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The Taxation of Private Pensions in the UK.

Carl Emmerson[1] and Paul Johnson[1]

[1] Institute for Fiscal Studies, UK

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Carl Emmerson and Paul Johnson

Institute for Fiscal Studies

Abstract

Private pension saving is hugely important in the UK and traditionally the taxation of pensions has been relatively stable and rather generous, beyond the treatment offered by an expenditure tax regime. Recently, though, there have been substantial changes. Annual and lifetime allowances have been cut dramatically, largely as a way of increasing tax revenues. At the same time the requirement to annuitise pension wealth has been abolished, making pension saving look much more similar to other forms of saving. Meanwhile the tax treatment of other important forms of saving has been made more generous.

The motivation for many of the reforms enacted has been largely one of increasing tax revenues. They have been encouraged by a misunderstanding of the purpose, and cost, of the current system. They have not dealt with elements which are over-generous whilst limiting opportunities for receiving a “neutral” treatment on savings. We have now reached a position of great uncertainty about the future tax treatment of pensions.

Introduction

The taxation of pensions, and savings more generally, in the UK has been subject to substantial reform in the last few years, and further changes appear to be on the cards. Indeed, in July 2015 the government launched a consultation about fundamental reform – moving from the long established system in which contributions are exempt from tax and pensions in payment are taxed, to one in which savings are made out of taxed income and withdrawals are free of tax. (HM Treasury 2015). For long term savings vehicles such as pensions this degree of change and uncertainty clearly has the potential to be damaging.

This paper looks briefly at the tax regime for the main different forms of saving in the UK but focuses on the taxation of private pensions looking at the current structure, recent reforms and proposals for further change. We start with a brief look at the principles for taxing pensions and savings.

Principles

There are three obvious points where pension saving (or indeed any other saving) could be subject to personal taxation: first, when income is first received (i.e. before or at the point at which it is paid into a pension); second, as the returns (interest, capital gains or distributable profit) accrue; and third, when funds are withdrawn from the pension. In addition, both corporation tax and stamp duties on purchases of shares and property might affect pension returns and consideration therefore needs to be given to whether the tax treatment of pensions at the personal level should reflect this.[1]

Very broadly (we will come to the exceptions later) private pensions in the UK are subject to an expenditure tax or EET regime as far as income tax is concerned. That is contributions to the pension are exempt from income tax, accrual in the pension fund is again exempt, while the pension in payment is taxed. (Hence Exempt, Exempt, Taxed or EET). By contrast savings in ordinary bank and building society accounts, and direct holdings of shares have traditionally been subject to an income tax (TTE – savings are made from taxed income, returns are taxed, no further tax on withdrawal). Savings in tax privileged Individual Savings Accounts (ISAs) are subject to TEE taxation – savings are made from taxed income but no tax is charged on returns or at withdrawal.

This EET treatment is the most common tax treatment of private pension saving at the personal level across industrialised countries.[2] It broadly achieves neutrality between consumption now and consumption in the future. It ensures that, at the personal level, there is no tax on the normal return to saving. But any returns in excess of this return are subject to tax (by contrast with the TEE regime which is applied to Individual Savings Accounts (ISAs) in the UK). If higher returns are generated more tax will be paid on the eventual pension income.

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[1] Inheritance tax – for example, how funds held in a private pension, and how pensions-in-payment that provide survivor benefits, are treated at death – can also affect the incentive to save but this outside the scope of this chapter. For a discussion of whether inheritances should be taxed at all and, if so, how the UK system of inheritance tax could be improved, see, for example, chapter 15 of J. Mirrlees et al., *Tax by Design*, OUP for IFS, Oxford, 2011, http://www.ifs.org.uk/mirrleesreview/design/ch15.pdf and R. Boadway, E. Chamberlain and C. Emmerson, 'Taxation of wealth and wealth transfers', in J. Mirrlees et al. (eds), *Dimensions of Tax Design*, OUP for IFS, Oxford, 2010, http://www.ifs.org.uk/mirrleesreview/dimensions/ch8.pdf.

[2] See table 1 of K-Y. Yoo and A. de Serres, 'Tax treatment of private pension savings in OCDE countries', *OECD Economic Studies*, No. 39, 2004/2, http://www.oecd.org/tax/public-finance/35663569.pdf.

In the face of a progressive tax system some individuals will be subject to a higher rate of income tax during part of their working life but subject to the basic rate of income tax during their retirement. The EET regime allows them to smooth their income so that they need not end up paying more tax over their lifetime than an otherwise-equivalent individual who receives the same lifetime income in a less variable way. Essentially, an EET regime allows tax-rate smoothing so that changes in the marginal income tax rate can be evened out over the lifetime. Such a system has been advocated by, among others, the 1978 Meade Committee.[3]

Ideally, taxes on corporate profits and transactions taxes would be well designed so that they need not be a consideration for how pensions (or indeed any other saving) should be taxed at the personal level.[4] But faced with a system for taxing corporate profits, share transactions and property purchases that harshly taxes certain investments, there is the issue of whether this should be reflected in the way that the personal tax regime treats returns on funds held in pensions. Specifically, should investments made from funds in private pensions be exempt from any stamp duties and should returns that accrue on investments held in private pensions be given a repayable credit to compensate for the fact that tax will have been paid on normal returns at the corporate level? Doing so could help ensure that a significant proportion of overall UK wealth – that held in private pensions[5] – was being treated by the overall tax system in a way that was neutral between saving and spending.

