Pensions tax reform: a briefing

Calls to overhaul pension tax relief by scrapping higher rates of relief and setting a so-called 'flat rate' 'tax relief' are misguided. Such proposals would also face huge practical problems and lead the tax system to become even more complex.

Pension tax relief has been criticized as being expensive and skewed towards those on high incomes. But:

- Estimates of the 'cost' of tax relief under the current system hugely over-estimate the real cost.
- Those on high incomes receive more relief largely because they pay more tax.
- For those who are paying higher-rate tax in retirement, the current system of tax relief largely involves the deferral of tax until retirement as tax is paid on pensions received. A lower rate of tax relief would effectively fine such people for making contributions.
- The fact some people can receive tax relief at 40 per cent and only pay tax at 20 per cent in retirement is a desirable feature of and not a problem with the current system of tax relief as it ensures more equitable treatment of people whose earnings vary over their lifetime..

The existence of the tax-free lump sum does cause serious problems within the current system. It leads to the requirement for complex tax regulations to prevent abuse and significantly and unjustifiably benefits people on higher earnings. It should be abolished or (phased in) to limit of around £30,000. This would facilitate huge simplification of the tax system surrounding pensions.

Why incentivise pension saving in principle?

There are two reasons, in principle, for supporting pensions saving through the tax system.

The first is that it provides individuals with an incentive to save in an institutional form that the government requires is "locked-up" until retirement. Arguably, this reduces the incentives not to save that arise from means-tested social security provision in old age. This argument has been undermined, but not entirely eliminated, by the government's movement towards a flat-rate state pension above subsistence levels.

The second reason is more technical. Broadly, economists support two basic types of tax system: a comprehensive income tax and an 'expenditure' tax. A comprehensive income tax taxes all income sources explicitly, including income from savings. An expenditure tax, on the other hand, seeks to only tax consumption – exempting returns from saving from tax until they are consumed.

Most (though not all) economists would accept one or the other of the above two reasons for some system of tax exemption of pensions saving from taxation, commonly known as tax relief.

The advantages of a tax relief framework in theory

Broadly, there are ways of delivering tax relief for pensions.

- **TEE**: this is sometimes described as the ISA-method. Contributions to pensions are made from post-tax incomes. Investment returns are not taxed, and the funds are not taxed as they are withdrawn.
- **EET**: this is closer to how the UK currently treats pension contributions. Tax relief is given on pension contributions at individual's marginal rates and investment returns are not taxed, but tax is paid when the fund is accessed.

Under a flat tax system where everyone pays the same rate of income tax, these two systems are exactly equivalent over an individual's lifetime, though the timing of when the tax is collected differs between the two systems. However, in a progressive tax system, the outcomes can be very different. For example, in the EET system, someone could save into a pension and receive tax relief at the 40 per cent rate, but only pay 20 per cent tax on their pension in retirement. Whereas for most people the system then is merely about deferring taxation, for some the EET framework might provide a big incentive to save more today than under a TEE framework (if you suspect you will be paying tax at a lower rate in retirement).

As Emmerson (2014) has outlined, there are two big advantages to this system over TEE. Its main advantage is that it allows tax smoothing over an individual's lifetime (where individuals' income fluctuate between tax brackets), so that they do not end up paying more tax across their lifetime than someone on a less variable income (see more below). The second is that by taxing pension income when it is received, it in effect taxes above-normal returns from investment as earned income.

Does the UK fit the EET model for pension savings in practice?

The UK system of taxing pensions is closest to EET, but deviates from it in a few respects.

Firstly, up to a quarter of a private pension can be taken as a tax free lump sum in retirement, thus the income earned avoids the tax system entirely.

Secondly, there are limits on contributions that can be made, including an annual limit (£40,000 in 2015/16) and a lifetime limit on the amount that can be saved whilst receiving full tax relief (£1.25 million for 2015/16 but falling to £1 million in 2016/17). These tend to affect only a small number of very high earners.

Thirdly, although the middle E (investment returns being exempt from tax) holds for investment income from many types of investment, corporation tax paid by companies is not reclaimable and stamp duty on shares and property transactions reduce the returns from these investments. Before 1997, some of the corporation tax paid by companies was, in effect, reclaimable.

Why are many advocating a huge overhaul in the way pensions are taxed?

Most of the critics of the pension tax framework have criticised the current system of tax relief as being very expensive, with a disproportionate amount of the 'cost' being directed towards the wealthy. In particular, the ability for some to obtain tax relief at 40 per cent and only pay 20 per cent on their pension income is claimed to be 'unfair'. It is argued below that all of these criticisms are misconceived.

