individuals from below (red) to above their target replacement rate (green). Apart from Sam, our non-taxpayer, it is only in a DB scheme that our individuals achieve their target rates.

FIGURE 1: REPLACEMENT RATES AND PENSION COMMISSION TARGETS

Average replacement rate (no lump sum taken)		Current system EET net pay	TEE system	Flat rate relief: 20%	Flat rate relief: 25%	Flat rate relief: 30%
Sam (non-taxpayer)	DC AE	103%	103%	104%	105%	105%
	DC 12%	122%	122%	127%	127%	129%
	DB CARE	172%		174%	179%	183%
Alex (median earner, basic rate)	DC AE	52%	51%	52%	53%	54%
	DC 12%	62%	59%	62%	63%	64%
	DB CARE	125%		125%	126%	128%
Jamie (cusp of higher rate)	DC AE	39%	37%	38%	39%	40%
	DC 12%	48%	43%	45%	47%	48%
	DB CARE	116%		112%	114%	115%
Chris (occassional higher rate taxpayer)	DC AE	42%	40%	41%	42%	43%
	DC 12%	50%	47%	49%	50%	52%
	DB CARE	117%		114%	116%	117%
Ronnie (90th percentile, mostly higher rate taxpayer)	DC AE	33%	30%	31%	31%	32%
	DC 12%	44%	38%	39%	41%	42%
	DB CARE	115%		110%	111%	113%

The modelling also demonstrates how few people are currently likely to achieve a "Moderate" or 'Comfortable' Retirement Living Standard from pensions. All but high earners, 90th percentile earners in a generous DB scheme or some of those making very large DC contributions throughout large part of their career, get near the "Comfortable" level. Under current minimum automatic enrolment savings levels of 8%, people on median earnings saving by themselves are only likely to achieve somewhere between the 'Minimum' and 'Moderate'.

[5] Pensions Commission 2004, Pensions: Challenges and Choices, The First Report of the Pensions Commission

The PLSA found in its previous report, 'Five Principles for Pensions Taxation' (February 2021) that adopting a single rate of 25% might be expected to raise £3.5 bn to £4.8 bn per year. Removal of all higher rate relief, i.e. applying a 20% rate, might save HM Treasury around £8bn to £10bn per year. However, these savings for the Treasury result in lower pensions saving for many.

MEDIAN EARNER (ALEX)

For Alex, a shift to basic rate income tax relief on pension contributions results in no change to either her tax bill or her pension in retirement. However, a single rate of 25% or 30% boosts her private pension regardless of the scheme that she is in but most of all in a DB scheme.

TEE would be damaging to Alex as she would receive a lower income in retirement than under the current regime or a single rate of tax relief.

Under the current pension tax regime and in a DC scheme, Alex could expect to achieve at least a minimum single person retirement living standard (£10,200), as defined by PLSA over the course of her retirement. However, in a DB CARE scheme, Alex could expect to achieve a moderate standard (£20,200). If part of a couple household, Alex could more contribute more comfortably to a moderate or comfortable retirement living standard (RLS).

FIGURE 2: IMPACT OF TEE AND SINGLE RATE ON ALEX'S AVERAGE TOTAL RETIREMENT INCOME AND RETIREMENT LIVING STANDARDS (RLS)

Average total take home retirement income (no lump sum taken)		Current system EET net pay	TEE system	Flat rate relief: 20%	Flat rate relief: 25%	Flat rate relief: 30%
Alex	DC AE	£ 14,100	£ 13,700	£ 14,100	£ 14,300	£ 14,500
	DC 12%	£ 16,400	£ 15,700	£ 16,400	£ 16,700	£ 17,000
	DB CARE	£ 32,200		£ 32,200	£ 33,300	£ 34,500

Minimum RLS
Moderate RLS
Comfortable RLS

Changes to the tax regime would not significantly affect Alex's RLS, other than at a 25% and 30% single rate in a DB scheme where Alex could reach a comfortable RLS.

In all tax scenario, Alex remains a basic rate taxpayer in retirement.

HIGHER BASIC RATE TAXPAYERS (JAMIE AND CHRIS)

The picture is less clear for our two higher earners, one of whom (Jamie) earns just below the higher rate tax band for the whole of his career and one (Chris) who is a higher rate taxpayer for 10 of her 46 years of working life.

At a single rate of 20%, Jamie's DC pension drops by 7% (A/E) and 13% (12%) and by 16% in a DB scheme. This is a direct result of having to pay more tax and pension contributions / benefits falling as a result. Over a working lifetime, Jamie pays between £12,000 (A/E) and £119,000 (DB) in extra tax, reducing his pension contribution or benefits.

Chris' pre-tax pension income falls under TEE and a 20% single rate in DC schemes (by 2% and 5%) but falls under all single rates in DB (due to the higher value put on the employer contribution). Her pension falls by 12% in DB under a 20% single rate regime. Under a 20% single rate, Chris pays between £5,700 (A/E) and £81,000 (DB) in extra tax over a working lifetime, reducing her pension contribution or benefits.

Under a TEE regime, both Jamie and Chris receive considerably lower pensions in retirement than under the current tax regime or a single rate.

Like Alex, Jamie and Chris achieve a minimum single person retirement living standard in all DC scenarios and this is unchanged by the tax regime, although average take home retirement income drops in TEE and most single rates.

However, in a DB scheme, both Jamie and Chris achieve a comfortable RLS under all but the 20% single rate where Chris drops down to a moderate RLS.

FIGURE 3: IMPACT OF TEE AND SINGLE RATE ON JAMIE AND CHRIS' AVERAGE TOTAL RETIREMENT INCOME AND RETIREMENT LIVING STANDARDS

Average total take home retirement income (no lump sum taken)		Current system EET net pay	TEE system	Flat rate relief: 20%	Flat rate relief: 25%	Flat rate relief: 30%
Jamie	DC AE	£ 16,000	£ 15,000	£ 15,700	£ 15,900	£ 16,200
	DC 12%	£ 19,100	£ 17,400	£ 18,200	£ 18,700	£ 19,200
	DB CARE	£ 40,100		£ 33,800	£ 36,200	£ 38,500
Chris	DC AE	£ 15,400	£ 14,700	£ 15,300	£ 15,500	£ 15,800
	DC 12%	£ 18,300	£ 17,100	£ 17,900	£ 18,300	£ 18,800
	DB CARE	£ 36,100		£ 31,600	£ 33,800	£ 36,000

Minimum RLS
Moderate RLS
Comfortable RLS

Both Jamie and Chris are basic rate taxpayers in retirement under all scenarios and so will not suffer any double taxation.

HIGHER RATE TAXPAYERS (RONNIE)

Ronnie is a higher rate taxpayer for almost all of her working life. As a result, all of the reforms modelled result in more tax being paid and a lower private pension in retirement.

At 20% single rate, Ronnie's pre-tax private pension income is reduced by more than 20% regardless of the scheme type. At 25%, the reduction is around 16% while at 30% single rate, the reduction in income falls to around 10%.

Under a 20% single rate, Ronnie pays between £34,500 (A/E) and £205,700 (DB) in extra tax over a working lifetime, reducing her pension contribution or benefits. At 25%, the extra tax Ronnie pays is between £26,300 (A/E) and £150,400 (DB). At 30%, the extra tax has fallen to £16,900 (A/E) and £95,000 (DB).