The EET regime is neutral between spending now and spending in the future. In principle one might want the taxation of all forms of saving to be subject to such a regime. In practice this is more generous than the treatment of most forms of savings in the UK. Some additional tax incentive for specifically pension saving may indeed be appropriate to encourage people to lock their savings away for long periods.

Taxation of pensions and savings in the UK and recent reforms

The focus of this paper is on the taxation of private pensions in the UK. But it is important to put that in the context of the taxation of pensions and savings more broadly.

The UK's first tier, the basic state pension (soon to become the single tier pension), is in principle contributory but can be thought of as a universal payment largely unrelated to any contributions made. The pension is subject to income tax in the normal way. As with all non earned income, and indeed all income received by those over pension age, no National Insurance Contributions (NICs) are levied.

There is a variety of treatments for savings held in forms other than pensions, and these have been subject to major reforms in recent years. Most importantly:

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[3] See J. Meade, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J. E. Meade*, George Allen & Unwin for IFS, London, 1978, http://www.ifs.org.uk/publications/3433.

[4] A well-designed corporation tax would only tax returns in excess of the normal rate of return. The IFS-led Mirrlees Review set out proposals for introducing an Allowance for Corporate Equity into corporation tax, which would achieve this objective (see pages 421–5 in chapter 17 and pages 446–8 in chapter 18 of J. Mirrlees et al., *Tax by Design*, OUP for IFS, Oxford, 2011, http://www.ifs.org.uk/mirrleesReview). Furthermore, transactions taxes – stamp duty on shares and stamp duty land tax on property transactions – would not exist, since both discourage individuals from making mutually beneficial trades at no detriment to the rest of society. It is argued that some trades take place which use real resources and yet do not have any real economic value. But rather than have a broad-based transactions tax, a better policy response would be to target regulation and/or taxes at these specific activities.

[5] Estimated by the ONS at almost half of net household wealth. Figure from the 2008–10 wave of the Wealth and Assets Survey; source: figure 2 on page 3 of Office for National Statistics, *Chapter 2: Total Wealth, 2008/10*, 2012, http://www.ons.gov.uk/ons/dcp171776_271539.pdf.

1) Savings held in ordinary bank and building society accounts have historically been saved out of taxed income, with income tax then levied on interest received: a TTE regime. But from April 2016 basic rate taxpayers will be able to receive £1,000 of interest income tax free while higher rate taxpayers (the 20% or so with incomes over £42,700) will be able to receive £500 free of income tax. So for the vast majority of savers saving in an ordinary interest bearing account will be subject to a TEE regime;
2) Individual Savings Accounts are longstanding tax exempt (TEE) savings vehicles which allow investment in equities (or cash) of up to just over £15,000 every year with returns free of income tax and capital gains tax. Recent reforms have seen the annual maximum rise by about 50% from £10,000 to £15,000 and the liberalisation of rules restricting the amount of cash that can be held in an ISA (though this has been rather overtaken by more recent changes to the treatment of interest on cash deposits described above);
3) Owner occupied housing is effectively subject to a TEE regime. The property is bought out of taxed income (and there is no relief for mortgage interest), but there is no tax on imputed income from owner occupation and no tax on any capital gain made. Given the very high excess returns earned on housing over recent decades this TEE treatment will have been more generous *ex post* than an EET treatment. (There is though a substantial tax on transactions, Stamp Duty, formally incident on the purchaser).

For most people the pension regime is more generous than any of these treatments since something rather more generous than an EET regime is applied since a tax-free lump sum can be taken and contributions, formally from the employer, can be made free of National Insurance Contributions (NICs).

Table 1. Composition of household wealth 2010-12

	Aged less than 50		**Aged 50 and over**		**All**	
Total net wealth (£)	184,105	(% of total)	470,662	(% of total)	340,888	(% of total)
Of which:						
Primary housing	72,203	39.2%	168,643	35.8%	124,968	36.7%
Buy-to-let and other houses	9,542	5.2%	16,046	3.4%	13,100	3.8%
Other property	5,825	3.2%	7,374	1.6%	6,673	2.0%
Net current and savings accounts	8,320	4.5%	20,107	4.3%	14,769	4.3%
ISAs (cash and investment)	4,307	2.3%	15,283	3.2%	10,312	3.0%
Shares (excl. employee shares)	1,741	0.9%	8,777	1.9%	5,591	1.6%
Other net financial wealth	8,766	4.8%	24,560	5.2%	17,407	5.1%
Private pension wealth	73,402	39.9%	209,872	44.6%	148,068	43.4%

Source: Wealth and Assets survey 2010/12

Total net wealth is the sum of the components listed (i.e. Excludes state pensions and physical wealth). Other net financial wealth includes: fixed term investment bonds, unit and investment bonds, employee shares, overseas gilts, UK gilts, insurance products, other investments and national savings products LESS formal loans, hire purchase arrears, loan arrears, outstanding value of loans, household bill arrears, outstanding value on credit cards, outstanding value of hire purchases, outstanding value of mail orders, outstanding value of store cards. Private pension wealth includes: value of retained rights in DB schemes, value of AVCs, value of retained rights in employer DC pensions, value of retained rights in personal pensions, value of pensions in payment, value of pensions of former spouse/partner, value of current employer DB schemes, value of current employer DC schemes

Table 1 provides a sense of the importance of different elements of wealth for two segments of the population – those aged 50 and over and those under 50. It illustrates the overwhelming importance of owner occupied housing and private pensions – the two most tax favoured. (We cannot use the same data to calculate state pension wealth, but

Banks et al (2013)[6] suggest that levels of state and private pension wealth are very similar among the over 50 population).

