Strengthening the incentive to save: a response from NEST Corporation

Overview

People are living longer and not saving enough to provide for themselves in retirement. The introduction of auto enrolment has made inroads into the UK’s problem with pension participation, but the question of adequacy remains. NEST welcomes the government’s consultation on strengthening the incentive for UK savers to save more and for longer towards their retirements.

The end outcome of any changes to the tax system should be a better, more sustainable pensions system. We believe this requires broad support for any changes, and a clear evidence base that those changes will contribute to greater overall saving and more adequate outcomes for people in their retirement.

We wish to highlight the following key issues in relation to possible reforms. These are listed below and expanded upon through the remainder of our response.

- The pensions industry is mid-way through the roll-out of auto enrolment. We believe that the inertia principle underpinning auto enrolment could well lead to lasting improvements in the coverage and penetration of pension saving. Any change should support rather than undermine the impetus created by the auto enrolment programme.

- As well as a potential incentive effect, tax relief has the straightforward impact of making saving for retirement cheaper. For those on lower and average incomes, for whom affordability could be a barrier to adequate saving, this shouldn’t be underestimated. Changes should not reduce the amounts flowing into the pensions of those on low or average incomes nor should they make saving more expensive for them.

- Changes should not weaken the role of pensions as a long term savings product or disincentivise employer contributions and engagement with pensions.

- Changes should seek to maintain the differentiation between, and distinct benefits of, long-term saving for retirement from short-term saving.

- Changes should not lead to complexity either for savers or for schemes, in transition or in 'steady state'.

- Changes should be able to stand the test of time. Repeated changes confuse people and undermine support for the system, even where they’re intended as simplifications. The system needs stability, which comes from broad support and persistency.
Supporting auto enrolment and incentivising people to save

Changes to private pension policy over the past decade have largely been implemented to address two specific issues: participation and adequacy. NEST welcomes the government’s desire to incentivise more people to save for their retirement but would argue that this is largely being achieved through the successful implementation of auto enrolment.

Tax relief is a welcome benefit in all pension saving but in particular it’s key in our desire to see people saving more. While this benefit is often understood by many who are already saving, its complexity means that this is rarely the case for those new to saving or those not saving at all. Its impact as an incentive to better saving behaviour, therefore, remains unclear.

Given that such complexity does exist, we consider that there may be scope for some simplification but would urge that further changes support auto enrolment by helping to further normalise retirement saving and build on it by focusing on the incentive to save more and for longer than might otherwise be the case.

Adequacy of contributions to pensions

As above, we believe tax relief is a welcome benefit in all pension saving but in particular it’s key in our desire to see people saving more. We note that options under consideration are likely to include those that would:

- reduce and equalise the overall levels of tax relief available, in effect reducing the amount of tax relief on offer to at least some savers, or

- restructure relief so that pension contributions were taken post-tax, potentially with some form of matching contribution from government, and then withdrawals in retirement would be tax-free.

We would caution that it’s unlikely reduced contributions into schemes from lower tax relief will be replaced by higher contributions by members or employers. Retirement pots are therefore likely in at least some cases to grow more slowly and to reach lower eventual levels. While withdrawals may then be tax free, the taxation regime would mean that for at least some people this could result in a lower overall retirement income.

By contrast, a general consensus exists that contribution rates will have to improve further in the coming years if savers are to achieve an adequate income in retirement. Any measures that reduce the amount of money going into a pension pot act counter to this widely held belief. The whole purpose of this consultation, and the extensive private pension reforms that have taken place over the past decade, have been to encourage greater levels of private saving. Any implementation of measures reducing the size of contributions run counter to this aim.

We believe that this is a particular issue for members of our target market, namely those earning up to and around average incomes. For this group, it would be relatively hard to offset the loss of tax relief with higher personal contributions. The presence of tax relief potentially makes achieving a given level of contributions materially more affordable for them.
The provision of an income in retirement

The other key consideration around the incentive impact of tax relief is the role the tax system plays in incentivising behaviour in the decumulation phase. Assuming that for any system to commend legitimacy it would need to continue to reflect the principle that income saved for a pension is only taxed once, changes will necessarily affect both the accumulation and decumulation systems and decisions.