The phoney 'cost' of pensions tax relief

In a paper advocating substantial reform to pension tax relief, the Centre for Policy Studies' Michael Johnson said,

> *"The state invests a huge amount in tax relief, primarily in the form of up-front income tax relief on employee and employer contributions (at a cost of £26.1 billion in 2010-11.) NIC relief on employer contributions totalled a further £13.0 billion."*[1]

These figures are taken from HMRC, which shows that for 2013/14 the 'cost' was £27 billion for up-front income tax relief and £14 billion for NIC relief on employer contributions, respectively.[2] To this can be added income tax relief on returns, to give a grand total gross cost of tax relief of £48.3 billion.

But highlighting the gross cost of tax relief like this is misleading – ***indeed, it is totally wrong***. Using the gross figure implies that the counterfactual is a world in which pension contributions are made out of net income and, also, pensions are taxed when received so that income tax would be charged twice on pension contributions. This then vastly overestimates the so-called 'cost'.

[1] http://www.cps.org.uk/files/reports/original/121123104830-costlyandineffective.pdf p3
[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/407258/PEN6__2001-02_to_2013-14___for_publication.pdf

Instead, sometimes HMRC data are used to calculate 'net' figures on the cost of tax relief on pensions, which adds up the gross amounts of all reliefs and then subtracts from it the tax raised from taxing the incomes of retirees' today. For 2013/14, the net calculation would suggest tax relief 'costs' £35.2 billion.

As Emmerson (2014) outlines, this also overstates the true 'cost' of pension tax relief. Firstly, these figures are based on the income tax received from the pensioners today, as is clear in note (iii) of HMRC's table. However, the tax to be reclaimed from today's contributors when they are pensioners will be greater than the tax reclaimed from today's pensioners (who received their tax relief in an earlier generation) because today's contributors are greater in number. Also, economic growth over time leads to higher incomes, meaning that future retirees are likely to have higher pension income than today's retirees. Furthermore, the issue of 'income spreading' is not properly taken into account (see below).

Overall then, the reports of the 'costs' of pension tax relief we often hear about are not judged against sensible counterfactuals and vastly overstate the cost relative to a neutral system of taxation.

The case against a so-called 'flat rate relief'

Many critics of the current system have argued in favour of "equalising" the rate of pension tax relief given to all taxpayers somewhere between 20 and 33 per cent. This would replace the current system of giving relief to contributors at their highest marginal rate (usually 40 per cent for higher earners, though it can be at different levels due to recently introduced complexities in the system). They argue for this by saying that the cost of pension tax relief is unfairly skewed towards the rich.

The cost of tax relief is not skewed to the rich

In reality, the fact that a high amount of tax relief can be attributed to higher rate taxpayers arises purely because these groups pay the vast majority of taxes on income. After all, the system of tax relief is supposed to be a system of tax deferral. Tax relief is granted at your marginal rate as you save, and then tax is paid on your pension income at your marginal rate.

Critics then point out that there are a large number of people who currently obtain relief at 40 per cent when paying in but only pay tax on pension income at 20 per cent when their income is lower. This is highlighted as if it is unfair. But far from being a bug in the system, this actually corrects for an injustice in a progressive income tax regime – namely, that a person with a fluctuating income gets taxed much more heavily than someone on a steady income, even if their lifetime income is the same.

Suppose that we have a 40 per cent taxpayer (Mrs Volatile) earning £45,000 on average but whose earnings are £60,000 every second year and £30,000 every second year. In contrast, Mr Steady earns exactly £45,000 every year. Over their lifetimes, Mrs Volatile will pay much more in tax than Mr Steady because a much higher proportion of her income will be subject to tax at 40 per cent. The only way Mrs Volatile can reduce her total tax bill to the same level of Mr Steady's is by making pension contributions in her years of plenty. Tax relief therefore facilitates income smoothing so that the tax system comes closer to taxing individuals with the same lifetime income at the same rate as is just.

Overhauling the whole tax relief system in the way proposed would be devoid of any economic rationale. It would move our system from one of genuine tax relief, and replace it with a system of arbitrary subsidy. After all, the proposed rate of 'relief' between 20 and 33 per cent is not a tax rate paid by any UK taxpayers at present. A so-called relief of, say, 30 per cent would tear that up and replace it with an arbitrary subsidy for pensions saving.

Significantly, under a so-called flat rate relief, higher rate taxpayers could end up obtaining tax relief of 30 per cent on a contribution that is then used to buy a pension that is taxed at 40 per cent. This would, in effect, mean they are 'fined' when they made pension contributions.