Details on the taxation of private pensions

There are a number of important complications and deviations from a simple EET regime set out below:

Tax-free lump sum

A quarter of the accumulated pension balance in a defined contribution scheme can be withdrawn as a lump sum free of income tax. (A roughly equivalent, though somewhat more generous, rule works for defined benefit schemes too). The result is that a quarter of contributions are effectively subject to a very generous EEE treatment for income tax purposes. This means that someone who accumulated £1 million in a private pension (the maximum on which tax relief is granted from April 2016) would be able to receive £250,000 that had escaped income tax altogether: it would be taxed neither when it was earned nor when it was withdrawn from the pension.

Contribution limits

Tax relief is given on private pension contributions (both individual and employer) up to an annual limit, known as the annual allowance. This is currently set at £40,000, having been £255,000 until 2011 when it was reduced to £50,000. It was cut again to £40,000 in 2014. Individuals are allowed to make use of any unused allowance from the previous three years, as long as they were a member of a scheme in those years. This means that, for many, the annual allowance will eventually effectively become a £160,000 limit over a rolling four-year window.

Clearly, the annual allowance only affects individuals who are relatively well off. However, the way that pension rights accrue in final salary defined benefit schemes also means that high-sounding annual allowances can affect people who are well off but perhaps not quite as rich as one might imagine: for example, an employee earning £38,000 a year with 30 years' membership of a final salary pension scheme who saw their pay rise to £55,000 in four years' time could be affected by the £40,000 limit. But defined benefit schemes that operate on a final salary basis are increasingly rare. In the private sector, they have almost entirely been replaced by defined contribution schemes; just 8.4% of private sector employees were members of a defined benefit scheme in 2012 and this percentage has been falling rapidly in recent years.[7] Defined benefit schemes are still prevalent in the public sector but, following the recommendations of Lord Hutton's Independent Public Service Pensions Commission review, for future accrual these are to operate on a career average rather than a final salary basis.[8] Career average defined benefit pensions typically accrue more gradually over an individual's lifetime than final salary pensions making it less likely that individuals will be constrained by a given level of annual allowance in future.

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[6] http://onlinelibrary.wiley.com/doi/10.1111/j.1475-5890.2013.12004.x/epdf

[7] Source: Table 2.1 of Office for National Statistics, *Annual Survey of Hours and Earnings Pensions Tables*, 2012 edition, http://www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings-pension-tables/index.html.

[8] See the commission's *Final Report*, 2011, https://www.gov.uk/government/publications/independent-public-service-pensions-commission-final-report-by-lord-hutton.

There is also a cap on the total amount that can be accumulated in a private pension, known as the lifetime limit. This is set to fall from £1.25 million in 2015 to £1 million in 2016 (having been £1.8 million up to 2012). To get a feel for how big a £1million pension pot is, note that a single man aged 65 with a pension pot that size could, at current annuity rates, take a tax-free lump sum of £250,000 and receive an RPI-linked annual pension of about £24,000 – a sum close to average earnings (or an annual pension fixed in cash terms of about £38,000).[9] For someone in a defined benefit pension arrangement, a £250,000 lump sum and an annual RPI-linked pension of £37,500 – some 50% higher than the maximum defined contribution pension – is deemed to be equivalent to a pension pot of £1 million (since defined benefit pension schemes are deemed to have a pot size 20 times the annual pension).

Finally, a new and complex addition to the rules on contributions is to be introduced from April 2016. From that date the maximum annual contribution will be tapered from £40,000 for anyone earning up to £150,000 (inclusive of pension contributions) to just £10,000 for anyone earning £210,000 or more. In other words the maximum contribution will be reduced by £500 for every addition £1,000 earned between £150,000 and £210,000. It is hard indeed to think of any reasonable justification for thinking that it is right to allow someone earning £150,000 to put £40,000 into a pension but allow anyone earning over £210,000 to put in only £10,000. This will also significantly increase the effective marginal tax rates faced by high earners.

National Insurance contributions

The NICs regime for pensions is quite different from the income tax regime. The treatment of pension contributions formally made by an individual is broadly sensible: there is no NICs relief on contributions, and no NICs are payable on pension income either (so, using the terminology set out above, these are subject to Taxed, Exempt, Exempt (TEE) treatment[10]). However, *employer* pension contributions are treated extremely generously: they are excluded from earnings for both employer and employee NICs – total NICs relief of 22.7% for those earning below the upper earnings limit[11] – while the pension income they generate is not subject to NICs either. Employer pension contributions are the only major form of employee remuneration that escapes NICs entirely and make up roughly three-quarters of all pension contributions.

Corporation tax and stamp duty

The current UK corporation tax does, in part, tax the normal rate of return. In addition, stamp duty is levied at a rate of 0.5% on all purchases of UK shares, while stamp duty land tax applies to any property purchases. At the moment, the personal tax system does not compensate pensions saving either for the tax paid on the normal return at the corporate level or for the presence of stamp duties. But versions of both forms of compensation have existed in the past. Prior to April 1993, repayable dividend tax credits on UK (not global) shareholdings were paid at a rate equal to the basic rate of income tax

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[9] Source: http://pluto.moneyadviceservice.org.uk/annuities calculation based on a non-smoking single man born in 1948 living in Ipswich.

[10] While this means that excess returns in a private pension are not subject to NICs, this is also true of excess returns more widely as NICs only ever apply to earned income.

