UK Pension Incentive Scheme: Unleashing the animal spirits through extension of tax-free withdrawal scheme

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(this paper is published by Daniel in a personal capacity and is not HM Government policy)

Problem: Pensions have under-invested in UK equities for many years and Mansion House Compact agreement has had minimal impact

Policy Outcome: An additional £200+ billion investment into UK equities before 2030 fuelling UK economic growth

Policy solution:

- Announce ***creation of a new tax-free lump sum on pension withdrawals***, based on the allocation of a pension pot to UK equities, at next fiscal event.

- But state that the tax-free lump sum **is not available to be taken until at least 2030.** This allows time for reallocation of pension investments ensuring a significant boost to the UK economy before any impact on tax revenue.

- For every 2% invested in UK equities, based on the average annual allocation to UK equities in the 10 years prior to taking the lump sum, an individual receives an additional 1% tax-free lump sum allocation up to a maximum of 10%.

- Advantages to this approach:
    - (1) no-one is "forced" to take the incentive and market (advisors, pension providers) is incentivised to move fast thereby "unleashing animal spirits"
    - (2) economic impact substantial and near-term
    - (3) Trustees of DC and DB pensions will need to consider their fiduciary duty to beneficiaries
    - (4) as a backward-looking incentive, it rewards actual investment (what has been done not what might be done in the future)
    - (5) the cost to HMT comes after the investment benefit to the UK economy

Background: The problem – unlocking equity investment for the UK economy

As has been highlighted by the Capital Markets Industry Taskforce (CMIT), there has been a massive structural shift in the UK economy over the last 25 years with the major source of long-term investment capital, our pension funds, diverting substantial sums out of UK equities[1].

[1] Wright, W. (2023). *Unlocking the Capital in Capital Markets*. New Financial. Retrieved from https://www.newfinancial.org/reports/unlocking-the-capital-in-capital-markets

Since 2000, UK pension funds have "de-risked" by reducing their allocation to equities from 73% to 27% with a commensurate reduction in allocation to UK equities from 53% to just 6%. Over the same period, they have quadrupled the allocation to bonds to 56%. The share of the UK stock market owned by UK pensions and insurance companies has fallen from 39% to just 4%. Moreover, just 1% of the £4.6 trillion in pensions and insurance assets is invested in unlisted UK companies.

This reduced investment in the UK economy seems to be at odds with Environmental, Social and Governance (ESG) investment policies. Pensions are a unique type of investment fund from the perspective of a Trustee or an asset manager – they know where beneficiaries live (the UK), what they are saving for (retirement) and when they will need the capital (retirement age is currently 66 years old). While the UK Government has adopted a "Green Finance Strategy" that aims to balance environmental objectives with investor financial returns, it is interesting to note that there is no social requirement for our pension funds to invest in the country where the beneficiaries reside.

Current structure of pensions market

The current pensions market comprises three different types of schemes – defined benefit (DB), defined contribution (DC) and self-invested pension plans (SIPP). Each of these schemes has different dynamics and incentives for Trustees, asset managers and beneficiaries.

Most private DB schemes are now closed to new members, following the implementation of a new accounting standard (FRS17) in 2005 that required companies to fully recognise DB pension liabilities on their balance sheets. As a result, these DB schemes are often run very conservatively with Trustees attempting to match assets to liabilities.

Prime Minister Gordon Brown introduced mandatory Defined Contribution (DC) pension enrolment in the Pensions Act 2008. Most private-sector employees in the UK are now covered by a DC scheme – this is the part of the UK pensions market that is growing rapidly. While described as a pension, these are really tax-exempt savings plans with no guarantee on potential returns.

A simplified view of Pension tax benefits

The taxation of pensions, irrespective of the type of scheme, can be divided into three categories: contribution, growth and withdrawals.

- Contributions receive tax relief at the marginal income tax rate. This means the government contributes at least 20p of every £1 invested in a pension scheme.

- Growth of assets held inside a pension are free from income tax and capital gains tax.

- Withdrawal of capital from a pension fund has probably the most generous tax benefit, where 25% of the pension can be taken tax-free as a lump sum.

While there are additional nuances and complexities to the taxation of pensions, for the purposes of this paper this simple overview shows where government could intervene.

Choices for government to redirect investment to the UK – mandate or incentivise?

The lack of investment into the UK has been noted by government, and the Chancellor has highlighted some measures that may change behaviour such as consolidation of smaller pension funds. In addition, there is discussion of greater communication and transparency so that asset managers will be required to communicate to beneficiaries where their money has been invested.

One idea that is gaining some traction is to create a UK mandate for pensions funds based on contribution. To receive the tax relief on pension contribution, pensions funds would be required to demonstrate that they plan to invest in the UK. For example, given the government contributes 20p in every £1, to receive the full tax relief a pension fund may be required to invest 20% in the UK.

While this is a reasonable course of action, it faces a few issues. A mandate is likely to be opposed by the pensions industry, highlighting the "risks" of such a strategy with Trustees citing a fiduciary duty to maximise returns. The consultants who advise pension funds are also unlikely to recommend a UK-first approach. More importantly, the financial impact of a mandate will take many years to have an effect on the UK economy. The UK allocation may apply only to newly contributed capital and will largely affect DC and SIPP schemes, it will have little impact on the existing £4.6 trillion already invested in pensions.