Under the current tax regime, Ronnie achieves a minimum single person RLS in a DC A/E scheme, a moderate RLS in a 12% DC scheme and a comfortable RLS in a DB scheme. However, Ronnie's retirement living standards are reduced to a minimum standard in a DC 12% scheme by either a shift to TEE or a single rate.

FIGURE 4: IMPACT OF TEE AND SINGLE RATE ON RONNIE'S AVERAGE TOTAL RETIREMENT INCOME AND RETIREMENT LIVING STANDARDS

Average total take home retirement income (no lump sum taken)		Current system EET net pay	TEE system	Flat rate relief: 20%	Flat rate relief: 25%	Flat rate relief: 30%
Ronnie	DC AE	£ 15,900	£ 14,400	£ 15,000	£ 15,200	£ 15,400
	DC 12%	£ 20,900	£ 17,900	£ 18,800	£ 19,300	£ 19,900
	DB CARE	£ 51,900		£ 44,400	£ 46,400	£ 48,400

Minimum RLS
Moderate RLS
Comfortable RLS

Ronnie becomes a basic rate taxpayer in retirement in all of the DC scenarios but remains a higher rate taxpayer in the DB scenarios and will be subject to some double taxation on her DB pension under single rates (she has received only 20%-30% relief during working life but pays 40% on some of her pension in retirement).

NON-TAXPAYERS (SAM)

Sam works part-time or in a low paid job for the whole of his working life. He benefits from a move to a flat rate of tax relief.

Under TEE, Sam's pension income is unchanged but under 20% single rate his income is boosted by 22% (A/E) and 25% in a 12% scheme and even more under higher single rates. However, in DB, more of Sam's contributions are subject to basic rate tax which means that the 20% single rate boost to his pension is lower at 4%.

Although he pays a little tax during his working life, his contributions are boosted by £5,000 in an A/E scheme and his benefits are boosted by £5,000 in DB under a 20% single rate and nearly £9,000 and £27,000 respectively at 30% single rate.

Under the current tax regime, Sam achieves a minimum single person RLS in all schemes. This is maintained under TEE and a single rate of 20%. It is only above 25% and in a DB scheme that Sam is lifted to a moderate RLS.

FIGURE 5: IMPACT OF TEE AND SINGLE RATE ON SAM'S AVERAGE TOTAL RETIREMENT INCOME AND RETIREMENT LIVING STANDARDS

Average total take home retirement income (no lump sum taken)		Current system EET net pay	TEE system	Flat rate relief: 20%	Flat rate relief: 25%	Flat rate relief: 30%
Sam	DC AE	£ 12,100	£ 12,100	£ 12,200	£ 12,300	£ 12,300
	DC 12%	£ 13,800	£ 13,800	£ 14,300	£ 14,400	£ 14,600
	DB CARE	£ 19,600		£ 19,900	£ 20,400	£ 20,900

Minimum RLS
Moderate RLS
Comfortable RLS

In nearly all scenarios, Sam becomes a basic rate taxpayer in retirement, albeit on only a small slice of his retirement income in a DC scheme, considerably more in a DB scheme.

CONCLUSION

In conclusion, the modelling illustrated in this report reveals that while some tax reforms could improve adequacy for some individuals, it is the level of contributions and scheme type that have a much bigger impact on retirement outcomes.

PPI MODELLING / PLSA ANALYSIS

The data described in this report originate from modelling undertaken for the PLSA by the Pensions Policy Institute (PPI). This report contains analysis of that data by Jackie Wells for the PLSA. A report of the modelling has been published by PPI[6].

INDIVIDUALS, PENSION SCHEMES AND TAX REGIMES MODELLED

The modelling was designed to reveal the impact of different pension tax reforms, specifically, a move from EET to TEE or a flat rate of tax relief on different individuals. The individuals were chosen specifically to illustrate the impact of different tax positions, specifically differentiating between:

- Non-taxpayers
- Basic rate taxpayers
- Those on the cusp of being higher rate taxpayers
- Higher rate taxpayers for part of their working lives
- Higher rate taxpayers for most of their working lives

The modelling also provided an insight into the way in which different scheme membership could influence the outcome with each individual modelled as a member of:

- A DC scheme with minimum automatic enrolment contributions applied to banded earnings
- A DC scheme with 12% contributions on total salary
- A career average DB scheme with 1/80th accrual (based upon the NHS pension scheme). TEE was not modelled for the DB scheme.

The modelling delivers results for four different tax regimes in addition to the current net pay and relief at source systems (the latter is not shown in this report):

- A shift from EET to TEE whereby contributions (both employer and member) are taxed at the individual's marginal rate but no tax is paid on withdrawal in retirement.
- Basic rate tax relief only on contributions.
- Single rates of 25% and 30%.

[6] https://www.pensionspolicyinstitute.org.uk/sponsor-research/research-reports/2021/2021-07-19-exploring-the-financial-impact-of-flat-rate-pensions-tax-relief-analysis-commissioned-by-the-plsa/

KEY ASSUMPTIONS ADOPTED IN THE MODELLING.

The PPI modelling assumes that individuals stay in the same pension scheme with the same level of contribution throughout 46 years of working life. In practice this is unlikely to be the case, particularly for those who need to take a break for caring responsibilities or those who struggle to stay in employment right up to state pension age (SPA). To that extent, the pensions, replacement rates and retirement living standards shown in this report might be expected to be at the upper end of the outcomes that people can achieve.

The model assumes that a pension begins to be paid at the individuals projected state pension age, in this case age 68 and that the pension is paid until age 100. All figures assume that no tax free cash is taken but that it is used to boost drawdown and DB benefits (but that this part of the pension is not subject to tax). For those in DC schemes, drawdown is assumed at 3.5% of fund increasing by CPI each year. DB pensions are also assumed to increase by CPI. Total retirement incomes include state pension which is inflated by triple lock.

Under reforms involving a single rate of tax relief:

- We have assumed that employer and member contributions would be subject to the same level of tax relief (as at present) and that this would have particular consequences for the tax treatment of the employer contribution by making them taxable benefits for the purposes of calculating the extra tax or rebate due.
- We have assumed that both DC and DB scheme members would be subject to the reforms.
- In DC schemes the employer and member contributions are taxed at the individual's marginal rate and the appropriate level of single rate relief is rebated to pension. If the individual is a higher rate taxpayer or on cusp of a tax rate band, DC members are assumed to pay less into their pension and pay more tax. Take-home pay is left unchanged. The alternative would be to maintain pension contributions and to reduce take-home pay.
- For members of DB schemes it is assumed that there is no change to pension contributions (since these are, in part, determined by the funding position of the scheme and the cost of future benefits). The amount of tax or tax relief due from or to the member was calculated using the current mechanism for testing against the annual allowance. PPI calculated the equivalent Pension Input Amount (PIA) and used that to calculate the tax or tax relief due from or to the member. In their original modelling PPI modelled the effect on take-home pay which was either boosted or reduced by the impact of a single rate of taxation. However, in subsequent discussions with PPI, an approximate mechanism for benefits to be reduced for higher earners each year or boosted for lower earners was developed to account for the additional tax due or a higher rebate (scheme pays or scheme boosts).