[11] If an employer pays out £100 in pension contributions, that is the amount that goes into the employee's pension. A salary payment that costs the employer the same amount would leave the employee with only £77.32, 22.7% less: paying a nominal wage of £87.87 would cost the employer £100 because of 13.8% employer NICs on top of the £87.87, while the employee would lose 12% of the £87.87 in employee NICs, leaving only £77.32. (22.7% is employee NICs of 12% plus employer NICs of 13.8% divided by total employer cost of (100% + 13.8%).)

(which in 1992–93 was 25%). This was reduced to 20% in 1993, and then abolished completely in his first in July 1997.[12]

Annuitisation

Historically tax relief for pension savings has been available in full only on the presumption that the accumulated pot of savings was used to purchase an annuity (with the exception of the tax free lump sum). Those with Defined Benefit schemes would receive an annual pension related to their final earnings and years of employment. Beyond the lump sum withdrawal other than via an annuity was subject to a penal, 55%, rate of tax.

By 2014 rules had been liberalised in a number of ways. People could "draw down" income from their pension pot, at a rate up to 120% of what they would have received from an annuity. Those who could show they had a secure annual income of £20,000 from other sources need not annuitise. Nor need those with very small amounts in DC pensions. Otherwise annuitisation was compulsory by age 75. In practice the large majority bought an annuity.

In 2014 a further liberalisation was announced effectively offering complete freedom over how and when to take money accumulated in a DC pension (subject to being 55 or older). From April 2015 any money withdrawn will be taxed at the individual's normal marginal rate of income tax – 0%, 20%, 40% or 45%. Additional changes will allow those inheriting accumulated pension pots to access them and pay income tax only at their own marginal rate.

The behavioural consequences of these changes are hard to predict. Purchases of annuities during 2014 fell substantially in anticipation of the changes. The government certainly expects the change to bring in significant additional revenues of up to £1billion a year in the next few years as people take their money earlier than otherwise, with lower revenues later on. These changes will substantially alter the nature of pension savings. Savings in a DC pension will become much more similar to savings made through any other savings vehicle, with the exception of the rules preventing access to the savings before age 55.

Means-tested benefits

We have so far ignored the existence of means-tested benefits and tax credits. To the extent that accumulated savings reduce entitlement to benefits, the incentive to save is reduced. On the other hand, if contributions to savings products are deducted from income in assessing entitlement to benefits, then incentives to save are enhanced. The way in which the benefit system in the UK takes account of savings is complex and inconsistent. Entitlements to means-tested benefits are reduced at high marginal rates in the face of income from private pensions. Entitlement to Pension Credit, for example, is reduced by 40p for every pound of pension income and Housing Benefit entitlement is

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[12] The March 1993 Budget measure is scored by the Treasury as boosting revenues in 1995–96 by an estimated £900 million. The July 1997 Budget measure is scored as increasing revenues in 1999–2000 by £5.4 billion. The latter is often described as a £5 billion pensions 'raid'. However, only £3.5 billion of the £5.4 billion came from pension funds, with the remainder coming from other exempt taxpayers such as charities. In addition, the concurrent cut in the main corporate tax rate from 33% to 31%, and a further cut to 30% in 1999, would have boosted the incomes of pension funds by up to £1 billion, reducing the net cost to pension funds to £2.5 billion or less. For analysis of the impact of the July 1997 Budget, see S. Bond, M. Devereux and A. Klemm, 'Dissecting dividend decisions: some clues about the effects of dividend taxation from recent UK reforms', IFS Working Paper 05/17, 2005, http://www.ifs.org.uk/publications/3422.

reduced by 65p in every pound. Significant numbers of pensioners are entitled to some form of means-tested benefit.

For pension savings, it also matters how contributions are treated for calculating benefit or tax credit entitlement. Pension contributions are in fact not counted as part of the income on which tax credit entitlement is calculated, just as they are excluded from income when calculating tax due. This potentially provides a significant saving incentive for tax credit recipients since it effectively costs a tax credit recipient only 39p in lost income to save £1 in a pension.

The potential impact of tax credits and Pension Credit, along with different income tax rates, on the incentive to save in a pension is illustrated in Table 2 which shows how much you would need to contribute to a pension to match the return to saving £1 under a TEE regime. The differences are dramatic. There is clearly a very strong incentive for anyone on the tax credit taper to contribute to a pension. Equally, there is a strong disincentive to pension saving for basic-rate taxpayers expecting to end up on the Pension Credit taper.

Table 2. Employee contribution to pension (ten-year investment) required to match £1 contribution to TEE vehicle for different combinations of working-life and retirement tax rates

Tax rate in work	Tax rate in retirement	Required contribution (p)
Basic rate (20%)	Basic rate (20%)	94
Higher rate (40%)	Higher rate (40%)	86
Higher rate (40%)	Basic rate (20%)	71
Basic rate (20%)	Pension Credit taper (40%)	114
Tax credit taper (59%)	Basic rate (20%)	48
Tax credit taper (59%)	Pension Credit taper (40%)	59

Note: Assumes 3% annual real rate of return and 2% inflation.
Source: Wakefield, 2009.

