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**Inland Revenue** **CONFIDENTIAL - POLICY**

Savings and Investment Division

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2. **CHANCELLOR**

**COMPANY TAXATION: PENSIONS AND TAX CREDITS**

**Purpose:** This note considers the effects on pension providers and friendly societies of the CT package. It reflects advice from the Government Actuary's Department (GAD).

**Summary:** The pensions industry will complain vigorously. They will paint the worst possible picture of the effects of tax credit abolition. They will claim that:

- ◇ people will be less willing to save through pensions; and
- ◇ extra employer contributions to pension schemes will cancel the savings from not paying tax credits.

We do not believe that these claims are realistic. Pensions will still have larger tax privileges than other savings; and we doubt that the effects on employer contributions will be as steep as will be claimed.

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So, the general message is that the big employer pension schemes will be able to cope at some cost to employers. But members of money purchase schemes would all be potential losers.

Outside the pension field there will be small, but vocal, losers. Among the holders of tax exempt life insurance policies sold by friendly societies.

### PENSION SCHEMES

#### Financial effects

1. A summary of the effects on employers' and Government's finances of abolishing tax credits is at **Annex A**; while **Annex B** illustrates the potential impact on members of money purchase schemes.
2. The tax credit change will affect different types of pension scheme in different ways. There are two main types of scheme:
  - **defined benefit schemes:** (where the employer promises a particular level of **benefit** and assumes the investment risk); and
  - **money purchase schemes:** (where the commitment is to a **fixed contribution** and the benefits depend on investment performance. With these schemes the individual member bears the investment risk). Personal pensions fall into this group.

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### Defined benefit schemes

3. These tend to be the big employer pension schemes. Around **10 million** employees (or just under half the total workforce) are members of pension schemes of this type. These schemes control the lion's share of over **£800 billion** of assets held by pension providers.

4. The actuaries who calculate pension contributions will be concerned about the effect of the tax credit change on:

- ◇ the asset backing for a scheme's existing benefit promises; and
- ◇ contributions required to secure future benefits.

5. When valuing a pension scheme's assets and liabilities the actuary is more concerned about the future income from investments than with their current market value. So if future income falls the actuarial value of the assets will be less. Some actuaries might therefore argue that abolishing the tax credit would reduce dividend income to tax exempt pension schemes by 20 per cent. This would mean that:

- the actuarial value of pension scheme assets would fall by up to **20 per cent**;
- this would cause a shortfall in existing assets of up to **£75 billion** to be made good and contributions for future benefits would have to rise;
- employers would have to contribute about an extra **£10 billion** a year for the next 10 to 15 years to get pension scheme funding back on

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track;

- some industry sources might claim even higher figures in the early years because some of this cost might be accelerated by the Pensions Act minimum funding requirements.

6. We agree that abolishing tax credits would make a big hole in pension scheme finances. But in terms of the impact on employer contributions we believe this scenario to be unrealistic because it does not take into account that:

- companies will increase dividends to share the benefits of CT changes with shareholders, so dividend income will fall by less than the industry suggest;
- many pension schemes have unused surpluses which will soften the blow and help ease schemes into a new world without tax credits, and part of the effect falls on money purchase schemes at no cost to employers; and
- employers will want to negotiate revisions to the actuarial valuation assumptions (which tend to be very cautious) to reduce their costs: here share prices may fall by much less than actuarial values, forcing actuaries to reconsider.

GAD's broad judgement is that around **one-half** of the extra costs of rebuilding the asset backing for existing benefits could be absorbed these factors.

7. The GAD have not been able to give a firm estimate of the size of surpluses. But they believe that most pension schemes have substantial surpluses (the extent of which will vary between schemes) because of very good investment returns. Much of the surpluses are already financing contribution holidays /

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reductions for employers. The CT package will therefore use up the remainder of these surpluses and bring forward the time when contributions have to be resumed and increased.

8. Despite GAD's firm view of the effect on employer contributions there cannot be total certainty about the outcome. On our central assumption of a 6% fall in share prices and a 16.5% reduction in dividend income, GAD's best estimate (detailed in Annex A) of increased employer contributions are:

Period	£ billion
1997/8	0.3
1998/99	3.0
1999/00	4.0
2000/01	4.7
2001/02	3.5
to	
2005/06	

9. The potential cost in terms of CT receipts would peak at about **£1 billion** and be delayed by almost another year. Employers can be expected to pass some of the cost of extra pension contributions into price increases. This would produce some offsetting increase to CT receipts.

### Money Purchase Schemes

10. These may be either occupational pension schemes or personal pension schemes. They cover some **8 million** individuals (many of whom use the schemes solely to contract-out of SERPs).

11. These schemes generally leave all the investment risk with the individual members. So, if investment returns on existing assets fall, retirement benefits will be lower unless extra contributions are paid. The low paid, in particular, will be

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least able to make good the shortfall by increasing contributions. Annex B illustrates the potential reduction to personal pensions under the central assumptions. The decrease can be as much as 9 per cent of the pension. Again the industry will paint a blacker picture.

12. We believe that abolishing the tax credit will be portrayed as:

- attacking the pensions of people in money purchase schemes (including the self-employed and 5 million people who have contracted-out of SERPs through a personal pension);
- being especially damaging to the pensions of people who are due to retire soon; or who have retired already, but have deferred buying an annuity with their accumulated pension fund.

13. Everyone in a money purchase scheme is a potential loser because members of this type of scheme do not have the comfort of knowing that their employer (if they have one) must make good a shortfall. Those who are about to retire (or have just retired) could be worst affected. They might find that:

- the value of their pension scheme assets have fallen;
- annuities have become more expensive; and
- it is too late to pay extra contributions to make good any loss.

14. But it is normally best advice for people to switch out of (volatile) equities and into (more secure gilts) when they get to within a few years of retirement. This could limit exposure to a fall in share prices. And the surge in stock market values this year will have increased the value of their pension fund beyond what they expected. They will also have some control over when to buy an annuity.

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This assumes that the Budget would cause only a modest dip in share prices. A decrease of 20 per cent remains a possibility and there is a **slight risk** that it might trigger a wider market correction.

### Government's costs

15. Most public service pension schemes are unfunded. But some, mainly in **local government**, are funded. The local government scheme has some 100 separate funds; about 1.3 million members; and £50 billion in total assets with around £30 billion invested in UK equities.

16. The financial situation of these funds varies. Some are in surplus but many have deficits. The GAD estimate that the shortfall in assets could be around **£3 billion**. But the local government scheme is not affected by the Minimum Funding Requirement in the Pensions Act 1995 and so the Government would be able to determine the timescale for making good the shortfall. For example, if the cost were spread over 20 years, the maximum extra contributions could be around £500 million, although a central estimate would be about **£300 million** a year. And, because of the timing of the actuarial cycle these costs would not start until 1999/00.

17. Abolishing the tax credit could also hit the incentives for contracting-out of SERPs. If the present level of incentive was to be maintained the GAD suggest that the rebate paid from the National Insurance Fund to contracted-out schemes might have to rise by around **£400 million** a year. There might otherwise be a risk that large numbers of employees would be best advised to rejoin SERPS.

### Windfall levy

18. The markets have almost certainly already adjusted for a windfall levy of up to £5 billion. We think that most pension schemes will already have adjusted their portfolios accordingly.

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19. In any event, pension funds are less exposed than one might think to the effects of the windfall levy. This is because the spate of takeovers will have substantially reduced their holdings in the utilities.