All values shown in this report are expressed in 2021 terms (discounted by assumed rate of increase in average earnings).

No allowance has been made for national insurance payments or other tax adjustments or benefits, all of which would have an effect on pre-retirement incomes and would change the calculation of target replacement rates shown in the report.

TARGET REPLACEMENT RATES

In its 2004 report[7], the Pensions Commission proposed target replacement rates for different levels of earnings. We have compared these targets to the income generated by the PPI modelling, uprated by earnings growth since 2004[8].

FIGURE 6: PENSIONS COMMISSION TARGET REPLACEMENT RATES

Overall 2004 income band	Income band in 2021 earnings terms	Target replacement rate
Up to £9,500	Up to £15,000	80%
£9,500-£17,500	£15,000-£27,500	70%
£17,500-£25,000	£27,500-£39,300	67%
£25,000-£40,000	£39,300-£62,800	60%
Over £40,000	Over £62,800	50%

PLSA RETIREMENT LIVING STANDARDS

We have also compared the output from the modelling to the Retirement Living Standards (RLS) published by the PLSA in 2019[9]. The standards show you what life in retirement looks like at three different levels, and what a range of common goods and services would cost for each level. The PLSA proposed a level of income for singles and couples that would enable them to have a minimum, moderate or comfortable standard of living in retirement.

FIGURE 7: PLSA RETIREMENT LIVING STANDARDS

[7] Pensions Commission 2004, Pensions: Challenges and Choices, The First Report of the Pensions Commission
[8] ONS June 2021, Seasonally adjusted Average Weekly Earnings (AWE) series, Table EARN01
[9] PLSA 2019, Retirement Living Standards

IMPACT OF REFORMS ON MEDIAN EARNERS

Alex is a basic rate taxpayer and earns the median salary for her age throughout her working life. Alex begins saving into a pension at age 22 and continues until her state pension age (68).

Alex

- Aged 22 in 2021
- Works for 46 years, retired for 32 years
- Typical career: retail store manager / nurse
- Median earner and basic rate taxpayer throughout career
- Gross income in 2021: £19,000
- Gross income at retirement (2021 value): £29,000

PRIVATE PENSION INCOME AT SPA

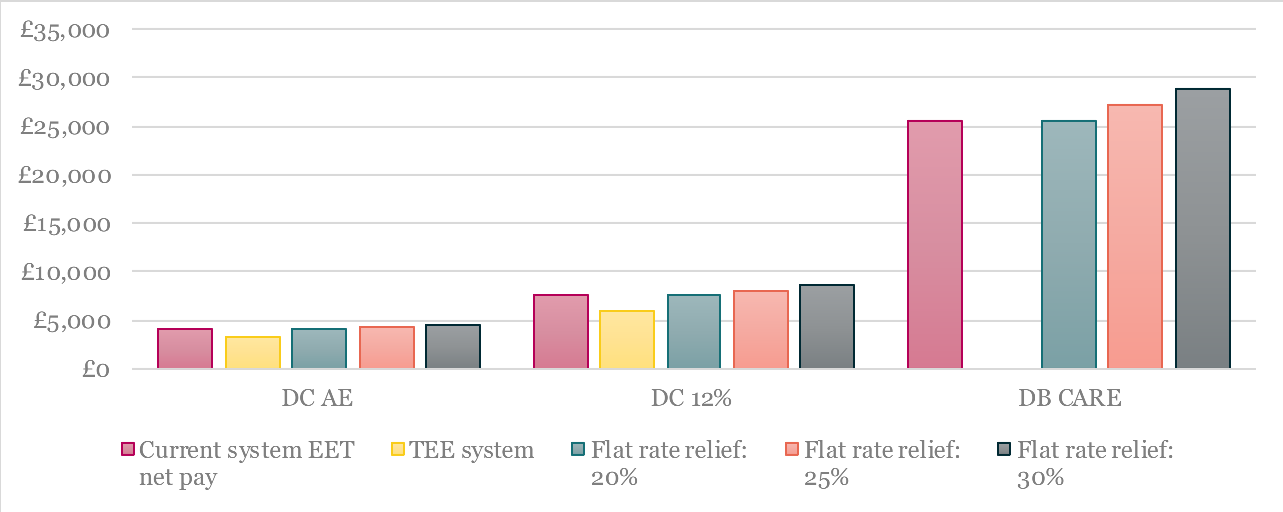
Under current net pay tax rules and assuming that she does not take her tax-free cash, Alex can expect to have accumulated an annual private pension at age 68 (SPA), career average replacement rate and achieved the PLSA retirement living standard as shown in Figure 8 below.

FIGURE 8: ANNUAL PRIVATE PENSION INCOME (BEFORE TAX) FOR BASIC RATE TAXPAYERS UNDER CURRENT NET PAY TAX REGIME

Alex	Annual private pension	Career average replacement rate (target 67%)	PLSA RLS (single person)
DC AE (banded earnings)	£4,000	52%	Minimum
DC 12%	£7,600	62%	Minimum
DB CARE	£25,600	125%	Moderate

Alex is unaffected by a change to basic rate tax relief only but benefits under some reforms, in particular where a single rate of tax relief above basic rate tax is introduced. At a single rate of 25%, Alex's private pension is boosted by between 5% and 8% depending upon scheme type. Under a 30% single rate, Alex's private pension is boosted by around 14% (see Figure 9 below). However, under TEE, Alex receives a lower pre-tax pension at retirement but does not pay tax on this amount. Overall, Alex loses out under TEE (see Figure 9 below). This outcome would be the same outcome as saving into an ISA but without the withdrawal flexibility of an ISA.

FIGURE 9 IMPACT OF TEE AND SINGLE RATE ON ALEX'S ANNUAL PRIVATE PENSION AT SPA (BEFORE TAX)



In the 25% and 30% single rate relief scenarios, Alex receives a lifetime boost to her savings from additional tax relief of up to £13,400 in DC A/E, £25,200 in DC 12% and £56,700 in DB. In the DB scheme, we assume that benefits are boosted by the receipt of additional tax relief.

TOTAL RETIREMENT INCOME AFTER TAX AND REPLACEMENT RATES

The pattern of change is also reflected in the total retirement income (including state pension and after tax) that Alex receives. However, tax and the dominance of state pension smooth out some of the differences and result in much smaller changes in average replacement rates.

Although Alex's pre-tax private pension rose by up to 14%, by the time this increase is taxed and diluted by the state pension, Alex's post tax total retirement rises by a maximum of 7% (DB and 30% single rate) and just 1% in an A/E DC scheme and 25% flat rate.

The Pension Commission target replacement rates suggest that Alex should be seeking to achieve a replacement rate of 67% in retirement. Alex's replacement rate differs significantly by type of scheme that she is in; from 52% in an A/E DC scheme to 125% in a DB CARE scheme under the current tax rules. However, reforms to the tax regime result in more limited increases in her replacement rate. Under a 25% single rate and in an A/E DC scheme, Alex's replacement rate rises from 52% to 53%.

Other than in a DB Care scheme, Alex fails to achieve a Pension Commission target replacement rate but comes close in a DC 12% scheme (Figure 10 below).