As set out in the Mirrlees Review no easy reform presents itself. Standard approaches to the taxation of savings are problematic when it comes to means-testing for two reasons. First, there is little correlation between being in receipt of any particular benefit when saving and when withdrawing the savings. Second, unlike a standard progressive tax schedule, means-testing implies levying higher effective tax rates on those with lower incomes. To quote the Mirrlees Review[13]:

A TEE-type regime makes little sense in the context of means-testing. If Pension Credit, for example, were not reduced in the face of higher private pension income, it would no longer be a means-tested benefit. One could conceive of a system in which a saver sacrifices Pension Credit now in order to enjoy the benefits of that saving, and of Pension Credit, in the future. But that is not consistent with the usual pattern of behaviour: almost nobody saves in a pension while in receipt of Pension Credit.

An EET regime suffers from the mirror-image problem. Many of those on means-tested tapers when they withdraw the savings (receive a pension) will have been facing just the

[13] Mirrlees p. 329-330

basic tax rate when saving (in work). They will face the 'T' without ever having benefited from the 'E'. And because means-testing involves higher effective tax rates when incomes are lower, saving to smooth consumption will result in an overall higher level of tax paid than would have occurred in the absence of saving. This is the opposite effect of an EET regime in the face of a tax system with rising marginal rates. In this case, as we have already seen, saving when income (and the tax rate) is higher and consuming when income is lower allows the overall tax paid to be smoothed, at least to some extent, to reflect income over a longer period.

There is no easy way around the issue of means-testing and savings. Obviously, less reliance on means-testing would help. But that can only be achieved either by reducing the generosity of benefits or by increasing universal benefits. The first makes poor people worse off; the second requires increases in taxes to pay for the benefits. Another path is to make some level of saving compulsory. If this leads to very small increases in eventual incomes because of the action of means-testing, then it has much the same effect as an increase in direct taxes on those affected.

Cost of UK pensions tax relief and who benefits

The tax system currently treats pensions more generously than it treats other forms of savings. It is often argued that there is a substantial cost associated with this and many proposals for reform are predicated on the belief that the costs are large and the benefits are inequitably distributed. Indeed, there are large costs and inequities in the system. They are just not those usually referred to.

The appropriate way of calculating the total cost of tax support for pension saving, and how much different types of individuals benefit, would require one to work out, for each individual, the total amount of tax they would pay on their pension saving over their entire lifetime under the current UK tax system. This could then be compared with how much they would pay under an alternative system. Clearly the choice of alternative matters.

HMRC produces an official estimate of the annual cost of tax relief given to private pension saving by the income tax and NICs systems. This estimate thus excludes the impact of capital gains tax, corporation tax and stamp duties. The methodology HMRC employs looks at the amount of tax relief given in a particular year and compares this with the amount of tax collected on pension income in the same year. This is comparing the gross cost of giving tax relief to today's working-age population and the revenue raised from taxing the pensions of today's retirees. This method will tend to overstate the cost of tax relief for two reasons. First, real growth in per-capita national income means that today's working-age individuals are likely, on average, to have higher pension incomes than today's retirees. Second, demographic change means that the current working-age population will, when they reach retirement, be more numerous at each age than the current retiree population.

In addition HMRC chooses to compare the current tax treatment of pension saving in the UK with a system with a TTE regime.

With these important caveats in mind, the HMRC estimates for 2011–12 are presented in Table 3. Because it is looking at how income tax and NICs treatment compares with a TTE system, and because it is using the tax paid by today's pensioners as a proxy for the tax that will be paid on today's pension contributions when that income is drawn, HMRC looks at the 'cost' of up-front relief and nets off the tax received on pension income. It also counts as relief the 'cost' of not subjecting returns on funds held in private pensions to income tax (but not the 'cost' of not subjecting them to capital gains tax). In 2011–12, total up-front income tax and NICs relief on pension contributions is costed at £43.2 billion and income tax relief on returns at £6.8 billion, giving a gross cost of £49.9 billion. Income tax on pension income in that year raised £11.5 billion, giving an estimated net cost of £38.3 billion.

Table 3. HMRC estimates of the cost of pensions tax relief, 2011–12

	£ billion
Income tax relief on contributions from employees	5.6
Income tax relief on contributions from self-employed	0.9
Income tax relief on contributions from employers	21.7
National Insurance relief on contributions	15.0
Income tax relief on returns	6.8
Gross tax relief	**49.9**
Income tax received on pension income	11.5
Net tax relief	**38.3**

Source: Table PEN6 of http://www.hmrc.gov.uk/statistics/pension-stats.htm.

HMRC also publishes estimates of the proportion of income tax relief that is given to individuals in different income bands based on their individual pension contributions. Since these data only show individual contributions – and not those made on individuals' behalf by their employers – they only include about one-quarter of the total estimated up-front cost of income tax relief on pension contributions (and they also ignore relief from NICs on employer contributions). The calculation makes no allowance for the amount of tax that will eventually be paid on the pension income. Not surprisingly these calculations suggest that a lot of the "cost" of tax relief is focused on higher income individuals. Indeed these numbers suggest that over 60% of tax relief accrues to higher rate taxpayers, with more than a fifth going to the 1% of income tax payers with incomes over £150,000.[14] It is often claimed that these numbers demonstrate that a disproportionate amount of pensions tax relief goes to high-income individuals.[15] But as well as getting an estimated 22% of the value of the tax relief the top 1% of income tax payers accounted for 24% of all income tax revenue.[16] These numbers, of course, take no account of the taxes this group will pay on their pensions in retirement. Nor do they account for either income tax or NI relief on employer contributions.