NEST has conducted extensive research\(^1\) which concludes that the large majority of UK savers want solutions or products that provide a steady and reliable income that mirrors their experience of earning a wage.

Potential changes to the pension tax relief regime interact with these conclusions in two key ways. First, the fact that pension income is taxed in the current regime creates a strong incentive for at least some smoothing of the withdrawal of pension savings under the new freedom and choice regime. If pension withdrawals were completely tax free this may lead to the earlier use of pension savings by people post-55, creating problems for retirees later in retirement and more pressure on the means tested State benefits system.

Secondly, the idea of a TEE tax framework for pensions has been conflated by some with ISAs. We believe it is important to draw distinctions between the two. Should the tax treatment of pensions be altered to look similar to that of ISAs, this doesn’t mean that pensions would automatically become more like ISAs in other ways, or that they should. People have a tendency towards placing greater emphasis on the present rather than the future. This tendency results in people engaging in hyperbolic discounting, over-valuing money today and undervaluing money tomorrow, and is one of the key reasons that many people welcome the ‘locked’ nature of pensions\(^2\).

Were other features of ISAs, notably earlier access or liquidity provisions, to accompany a change to TEE this could significantly undermine pension saving and future retirement incomes. This could also undermine the extent to which pension providers and trustees could properly put people’s money to work for them through long-term investment strategies able to tolerate higher degrees of short-term volatility and to seek illiquidity premia in alternative asset classes, potentially reducing the value of retirement pots.

We believe it’s vital that the long term nature of pensions, as a distinct product with different design considerations and benefits than more liquid savings products, must be protected. People value the security of a regular income in retirement, the changing nature of the tax framework upon which pensions sit should not lose sight of this fact. Moves to offer total freedom in savings at the expense of long term security and stability will only act contrary to the interests of NEST’s and the UK’s savers. An appropriate balance between long term income and flexibility must be found.

\(^1\) [https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/The-future-of-retirement.pdf.pdf](https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/The-future-of-retirement.pdf.pdf)

\(^2\) [http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/Blake-Boardman-Spend-more-today.PDF.pdf](http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/Blake-Boardman-Spend-more-today.PDF.pdf)
Simplicity and sustainability of the system

The consultation document is clear in its intent that changes made to the tax framework must be both simple and sustainable in its nature. Depending on how changes may be implemented, significant legacy issues could arise for schemes adding significant complexities to administration and processes. Clearly, overcoming these complexities would carry significant administrative and cost implications for providers which would ultimately be passed on to members.

Our concern over the impact of any major changes to the consumer extend beyond the administrative challenge of implementing them. While there are likely to be approaches to the transition to a new system which would make these administration issues more manageable, it’s also important to note that the same complexity is likely to feed through into customers’ understanding of the new system. Again, the benefits of a ‘simple’ new system could be offset by the complexities of members experiencing two systems in parallel over a potentially long period of time.

The other important consideration around sustainability is the extent to which any reformed system stands the test of time. The private pensions system has been subject to a substantial amount of change over the last several decades. Research among savers frequently cites the scale of change, and the uncertainty this creates, as a reason not to engage with savings. Anecdotally, some employers report the same logic in considering moving away from doing more than the statutory minimum on pensions.

Changes to the tax relief system should therefore be made in the expectation that they will last. This will require broad support for the detail of those changes, including from industry, employers and savers. We believe that this makes addressing the other issues highlighted in this paper all the more important.

Questions

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

There are clear complexities to the current system and we would welcome any initiatives which lead to simplification. For its part, NEST has sought to simplify understanding of a complex pension system through its communications to members – this is best evidenced in our annual statements to members which clearly set out both the benefit they have received from tax relief as well as their employer contribution.

That being said, changes to the tax regime are unlikely to have a significant impact on the initial decision to save, but there are positive signs that auto enrolment will address this issue. Any changes to the tax regime should build on auto enrolment and focus on improving incentives to continue to save, to engage with the idea of saving and therefore to consider saving more. Simplification is likely to have a positive impact in this context.