FIGURE 10: IMPACT OF TEE AND SINGLE RATE ON ALEX'S REPLACEMENT RATES (TARGET 67%)

Average replacement rates		Current system EET net pay	TEE system	Flat rate relief: 20%	Flat rate relief: 25%	Flat rate relief: 30%
Alex	DC AE	52%	51%	52%	53%	54%
	DC 12%	62%	59%	62%	63%	64%
	DB CARE	125%		125%	126%	128%

IMPACT ON RETIREMENT LIVING STANDARDS

Under the current pension tax regime and in a DC scheme, Alex could expect to achieve at least a minimum single person retirement living standard (£10,200), as defined by PLSA over the course of her retirement. However, in a DB CARE scheme, Alex could expect to achieve a moderate standard (£20,200). If part of a couple household, Alex could more contribute more comfortably to a moderate or comfortable retirement living standard (RLS).

FIGURE 11: IMPACT OF TEE AND SINGLE RATE ON ALEX'S AVERAGE TOTAL RETIREMENT INCOME AND RETIREMENT LIVING STANDARDS

Average total take home retirement income (no lump sum taken)		Current system EET net pay	TEE system	Flat rate relief: 20%	Flat rate relief: 25%	Flat rate relief: 30%
Alex	DC AE	£ 14,100	£ 13,700	£ 14,100	£ 14,300	£ 14,500
	DC 12%	£ 16,400	£ 15,700	£ 16,400	£ 16,700	£ 17,000
	DB CARE	£ 32,200		£ 32,200	£ 33,300	£ 34,500

Minimum RLS
Moderate RLS
Comfortable RLS

Changes to the tax regime would not significantly affect Alex's RLS, other than at a 25% and 30% single rate in a DB scheme where Alex could reach a comfortable RLS.

In all tax scenario, Alex remains a basic rate taxpayer in retirement.

IMPACT OF REFORMS ON HIGHER BASIC RATE TAXPAYERS

While the impact of TEE and a single rate on most basic rate taxpayers is quite clear, the PPI modelling also tested the effect of a single rate on two individuals who are at some point a higher rate taxpayer or on the cusp of being a higher rate taxpayer:

- Jamie, has an income which places him just below the higher rate tax band for the whole of his working life;
- Chris, is a basic rate taxpayer for most of her career but becomes a higher rate taxpayer for 10 years in the middle of her working life.

  Both start saving into a pension at age 22 and continue until their state pension age of 68.

Jamie

- Male, aged 22 in 2021
- Works for 46 years, retired for 32 years
- Typical career: Accountant / social care leader
- Higher than median earner and at cusp of higher rate throughout career
- Gross income in 2021: £50,000
- Gross income at retirement (2021 value): £50,000

Chris

- Female, aged 22 in 2021
- Works for 46 years, retired for 32 years
- Typical career: local solicitor / part time GP
- Higher earner, higher rate tax for 10 years mid-career
- Gross income in 2021: £24,657
- Gross income at retirement (2021 value): £41,988

These individuals were chosen specifically to understand how changes that could come with a shift to a single rate could affect those close to or occasionally over the higher rate tax band.

Under single rate, we believe that employer contributions will need to be taxed as income through payroll (DC) and the single rate of relief reclaimed by the scheme. In DB we assume that a formula like that used to calculate taxation on the annual allowance (the pension input amount – PIA) will be used and we assume a scheme pays basis for paying this tax.

For Jamie, this means that his total taxable pay trips into the higher rate tax band, which in turn results in a lower income from his private pension under TEE and single rate scenarios, except at 30% in a DC A/E scheme.

PRIVATE PENSION INCOME AT SPA

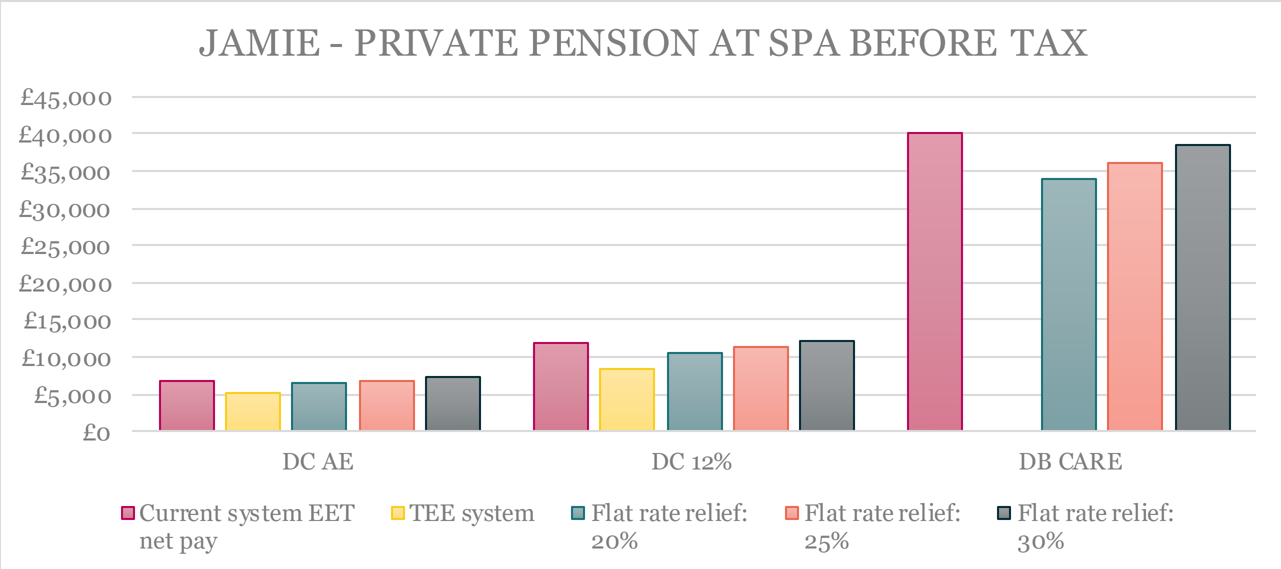
Under current net pay tax rules and assuming that they do not take their tax-free cash, Jamie and Chris can expect to have accumulated an annual private pension at age 68 (SPA), career average replacement rate and achieved the PLSA retirement living standard as shown in Figure 12 below.

FIGURE 12: ANNUAL PRIVATE PENSION INCOME (BEFORE TAX) FOR HIGHER BASIC RATE TAXPAYERS UNDER CURRENT NET PAY TAX REGIME

	Jamie (cusp of higher rate) annual private pension	Career average replacement rate (target 60%)	PLSA RLS (single person)	Chris (10 years HRT) annual private pension	Career average replacement rate (target 60%)	PLSA RLS (single person)
DC AE (banded earnings)	£6,900	39%	Minimum	£6,000	42%	Minimum
DC 12%	£12,000	48%	Minimum	£10,500	50%	Minimum
DB CARE	£40,100	116%	Comfortable	£36,100	117%	Comfortable

At a single rate of 20%, Jamie's DC pension drops by 7% (A/E) and 13% (12%) and by 16% in a DB scheme (Figure 13 below). This is a direct result of having to pay more tax and pension contributions / benefits falling as a result. Over a working lifetime, Jamie pays between £12,000 (A/E) and £119,000 (DB) in extra tax, reducing his pension contribution or benefits.