The lack of employer or employee NICs on pension contributions made on individuals' behalf by their employer, and the fact that up to a quarter of a pension pot can be drawn entirely free of income tax, mean that the personal tax system does, overall, treat private pension saving generously. It would be useful to have a good estimate of how much this relief costs. It is certainly not equal to £38 billion which is the HMRC estimate relative to a TTE benchmark.

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[14] See House of Commons, *Daily Hansard – Written Answers*, 20 February 2012, column 643W, http://www.publications.parliament.uk/pa/cm201212/cmhansrd/cm120220/text/120220w0006.htm#12022110000486.

[15] See, for example, Pensions Policy Institute, *Tax Relief for Pension Saving in the UK*, London, 2013, http://www.pensionspolicyinstitute.org.uk/default.asp?p=12&publication=0347&.

[16] Source: Author's calculations using data from HMRC Statistics, table 2.5, http://www.hmrc.gov.uk/statistics/tax-statistics/table2-5.xls.

A better estimate would be the cost of NICs relief – estimated by HMRC at £15 billion – plus the cost of the tax-free lump sum, for which HMRC no longer publishes an estimate but which it has previously estimated at £2.5 billion a year.[17] This suggests that the "true" cost of income tax and NICs relief, while still very substantial, could be less than half the official HMRC estimate.

This matters. The public debate is influenced by the way these figures are published. Particularly in a period of austerity it is not surprising that when politicians and others see such big numbers associated with the costs of tax relief they feel they may just have found the pot of gold they have been looking for.

We also lack a sensible analysis of the distribution of tax relief among individuals. Analysis of how pensions' tax relief is distributed relative to the EET benchmark is not available. The existence of the tax-free lump sum, and the lack of NICs on employer contributions, will likely mean that the lifetime rich will, on average, see their pension contributions more generously treated than lower-income individuals will.

Options for reform

In July 2015 the UK Treasury published a consultation on reform of pension tax relief. The centrepiece of the consultation was the following statement:

"it has been suggested that a fundamental reform of the system so that pension contributions are taxed upfront (a "Taxed-Exempt-Exempt" system like ISAs), and then topped up by the government, may allow individuals to better understand the benefits of contributing to their pension". (para 3.12).

A number of commentators, including Michael Johnson (Johnson 2015) of the right-leaning Centre for Policy Studies, have argued for this change. In addition to arguments about the apparent cost and inequity of the current system Johnson argues that the recent abolition of the requirement to annuitise removes one of the fundamental justifications for the current tax treatment. Indeed the Treasury is on record as saying as much (HM Treasury, 2006):

the fundamental reason for giving tax relief is to provide a pension income. Therefore when an individual comes to take their pension benefits they can take up to 25 per cent of the pension fund as a tax-free lump sum; the remainder must be converted into a pension – or in other words annuitized.

Certainly the removal of the annuitisation requirement makes saving in a pension look much more like saving in any other form, with the only additional restriction being that the savings cannot be accessed before age 55. The recent Treasury consultation also suggested that other problems of complexity, high charges and lack of effective competition in the pensions market might be related to the current system of taxation. These problems, the increased flexibility within pensions and popularity of ISAs led Andrew Tyrie, chairman of the influential Treasury Select Committee to argue

there may be scope in the long term for bringing the tax treatment of savings and pensions together to create a "single savings" vehicle that can be used – with additions and withdrawals – throughout working life and retirement. This would be a great prize.

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[17] See footnote 19.

In addition, of course, moving from an EET to a TEE system of taxation would have the very big attraction to the Treasury of moving a very large amount of revenue forward, reducing the deficit in the short term. Johnson refers to this as "The Great Trade to do".

There are clear attractions to all this. In addition one could take the chance of such radical reform to get rid of some of the anomalies alluded to above – the excessively generous treatment of employer contributions within the NI system and the generous and poorly targeted tax free lump sum. Some of the money spent on these subsidies could be used to fund the "top up" mentioned in the Treasury consultation, presumably intended to provide an additional reward for those who don't access the accumulated savings until a particular age. There would, however, be three substantial downsides to such a dramatic change (beyond any difficulties in transition):

First, the apparent improvement in the public finances would be largely illusory, bringing forward tax revenues rather than adding to them. If we could rely on politicians to bank this temporary windfall then that would be fine. But the temptation to use a stronger headline fiscal position to justify tax cuts or spending increases in the short run would surely be hard to resist. Long term fiscal sustainability would therefore be put at risk. Related to that the EET system has the nice feature of reducing the sensitivity of the public finances to population ageing: while a growing older population will weaken the public finances due to additional spending on the NHS and social care, taxing pension income when it is received will offset this to some extent. This makes it easier for the government to manage the public finances appropriately. Moving to TEE would make that more difficult.

Second, a TEE regime does not allow the sort of tax smoothing that is possible under the current EET regime. A progressive income tax system, in which tax liability is based on annual income, takes more tax from people whose incomes are volatile than from people with the same lifetime income but whose incomes are stable. The current system provides 40% relief for higher-rate taxpayers to save in a pension, but many will pay 20% tax on incomes in payment. In effect, such individuals are simply smoothing their taxable income between high-income and low-income periods, undoing the 'unfairness' that an annually-assessed progressive tax schedule creates.

Third, a TEE regime allows excess returns to go untaxed – in the presence of greater than normal returns TEE is more generous than EET. The government would not get to share in any excess returns. The reverse would be true if returns were low. This feature of a TEE regime explains why the Mirrlees Review favoured a "rate of return allowance" regime which would be a TEE regime with a tax on any excess return, or rebate on below normal returns.