An alternative idea, proposed in this paper, is to focus on an incentive based on withdrawals. There are a number of advantages to this approach: (1) no-one is "forced" to take the incentive, (2) the impact could be substantial and near-term, (3) Trustees will need to reconsider their fiduciary duty, (4) as a backward looking incentive it rewards what has been done not what might be done in the future, and (5) the cost to HMT comes after the benefit of investment in the UK economy.

The UK Pension Incentive builds on existing pension provisions

The concept of a tax-free lump sum exemption for pensions was first introduced in 1970. The Finance Act 2004 formally defined the current Pension Commencement Lump Sum (PCLS), commonly known as the tax-free lump sum. In brief, this legislation allows an individual to take 25% of their pension pot as a tax-free lump sum, up to a maximum of £268,725. There is some flexibility around the PCLS, it does not need to be taken in one go and can be crystallised in stages over multiple years.

- The proposal is that the government creates a new UK Pension Incentive scheme, which builds on these existing provisions, by creating a new tax-free lump sum allocation based on the allocation of a pension pot to UK equities.

- For every 2% invested in UK equities, based on the average annual allocation to UK equities in the 10 years prior to taking the PCLS, an individual receives an additional 1% tax-free lump sum allocation up to a maximum of 10%.

Currently, an individual with a pension pot of £100,000 can take £25,000 as a tax-free lump sum on retirement. Under this new scheme, an individual with a £100,000 pension pot and a 20% UK equity allocation could take £25,000 + £10,000 = £35,000 as a tax-free lump sum on retirement.

For an individual with a £2,000,000 pension pot and a 20% UK equity allocation, they could take £268,725 + £200,000 = £468,725 as a tax free lump sum, assuming that no cap is applied to the UK Pension Incentive.

While this measure may seem to create a substantial incentive for wealthy individuals, the goal is to persuade those individuals to invest their capital in the UK economy and not elsewhere. The government could choose to place a cap on the new lump sum.

Delayed implementation would drive investment prior to loss of tax revenue. One important aspect of this proposal is that introduction of the UK Pension Incentive should be delayed by at least 5 years – so the tax-free lump sum is not available to be taken until at least 2030. This allows time for reallocation of pension investments and will provide a significant boost to the UK economy before there is an impact on tax revenue.

Impact on SIPP and DC pension allocations likely to be quite rapid. The SIPP market tends to be self-directed by individuals, often with the help of a financial advisor. The tax advantages of this scheme would be clear very quickly.

For DC pensions, the government should determine that the default fund for a DC scheme should have a 20% UK equity allocation, so that beneficiaries can benefit from this new tax incentive. Individuals are free to make their own decisions in a DC scheme, although very few deviate from the default, and so they are not forced to take this UK allocation. Moreover, a DC provider should be required to indicate on the annual statement what the potential UK Pension Incentive will be on retirement based on a beneficiary's asset allocation.

For DB pensions, the Trustees will need to exercise their fiduciary duty and consider the tax benefit of this new scheme for DB beneficiaries who are yet to retire. Most DB schemes offer a tax-free lump and the size of this lump sum will be affected by the UK Pension Incentive. If Trustees decide not to increase the UK allocation, they will need to show that this decision is in the interests of all beneficiaries. This may be a difficult argument to make given that any deficit in a private DB pension fund, which may affect already retired beneficiaries, is a liability of the sponsoring employer.

Likely impact needs to be calculated but could be an additional £200+ billion. The potential impact warrants more detailed analysis, but the UK pensions and insurance market is currently £4.6 trillion. With SIPP and DC allocations likely to change quite

rapidly, with DB schemes slower to move, it is not unreasonable to assume that we could see at least an additional £200 billion move into UK equities before 2030.

The cost to the Exchequer also requires modelling. The Institute of Fiscal Studies[2] has estimated that the current cost of the existing PCLS is £5.5 billion per annum although this is subject to a cap of £268,250 per person. Therefore, if a *pro rata* cap per individual were applied to the UK Pension Incentive scheme, it would indicate that the additional 10% tax-free lump sum would cost in the region of £2.2 billion per annum.

Moreover, a major change in the behaviour of UK pensions would not go unnoticed by international investors – one would expect additional international capital to flow into the UK. The result would be a reduction in the cost of capital for UK businesses, an increase in the price of assets and a major boost to the UK economy.

To put this in perspective, if the asset allocation of the UK pensions fund industry in 2000 was applied to the current size of the market, there would be an additional ca. £1.5 trillion invested in UK equities. The UK economy has suffered from a slow and steady removal of capital over the last two decades, it is time for this trend to be reversed and for British investment to back British business.

[2] Adam, S et al. (2024). Raising revenue from reforms to pensions taxation [Comment] Institute for Fiscal Studies. Available at: https://ifs.org.uk/articles/raising-revenue-reforms-pensions-taxation