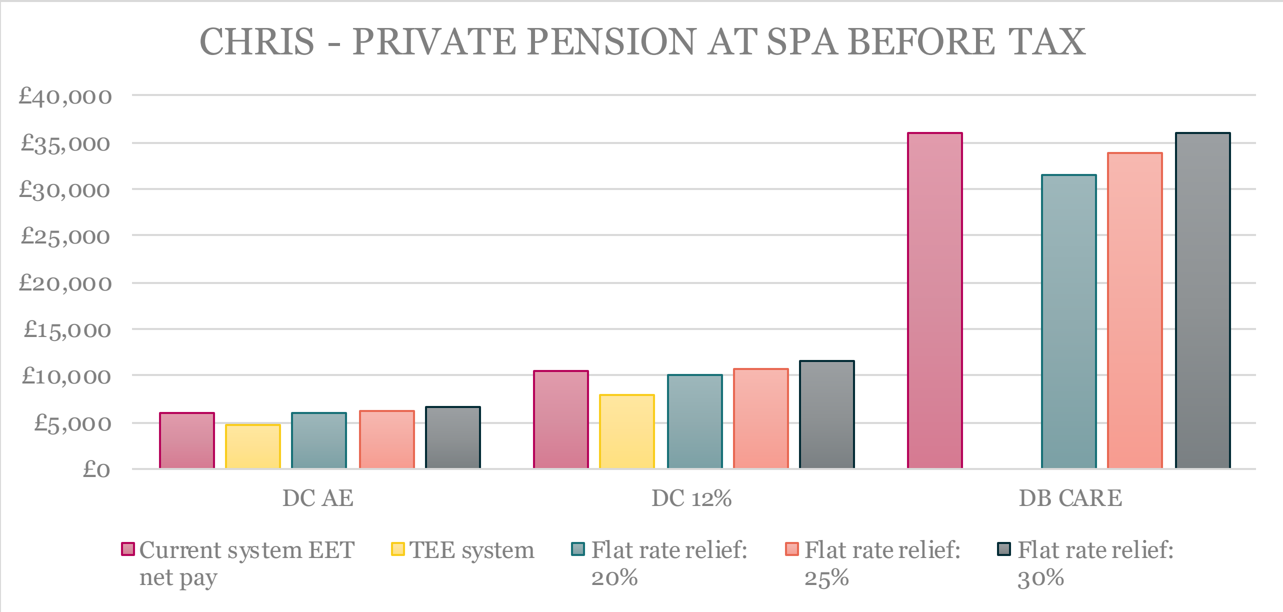
FIGURE 13: IMPACT OF TEE AND SINGLE RATE ON JAMIE'S ANNUAL PRIVATE PENSION AT SPA (BEFORE TAX)



For Chris, her position is changed by being a higher rate taxpayer for part of her career, perhaps returning to full-time work in between stints of part-time work. However, even during the latter years when she is not a higher rate taxpayer, the addition of the employer contribution (or PIA) can sometimes be enough to tip her into a higher rate tax band.

Chris' pre-tax pension income falls under TEE and a 20% single rate in DC schemes (by 2% and 5%) but falls under all single rates in DB (due to the higher value put on the employer contribution). Her pension falls by 12% in DB under a 20% single rate regime (Figure 14 below).

FIGURE 14: IMPACT OF TEE AND SINGLE RATE ON CHRIS' PRIVATE PENSION AT SPA (BEFORE TAX)



Under a 20% single rate, Chris pays between £5,700 (A/E) and £81,000 (DB) in extra tax over a working lifetime, resulting in lower pension contributions or benefits.

TOTAL RETIREMENT INCOME AFTER TAX AND REPLACEMENT RATES (TARGET 60%)

The Pension Commission target replacement rates suggest that Jamie and Chris should be seeking to achieve a replacement rate of 60% in retirement. Only in a DB scheme do they come close to this under any of the tax scenarios.

Jamie and Chris achieve very similar replacement rates to each other and both experience lower total retirement income and lower replacement rates under TEE and 20% single rate. In DC schemes, Jamie and Chris recover at 25% single rate and improve slightly at 30%. In a DB scheme, only Chris recovers at 30% single rate.

FIGURE 15: IMPACT OF TEE AND SINGLE RATE ON JAMIE AND CHRIS' REPLACEMENT RATES

Average replacement rate (no lump sum taken)		Current system EET net pay	TEE system	Flat rate relief: 20%	Flat rate relief: 25%	Flat rate relief: 30%
Jamie (cusp of higher rate)	DC AE	39%	37%	38%	39%	40%
	DC 12%	48%	43%	45%	47%	48%
	DB CARE	116%		112%	114%	115%
Chris (10 year HRT)	DC AE	42%	40%	41%	42%	43%
	DC 12%	50%	47%	49%	50%	52%
	DB CARE	117%		114%	116%	117%

IMPACT ON RETIREMENT LIVING STANDARDS

Like Alex, Jamie and Chris achieve a minimum single person retirement living standard in all DC scenarios and this is unchanged by the tax regime, although average take home retirement income drops in TEE and most single rates.

However, in a DB scheme, both Jamie and Chris achieve a comfortable RLS under all but the 20% single rate where Chris drops down to a moderate RLS.

If part of a couple household, Jamie and Chris could more contribute more comfortably to a moderate or comfortable retirement living standard (RLS).

FIGURE 16: IMPACT OF TEE AND SINGLE RATE ON JAMIE AND CHRIS' AVERAGE TOTAL RETIREMENT INCOME AND RETIREMENT LIVING STANDARDS

Average total take home retirement income (no lump sum taken)		Current system EET net pay	TEE system	Flat rate relief: 20%	Flat rate relief: 25%	Flat rate relief: 30%
Jamie	DC AE	£ 16,000	£ 15,000	£ 15,700	£ 15,900	£ 16,200
	DC 12%	£ 19,100	£ 17,400	£ 18,200	£ 18,700	£ 19,200
	DB CARE	£ 40,100		£ 33,800	£ 36,200	£ 38,500
Chris	DC AE	£ 15,400	£ 14,700	£ 15,300	£ 15,500	£ 15,800
	DC 12%	£ 18,300	£ 17,100	£ 17,900	£ 18,300	£ 18,800
	DB CARE	£ 36,100		£ 31,600	£ 33,800	£ 36,000

Minimum RLS
Moderate RLS
Comfortable RLS

Both Jamie and Chris are basic rate taxpayers in retirement under all scenarios and so will not suffer any double taxation.

IMPACT OF REFORMS ON HIGHER RATE TAXPAYERS

Ronnie is a 90th percentile earner for her age for all of her working life. That results in her being a basic rate taxpayer for the first 7 years of her working life but a higher rate taxpayer for the remainder.

Ronnie

- Aged 22 in 2021
- Works for 46 years, retired for 32 years
- Typical career: optometrist / associate professor
- 90th percentile earner, higher rate taxpayer from age 29
- Gross income in 2021: £29,000
- Gross income at retirement (2021 value): £64,000

PRIVATE PENSION INCOME AT SPA

Under current net pay tax rules and assuming that she does not take her tax-free cash, Ronnie can expect to have accumulated an annual private pension at age 68 (SPA), career average replacement rate and achieved the PLSA retirement living standard as shown in Figure 17 below.