To these issues might be added the political economy risk that if very large sums of money end up being withdrawn from pensions free of tax (although tax will have been paid on contributions) future governments might be tempted to renege on the deal with the taxpayer and attempt to impose an additional tax at a later date. Under the current system the taxpayer has at least banked his tax relief up front.

The immediate fiscal temptation to move away from the current system is obvious. There are also arguments in favour of a simpler system, aligning pension taxation with that of ISAs. And there are elements of the current regime which are over generous. But we would almost certainly be better served by ironing out the current anomalies and moving towards a "purer" EET system than starting again with a new TEE regime. Achieving that would involve abandoning the complex plans to taper away tax relief from high earners described above, and possibly reversing at least some of the cuts to annual and lifetime allowances, but would also involve two significant reductions in the generosity of the current system – in the treatment of the tax free lump sum and in the NI treatment of employer contributions.

Capping the tax-free lump sum

The argument that is usually made for the tax-free lump sum, which means that up to a quarter of a pension pot can escape income tax altogether, is that it is compensation for the fact that pensions are constructed to be a highly inflexible form of savings, available only after a certain age. If, for reasons of public policy, we want people to lock money away for long periods, we are likely to have to provide them with a good reason for doing so.

That is a strong argument, but it has its limits. At the moment, the size of the lump sum that can be taken tax-free is limited only by the lifetime limit on the size of a pension pot: with a £1million lifetime allowance, this means that £250,000 can be taken tax-free. There may be a good case for introducing a cash limit on the amount that can be taken as a tax-free lump sum, at a level considerably below this.[18] Unfortunately, no reliable current estimate exists of the revenue that this would raise.[19]

With the end of rules compelling annuitisation the case for an additional "bonus" becomes less strong. The money saved is still tied up until at least age 55, but access will otherwise become much more flexible.

Levy NICs on employer contributions

Employer pension contributions are the only major form of employee remuneration that escape NICs entirely, and do so at an estimated cost to the government of £15.0 billion in 2011–12. This is a big incentive and creates a large bias towards contributions coming (formally) from employers rather than employees: a pension contribution that costs an employer £100 to make would cost him nearly £130 if it came instead from an employee earning below the upper earnings limit.[20] This no doubt helps to explain why HMRC records income tax relief on employer contributions as more than three times as great as that on employee contributions (as shown in Table 3).

The obvious solution would be to start charging NICs on employer pension contributions, so that they are treated like any other form of remuneration. Employer NICs are already virtually flat rate (other than the earnings threshold) and could readily be charged at a flat rate on any contributions made by the employer. This solution would, however, be harder to implement with respect to charging *employee* NICs on *employer* pension contributions. The non-flat-rate structure of employee NICs would require employer contributions to be allocated to individuals; that is difficult for defined benefit pension

[18] To prevent charges of retrospective taxation, the government could consider exempting pension savings already in place that would exceed the cap. The last Labour government did the equivalent when it introduced the new lifetime cap on pension saving but did not apply the new cap to existing pension funds whose value exceeded it.

[19] The government previously estimated the total cost of the tax-free lump sum at around £2.5 billion (it was formerly in HMRC Statistics table 7.9, as cited in, for example, footnote 20 of M. Lloyd and C. Nicholson, *A Relief for Some: How to Stop Lump Sum Tax Relief Favouring the Wealthy*, Centre Forum Report, 2011, http://www.centreforum.org/assets/pubs/a-relief-for-some.pdf) but no longer produces an estimate. Note that this £2.5 billion figure assumed that no one would change their behaviour in response to the reform and that the tax-free lump sums would otherwise be taxed at 20%. Based on this £2.5 billion figure, Lloyd and Nicholson (ibid.) estimated that restricting the tax-free lump sum to the then higher-rate threshold of £42,475 would raise £0.5 billion per year.

[20] For an employee to contribute £100 to a pension requires earnings of £113.64 (since 12% employee NICs are taken out of the £113.64), which costs the employer £129.32 (since 13.8% employer NICs are levied on the £113.64).

schemes. But, even if only employer NICs were charged, this would be an improvement on the current system and would raise an estimated £10.8 billion in 2013–14.[21]

This would get rid of an expensive anomaly. Perhaps even better would be to move towards providing NICs relief on all pension contributions and levying NICs on all pension income, so that NICs treated pensions in the same way as income tax does (with the added advantage of moving further towards the integration of income tax and NICs).[22] This change would need to be introduced gradually both to avoid retrospective double taxation – levying NICs on pension income despite having already levied NICs on employee contributions to that pension – and to avoid undermining the legitimate expectations of those who have saved up to now. A long transition could create political risk (and would mean that while the reform generated significant revenue in the long run, it would actually cost money up front).

A simple alternative would be to start charging NICs on pensions in payment at a relatively low rate now and to increase this gradually over time. Each 1 percentage point charged would raise an estimated £350 million.[23]

Such a change could help to spread fiscal consolidation more evenly across the generations. Tax and benefit reforms announced to date have reduced the incomes of pensioners by less than those of working-age individuals.[24] Starting to charge some NICs on pension income would also do something to unwind some of the, almost certainly unintended, consequences of the shift from income tax to NICs that has occurred over recent decades. This has meant that less tax on pension income will be paid by today's pensioners than they might have expected when they were saving for retirement. As shown in Figure 1, the period between 1978–79 and 2011–12 saw a fall in the combined rates of income tax and employee NICs across the income distribution (compare the dashed lines with the solid lines). They fell by more for those aged 65 to 74 (the light green lines) than they did for those aged under 65 (the dark green ones), because income tax rates have fallen by more than NICs rates and the latter do not apply to those aged 65 and over.