To sum up, it is often argued that the better off receive a greater proportion of the tax relief than the less-well-off. There are two potential groups of better off people. The first would be receiving relief at 40 per cent and paying tax at 40 per cent. It is true that they receive tax relief at a higher rate. However, they also then pay tax at a higher rate in retirement – the system works as a system of tax deferral exactly as it does for less-well-off people. Such people would be effectively 'fined' for making contributions under proposed reforms. The second group receive relief at 40 per cent and pay tax on their pensions at only 20 per cent. This group is, quite rightly, benefiting from income spreading.

The practical difficulties of a flat rate relief

Introducing a single rate of 'tax relief' would detach the taxation of pensions from any reasonable economic principles. As a result, its implementation would be incredibly complex in practice. It would necessitate hundreds more pages in the tax code to counteract potential loophole exploitation and to correct for the incentives the new regime creates.

For example, if 'relief' was restricted to 30 per cent, any highly paid employee would simply take a salary cut and ask his employer to make higher pension contributions instead (something already widely done in order to reduce National Insurance contributions). This would reduce the employee's net wages so that the effective tax relief of 40 per cent is restored. HMRC would obviously wish to clamp down on such a loophole. But the only way they could do so would be to attribute employers' contributions to individual employees, and tax them at a special rate of 10 per cent as a taxable benefit (the difference between their normal rate of tax and 30 per cent if this were the single rate of 'relief'). This would be close to impossible to manage in defined benefit schemes (mainly affecting the public sector).

At the same time, an individual paying basic rate tax who is approaching retirement could make pension contributions receiving 30 per cent tax relief and then take the contributions out of the fund and pay tax at 20 per cent the following year – in other words receiving 'free money'. Further HMRC regulations would be needed to stop this abuse towards the end of careers. This would certainly be good news for accountants, but it would lead to a vastly more complicated tax system.

Further restrictions on the lifetime allowance or annual limit

Another possible change would be a reduction in the lifetime or annual allowances which limit the extent to which tax relief can be claimed. In a sense, the lifetime limit exists to prevent abuse of the tax relief system by those higher earners who see significant benefits from very high levels of pension saving. Such very high levels of pension saving are especially motivated by the existence of the tax-free lump sum (discussed further below). The other tax benefits of pension saving really involve the legitimate deferral of tax and should not be regarded as an 'abuse'. In our view, the problem of the tax-free lump sum encouraging 'excessive' pension saving should be tackled at source.

Lowering the annual allowance would be seriously mistaken. There is no need for both a lifetime and an annual limit. The annual limit on pension saving penalises those with highly fluctuating incomes by preventing them from making very large contributions in the years of plenty, even if their lifetime incomes are the same as someone who is able to make regular smaller contributions. Severely restricting the annual limit is especially problematic for defined benefit schemes, where valuing annual contributions made on behalf of an employer is difficult.

Sensible policy reforms

Proposals to restrict tax relief further and/or create an entirely arbitrary rate of tax relief should be rejected as wrong in principle and impossible to implement in practice. However, there are reform options which would make the system very much simpler and reduce the potential for abuse so that restrictions on pension contributions could be liberalised. There are three options that make sense:

1) We could take steps to move entirely to an ISA system of TEE tax relief, though recognising (following the logic above) that this would punish those on volatile incomes.
2) We could abolish tax relief on pension contributions and ISAs entirely and move towards a comprehensive income tax system, though this goes against the current direction of travel elsewhere.

3) We could take steps to move closer towards a genuine EET system, by severely restricting or abolishing the tax-free lump sum.

We believe that the latter is the best option. As outlined above, the tax-free lump sum allows contributors to sidestep the tax system completely – in effect creating an EEE regime for that quarter of the pension pot. This then necessitates a huge volume of tax regulation to prevent perceived abuse. The tax-free lump sum, as Emmerson (2014) notes, is also a bizarre way of trying to encourage pension saving, given that the whole point of pension saving is so people can obtain a regular retirement income.

The alternative is to limit tax-free cash to a much lower amount, so that it does not affect decisions at the margin enabling the Treasury to tear up pages of tax legislation designed to prevent abuse of pension fund tax relief (which would no longer be worthwhile). This would also, as it happens, hugely reduce the 'benefits' that flow to the rich from tax relief. We would propose £30,000 as a reasonable limit to the tax-free lump sum. It would be possible to phase in this limit, as long as such phasing in did not affect pensions saving or retirement behaviour (for example, basing the phasing on age).

References

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