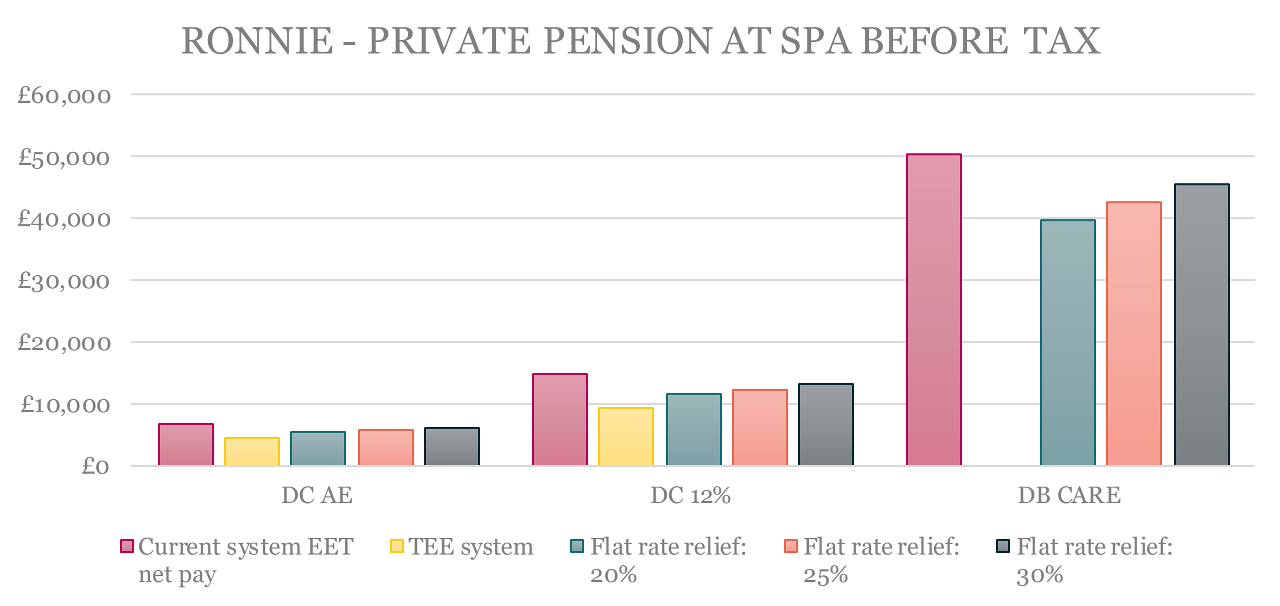
FIGURE 17: ANNUAL PRIVATE PENSION INCOME (BEFORE TAX) FOR BASIC RATE TAXPAYERS UNDER CURRENT NET PAY TAX REGIME

Ronnie	Annual private pension	Career average replacement rate (target 50%)	PLSA RLS (single person)
DC AE (banded earnings)	£6,800	33%	Minimum
DC 12%	£14,800	44%	Moderate
DB CARE	£50,500	115%	Comfortable

Ronnie suffers a reduction in private pension income under all reform scenarios with the most significant reductions at TEE and 20% single rate.

At 20% single rate, Ronnie's pre-tax private pension income is reduced by more than 20% regardless of the scheme type. At 25%, the reduction is around 16% while at 30% single rate, the reduction in income falls to around 10%.

FIGURE 18 : IMPACT OF TEE AND SINGLE RATE ON RONNIE'S ANNUAL PRIVATE PENSION AT SPA (BEFORE TAX)



Under a 20% single rate, Ronnie pays between £34,500 (A/E) and £205,700 (DB) in extra tax over a working lifetime, reducing her pension contribution or benefits. At 25%, the extra tax Ronnie pays is between £26,300 (A/E) and £150,400 (DB). At 30%, the extra tax Ronnie pays has fallen to £16,900 (A/E) and £95,000 (DB).

TOTAL RETIREMENT INCOME AFTER TAX AND REPLACEMENT RATES (TARGET 50%)

Ronnie achieves the highest retirement income of all of the individuals modelled here but the lowest replacement rates. Under Pension Commission target replacement rates, Ronnie should be seeking to achieve a 50% replacement rate in retirement. She only achieves this in a DB Care scheme. Her replacement rates in DC do not achieve this under the current regime and fall further away under single rate relief.

FIGURE 19: IMPACT OF TEE AND SINGLE RATE ON RONNIE'S REPLACEMENT RATES

Average replacement rate (no lump sum taken)		**Current system EET net pay**	**TEE system**	**Flat rate relief: 20%**	**Flat rate relief: 25%**	**Flat rate relief: 30%**
Ronnie	DC AE	33%	30%	31%	31%	32%
	DC 12%	44%	38%	39%	41%	42%
	DB CARE	115%		110%	111%	113%

IMPACT ON RETIREMENT LIVING STANDARDS

Under the current tax regime, Ronnie achieves a minimum single person RLS in a DC A/E scheme, a moderate RLS in a 12% DC scheme and a comfortable RLS in a DB scheme.

However, Ronnie's retirement living standards re reduced to a minimum standard in a DC 12% scheme by either a shift to TEE or a single rate.

If part of a couple household, Ronnie could contribute more comfortably to a moderate or comfortable retirement living standard (RLS) in all scenarios.

FIGURE 20: IMPACT OF TEE AND SINGLE RATE ON RONNIE'S AVERAGE TOTAL RETIREMENT INCOME AND RETIREMENT LIVING STANDARDS

Average total take home retirement income (no lump sum taken)		Current system EET net pay	TEE system	Flat rate relief: 20%	Flat rate relief: 25%	Flat rate relief: 30%
Ronnie	DC AE	£ 15,900	£ 14,400	£ 15,000	£ 15,200	£ 15,400
	DC 12%	£ 20,900	£ 17,900	£ 18,800	£ 19,300	£ 19,900
	DB CARE	£ 51,900		£ 44,400	£ 46,400	£ 48,400

Minimum RLS
Moderate RLS
Comfortable RLS

Ronnie becomes a basic rate taxpayer in retirement in all of the DC scenarios but remains a higher rate taxpayer in the DB scenarios and will be subject to some double taxation on her DB pension under single rates (she has received only 20%-30% relief during working life but pays 40% on some of her pension in retirement).

IMPACT OF REFORMS ON NON-TAXPAYERS

Sam is a low earner and remains a non-taxpayer throughout his working life, earning just below the threshold for basic rate tax. However, he begins saving into a pension at age 22 and continues until his state pension age (68).