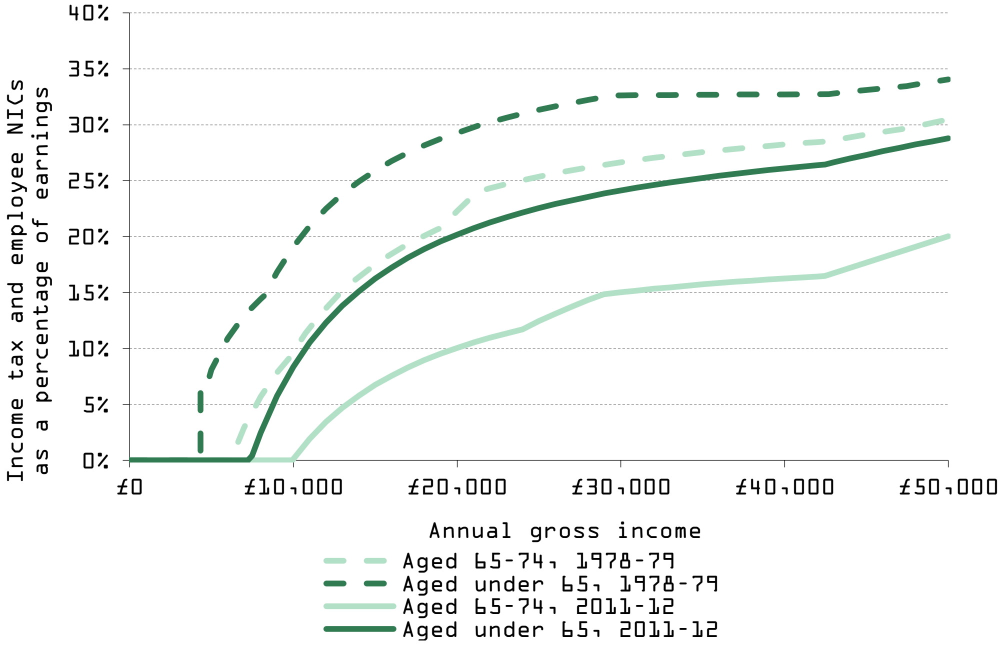
[21] Source: HMRC, 'Estimated costs of the principal tax expenditure and structural reliefs', http://www.hmrc.gov.uk/statistics/expenditures/table1-5.pdf.

[22] Pages 339–40 of J. Mirrlees et al., *Tax by Design*, OUP for IFS, Oxford, 2011, http://www.ifs.org.uk/mirrleesreview/design/ch14.pdf.

[23] Page 29 of S. Adam, J. Browne and P. Johnson, 'Pensioners and the tax and benefit system', IFS Briefing Note 130, 2012, http://www.ifs.org.uk/bns/bn130.pdf.

[24] See slide 23 of J. Browne, 'Autumn Statement policy measures', IFS Post Autumn Statement Briefing, 6 December 2013, http://www.ifs.org.uk/budgets/as2013/as2013_james.pdf.

Figure 1. Income tax and employee NICs rates by income, 1978–79 and 2011–12



Note: Assumes single man, no children, no income other than earnings for individual aged under 65, one job, contracted into S2P/SERPS.
Source: Figure 2.9 of S. Adam, J. Browne and P. Johnson, 'Pensioners and the tax and benefit system', IFS Briefing Note 130, 2012, http://www.ifs.org.uk/bns/bn130.pdf.

Conclusion

As the UK government has engaged in an unprecedented programme of austerity measures since 2010 it is perhaps not surprising that the apparently generous tax treatment of private pensions has come under some scrutiny and been subject to reform. The amount which can be contributed tax free each year, and over a lifetime, to a pension has been reduced very substantially. The capacity to make pension contributions at all is being substantially withdrawn from high earners. This series of reforms will raise around £6 billion a year for the government, at the cost of creating complexity, uncertainty and further incoherence to the pension tax system. Rather than raising money by tackling the genuinely generous aspects of the current system – exemption from NICs and availability of a tax free lump sum – the reforms have reduced the scope of the neutral EET tax treatment.

At the same time rules requiring annuitisation of DC pensions have been ditched, making pension saving look more like saving in other forms. And taxation of other forms of saving has moved in the other direction. Most people with money in interest bearing accounts will now receive interest free of tax and there has been a 50% increase in the amount of money that can be contributed to tax free Individual Savings Accounts. These changes were, when announced, explicitly attributed to the recommendations of the Mirrlees Review. Further reforms announced in the July 2015 budget will also allow the first £5,000 of any dividend income to be received free of tax.

So this has been a period of substantial reform reducing scope for saving in EET pension vehicles, but increasing scope for saving with TEE treatment. At the same time the abolition of the annuitisation requirement has led pension saving to look much more like other forms of saving. In these circumstances there have been calls to change the tax treatment of pensions altogether and move from an EET treatment to a TEE treatment. The Treasury is now consulting on possible reforms including changes as radical as that.

From the point of view of achieving neutrality between consuming now and in the future, allowing risk sharing between savers and government, and allowing tax rate smoothing over time there are clear advantages to an EET system. But the system we have now is not a pure EET system. It is more generous in some respects, and also increasingly constrained and circumscribed by a complex set of limits. The choice between the current imperfect system and a new, simple and “purer” TEE system may be finely balanced.