2. 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?

We believe a system that would provide greater clarity on final outcomes could help people eventually plan for their retirements. There’s evidence that people engage more over time as they see the value of their pots grow, and a clearer understanding of the role tax relief plays in this growth could be beneficial.
A contribution matching system from government could be explored as a means to encourage people to save more and for longer. This concept is better understood by the general public than tax relief, and is more accessible for the financially uninformed.

3. Would an alternative system allow individuals to take greater responsibility for saving an adequate amount for retirement, particularly in the context of the shift to defined contribution pensions?

There are alternatives to tax relief that could offer the reward of greater engagement with and investment into pensions. Government putting a contribution matching system in place of tax relief could potentially act as a powerful tool in encouraging saving. This concept is better understood by the general public than tax relief, and is more accessible for the financially uninformed.

We would urge that any alternative system under consideration ensures that overall minimum contribution rates remain at current statutory levels, at least for those in the lower part of the income distribution for whom a reduction in the minimum is likely to result in a reduction in the total. Any drop below this, we consider, would have severe consumer detriment.

We strongly believe that any change to the taxation of pensions should have no impact on the statutory minimum levels of contributions into a pension but that could mean, in a TEE scenario, that a contribution of up to 8 per cent would lead to a reduction in the take home pay of a worker. We consider that the potential for opt out would be much greater in this event.

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

We consider that the current system provides an additional ‘line of defence’ for UK savers. Currently the tax implications of taking the entirety of your pot at retirement can be severe. In the new regulatory landscape, which provides consumers with total freedom, this in our view can prevent them from fully drawing down on their pension pot as cash. As we evidenced in our retirement income blueprint, we consider that the optimal default path for many savers will be a mixture of cash access as well as an income to help them have a comfortable retirement. Full access to cash at an early age could lead to poor financial decisions and ultimately a sub-optimal retirement.  

There are also important interactions between retirement savings and other aspects of the tax and welfare systems such as income-related benefits and later-life care costs. The incentives created by the taxation of pensions should be consistent with government’s objectives in these other spheres of policy.

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

We have no strong views on the relative treatment of DB and DC pensions.

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

In the event of a shift from an EET framework to a TEE framework, considerations would have to be given to how we identify pots that have been taxed and those that are to be taxed at decumulation. This could run from some approach to flagging pots, to approaches as technically challenging as running two schemes for each member which would be burdensome from both a cost and administrative perspective. We would urge the government to be wary of any policy changes which have cost implications in an environment where schemes also need to take into consideration the charge cap and would encourage any solution which can be administered in a simple, pragmatic way that avoids legacy transitional arrangements. Ultimately members need and deserve to be provided with schemes of the highest quality.

We would also urge the government to take into account the views of the payroll profession on this point. Payroll providers will be absolutely key in the final roll out of auto enrolment and we would hope that any significant changes would be enacted within their already stretched capacity.

7. How should employer pension contributions be treated under any reform of pension tax relief?

We favour an approach of fairness where employers and workers are incentivised to continue contributing. We would urge the government to be mindful of the long term benefit to employers to continue contributing to a pension scheme for its workers. If final outcomes are demonstrably less through any change in the taxation of pensions, it’s likely that workers will be forced to work longer in order to finance their retirement.

Additionally we would ask the government to consider the burden placed on employers. Should the government do away with tax relief altogether, costs to the employer may have to increase in order to keep contribution levels the same.

8. How can the government make sure that any reform of pension tax relief is sustainable for the future?

UK pension policy has recently been built on consensus. Auto enrolment is a rare example of a policy which has cross-party support. We would urge the government to consider how any changes might be viewed by a different administration beyond the term of the current Parliament or the next. Assurance to providers and crucially savers on the stability, such as 10 years or longer, of the change would go some to allowing people to plan with confidence for their futures.

But key to the consensus behind auto enrolment has been the participation of both employers and the workers. Any change made needs to be done in a manner which is neither burdensome for the employer nor short changes the worker.