Sam

- Aged 22 in 2021
- Works for 46 years, retired for 32 years
- Typical career: part-time call centre worker or local authority administration
- Low earner and non-taxpayer throughout career
- Gross income in 2021: £12,000
- Gross income at retirement (2021 value): £12,000

PRIVATE PENSION INCOME AT SPA

Under current net pay tax rules and assuming that he does not take his tax-free cash, Sam can expect to have accumulated an annual private pension at age 68 (SPA), career average replacement rate and achieved the PLSA retirement living standard as shown in Figure 21 below

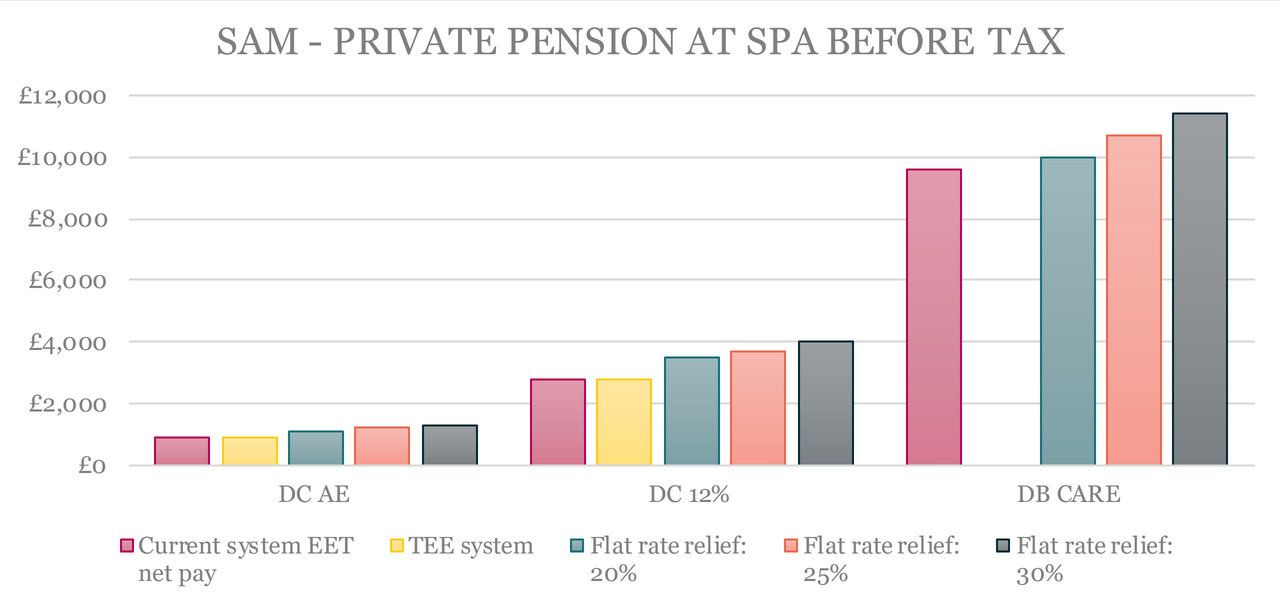
FIGURE 21: ANNUAL PRIVATE PENSION INCOME (BEFORE TAX) FOR BASIC RATE TAXPAYERS UNDER CURRENT NET PAY TAX REGIME

Sam	Annual private pension	Career average replacement rate (target 80%)	PLSA RLS (single person)
DC AE (banded earnings)	£900	103%	Minimum
DC 12%	£2,800	122%	Minimum
DB CARE	£9,600	172%	Minimum

Sam benefits from any of the changes to a single rate because of the way in which we believe that the reforms could be applied. Sam will end up being taxed a little on his employer contribution as it nudges him into being a basic rate taxpayer, the rebate of the single rate on all contributions enhances his pension income by up to 46% (DB and 30% single rate).

Under TEE, Sam's pension income is unchanged but under 20% single rate his income is boosted by 22% (A/E) and 25% in a 12% scheme and even more under higher single rates. However, in DB, more of Sam's contributions are subject to basic rate tax, which means that the 20% single rate boost to his pension is lower at 4%.

FIGURE 22: IMPACT OF TEE AND SINGLE RATE ON SAM'S PRIVATE PENSION AT SPA (BEFORE TAX)



Although he pays a little tax during his working life, his contributions are boosted by £5,000 in an A/E scheme and his benefits are boosted by £5,000 in DB under a 20% single rate and nearly £9,000 and £27,000 respectively at 30% single rate.

TOTAL RETIREMENT INCOME AFTER TAX AND REPLACEMENT RATES (TARGET 80%)

The Pension Commission target replacement rates suggest that Sam should be seeking to achieve a replacement rate of 80% in retirement. In fact, Sam achieves more than this in all schemes even under the current tax regime and in DB achieves closer to double his average take-home pay during working life. His replacement rate increases slightly under all tax scenarios.

FIGURE 23: IMPACT OF TEE AND SINGLE RATE ON SAM'S REPLACEMENT RATES

Average replacement rate (no lump sum taken)		Current system EET net pay	TEE system	Flat rate relief: 20%	Flat rate relief: 25%	Flat rate relief: 30%
Sam	DC AE	103%	103%	104%	105%	105%
	DC 12%	122%	122%	127%	127%	129%
	DB CARE	172%		174%	179%	183%

IMPACT ON RETIREMENT LIVING STANDARDS

Under the current tax regime, Sam achieves a minimum single person RLS in all schemes. This is maintained under TEE and a single rate of 20%. It is only above 25% and in a DB scheme that Sam is lifted to a moderate RLS.

If part of a couple household, Sam could contribute more comfortably to a moderate retirement living standard (RLS) in all scenarios.

FIGURE 24: IMPACT OF TEE AND SINGLE RATE ON SAM'S AVERAGE TOTAL RETIREMENT INCOME AND RETIREMENT LIVING STANDARDS

Average total take home retirement income (no lump sum taken)		Current system EET net pay	TEE system	Flat rate relief: 20%	Flat rate relief: 25%	Flat rate relief: 30%
Sam	DC AE	£ 12,100	£ 12,100	£ 12,200	£ 12,300	£ 12,300
	DC 12%	£ 13,800	£ 13,800	£ 14,300	£ 14,400	£ 14,600
	DB CARE	£ 19,600		£ 19,900	£ 20,400	£ 20,900

Minimum RLS
Moderate RLS
Comfortable RLS

In nearly all scenarios, Sam becomes a basic rate taxpayer in retirement, albeit on only a small slice of his retirement income in a DC scheme, considerably more in a DB scheme.

CONCLUSIONS

It is clear that a move to a single rate of income tax relief for pension contributions would create some winners and losers. Because the number of higher rate taxpayers is much lower than the number of basic rate taxpayers in pension schemes, a large amount of extra tax paid by the former would be spread much more thinly across the latter. As a result, the loss of pension benefits for the higher earners would be proportionately greater than the gain for lower earners.

A SHIFT TO BASIC RATE INCOME TAX RELIEF

Limiting pension contribution income tax relief to basic rate (currently 20%), will result in few winners and many losers. Basic rate tax relief will reduce the cost of pension tax relief by around £8-10bn but will not improve levels of pension adequacy. Furthermore, as we have shown in our report 'Five Principles for Pension Taxation'[10], it will create significant transition costs for employers and schemes.

Most basic rate taxpayers will see no change to their pension contributions or tax bill. Some non-taxpayers may see a slight uplift in their pension contributions through a 'relief at source' boost to their employer contribution. However, this will not be the case if their earnings are close to the basic rate band.

All higher or additional rate taxpayers will pay more tax for every year that they remain a higher or additional rate taxpayer. For some, particularly those in DB schemes, there would be very substantial tax bills to pay and for their schemes a decision to make as to whether to allow the tax bills to be paid by the scheme in return for lower benefits at retirement.

Higher earners in a DC scheme will face the choice of reducing their pension contributions (if they are above the automatic enrolment minimum) so that their take-home pay is unaffected or continuing to pay the same pension contribution and see a reduction in take-home pay. In our modelling, we have assumed the former.

However, as the modelling demonstrates, it is not just those who are higher rate taxpayers that would pay more tax. Those who earn just below the higher rate tax band could also be caught and will pay tax on their employer contributions.

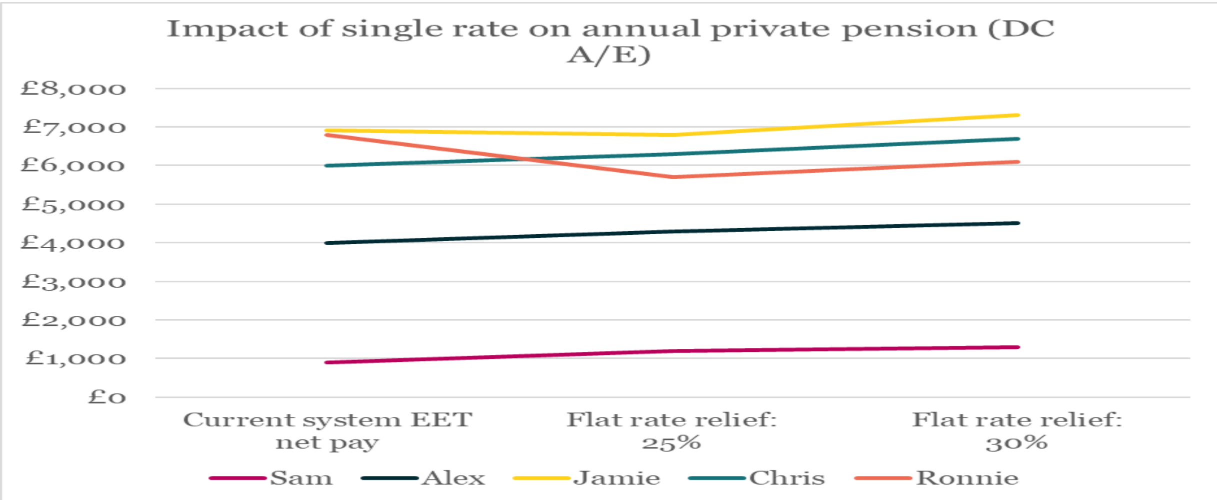
[10] https://www.plsa.co.uk/Policy-and-Research/Document-library/Five-principles-for-pension-taxation

A SINGLE RATE ABOVE BASIC RATE

Setting a single rate of income tax relief at somewhere between basic and higher rates (say 25% or 30%) yields a different result. At these rates, basic rate taxpayers generally benefit from improved pension contributions or benefits. However, higher rate taxpayers still pay more tax with the result that they receive lower pensions in retirement or reduce their take-home pay during their working life.

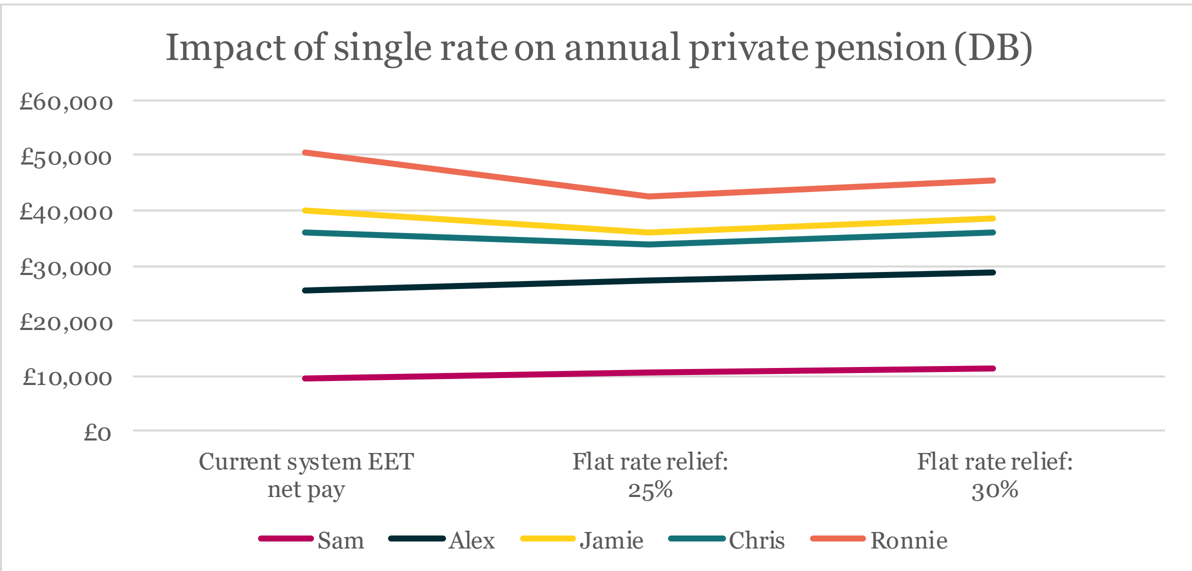
As the chart below shows, private pension income is higher at both rates for Sam (non-taxpayer), Alex (basic rate taxpayer) and Chris (occasional higher rate taxpayer). Ronnie (higher rate taxpayer) receives less at both rates and Jamie (cusp of higher rate) gets less at 25% but more at 30%.

FIGURE 25: IMPACT OF SINGLE RATE (25% AND 30% ON PRIVATE PENSION INCOME (DC A/E)



In DB, the picture is similar but with Ronnie, Jamie and Chris all getting less than under the current regime at both rates.

FIGURE 26: IMPACT OF SINGLE RATE (25% AND 30%) ON PRIVATE PENSION INCOME (DB)



However, even at these higher rates, there is a much smaller impact on total retirement income and replacement rate, due in large part to the dominance of the state pension in the retirement incomes of most of the individuals we have modelled.

- Sam (our non-taxpayer) who already achieves a replacement rate of 103% under the current system of tax relief in a DC A/E scheme is lifted to 105% replacement rate under a 30% single rate.
- Ronnie at the other extreme (higher rate) achieves a replacement rate of 33% in DC A/E scheme and would see this drop to 31% under a 30% single rate.

A SHIFT TO TEE

The most dramatic shift in pension tax policy modelled here would be a shift to taxing contributions but income in retirement being tax-free. In essence, a change of this kind would result in pensions being taxed in the same way as ISAs but with the additional, perceived downside of not having access to the money until retirement.

Because the benefit of the tax-free cash would be lost, the individuals modelled, with the exception of some non-taxpayers, would lose out under a TEE regime. Basic rate taxpayers would lose around 20% of the value of their private pension while higher rate taxpayers could lose up to 38%.

IMPLICATIONS FOR RETIREMENT LIVING STANDARDS

The modelling demonstrates how difficult it is for most people to achieve a comfortable RLS from pensions. All but the very high earners, 90th percentile earners in a generous DB scheme or some of those making very large DC contributions throughout large part of their career get near the comfortable level.

In conclusion, the modelling illustrated in this report reveals that while some tax reforms could improve adequacy for some individuals, it is the level of contributions and scheme type that have a much bigger impact on retirement outcomes.

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