Simplifying the Taxation of Pensions

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Abstract

The current tax framework for pensions is now economically incoherent. The changes in the 1997 budget made it more so. Changes can be made to restore its coherence. However, any attempt to remove tax relief at the higher rate, as has been discussed by academics and commentators recently, would be wrong in principle and could not work in practice. The pension-fund tax codes and the rules for annuitisation should be simplified significantly. The Inland Revenue no longer needs to design detailed rules to prevent people "abusing" tax relief. Such detailed rules are extremely costly to implement and, because they make the whole system impenetrable, stop people from using pension vehicles for saving. The recent pensions Green Paper[2] also proposed tax simplification. Our suggestions have certain advantages over the government's suggestions, but the case is finely balanced.

Introduction

Since 1921, pension fund taxation has been based on the principle that income used to finance pension provision remains outside the tax system until a pension is received. However, in practice the tax system deviates from that principle in important elements of detail. The general approach, established at the beginning of the 1920s was that earned income used for pension provision would be deductible before income was taxed, that money invested in pension funds would accumulate free of tax. Tax would then be paid on pension income once received. The application of this so-called expenditure tax system to pensions manifested itself in what has now become known as the EET system (money invested in the pension fund is exempt from tax, money is accumulated with interest that is exempt from tax and the proceeds of the fund are taxable). The system is still incorrectly described as EET by many commentators[3]. This tax treatment of pensions reinforced the notion (explicit in civil service schemes at the time) that pensions were "deferred pay". The pay was only to be taxed once received as a pension.

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[2] Pension Green Paper (2003), Simplicity, security and choice: Working and saving for retirement, Department of Work and Pensions, HM Government.

[3] See Booth P. M. and Cooper D. R. (2002), The Tax Treatment of UK Defined-Contribution Pension Schemes', *Fiscal Studies*, Volume 23 No. 1 for an analysis.

One would expect that the concept of removing pensions from the tax system would be a reasonably simple concept that would lead to tax efficiency and simplicity, rather than to complexity. However, a number of factors have conspired to undermine the concept of simplicity. First the EET principle has only been applied partially. Secondly, the interaction of the corporation tax system with the income tax system creates complexity in terms of the treatment of equity investments. Thirdly, the Inland Revenue has created restrictions on the use of pensions vehicles to constrain the amount of income that is temporarily removed from the tax system. Each of these aspects gives rise to particular and serious problems. The system for taxing pensions is economically incoherent; there is tax discrimination between equity and debt that distorts pension fund investment policy and corporate finance decisions; and the system is so complex there are huge explicit and implicit costs of compliance and it may well deter many people from making pension provision. We will examine each of the issues.

The Expenditure Tax Basis for Pension Funds

If pensions were taxed under a comprehensive income tax system, contributions made to a pension scheme would be taxed, interest income and capital gains earned by the fund would be taxed and the pension would be free of tax when paid. This system could be described as TTE and is the system underlying most savings provision, with the exception of pensions and ISAs. There are economic arguments both in favour of and against this approach being applied in respect of general savings. However, in the case of pensions saving, a strong case can be made for the expenditure tax (EET) basis described in the introduction[4]. We will assume in this discussion that the expenditure tax treatment of pension saving is the aim of the tax system. To what extent does the current pension fund tax regime follow an EET system?

The True Tax Treatment of Pensions

We will consider the tax position of contributions, investment returns and pensions in payment in turn.

Contributions: In general income that is contributed to a pension scheme is tax-free. Similarly, employer’s contributions are not classed as a taxable benefit in the hands of the employee. A huge amount of complexity arises as a result of rules designed to limit contributions that receive tax relief. However, of themselves, these rules do not undermine the EET basis of the tax system.

Investment returns: All investment income is exempt in the sense that no further tax is paid once the investment returns are in the hands of the fund. In the case of investments in bonds, direct real estate and cash, any tax deducted at source is reclaimable by the pension fund, so the entire return is tax-free. However, in

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[4] See Booth and Cooper op cit and the references contained therein for a detailed discussion of this issue.

the case of investments in equities, profits are taxed at source in the company's hands and this tax cannot be reclaimed by the pension fund. (Prior to the July 1997 Budget a tax credit was available for the return from UK equities received in the form of dividends.) The tax rate suffered by pension funds on equity investments is thus the UK corporation tax rate or, in the case of overseas equities, the equivalent tax rate of the foreign country plus any non-reclaimable withholding tax. Returns from equities are not tax-free.

Benefits: Benefits taken in pension form are taxed at normal income tax rates. The maximum pension from a defined benefit scheme or an occupational defined contribution scheme is broadly 2/3rds final salary[5] and a tax-free lump sum benefit is restricted to 2.25 times the maximum defined benefit pension. In a personal pension the maximum tax-free lump sum is 25% of the fund.

The overall effect of these tax rules is complex:

- Subject to the limits, contributions made to approved schemes are generally fully exempt. Breach of the contribution limits would result in a scheme losing Inland Revenue approval and hence the regime for unapproved schemes applying. The first E is, therefore, for most employees, unqualified for approved schemes. However, its administration can be complex (see below).
- The apparent exemption of investment income is illusory: some three-quarters of the average pension fund was invested in equities at the time dividend tax credits were withdrawn[6]. Equities are taxed at the relevant corporation tax rate. So, assuming an average corporation tax rate of 30% and an income tax basic rate of 22%, the current system of taxing investment returns could be regarded as T, or even T^{+}, by a basic-rate taxpayer.
- Typically one quarter of benefits are taken in tax-free form, so the final T is partial.

Overall, therefore, the current system could best be described as $ETT^{partial}$ or $ET^{+}T^{partial}$. This is economically incoherent. A comprehensive income tax system (TTE) has some economic merit in that it taxes the returns from all factors of production equally. An expenditure tax system (either EET, or TEE as used in the case of ISAs, although in that case the dividend tax credit is limited too) is economically coherent in that it does not distort savings decisions. The current system for taxing pensions has no economic basis. Furthermore, it is worth mentioning that employee's contributions to pension funds are subject to national insurance whereas contributions made by employers are not.

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[5] The limits are more complex than this, but this illustrates the broad position. Also, in practice, the final salary is "capped" using rules designed to prevent abuse.
[6] 76%: see W.M. All Funds Universe, Quarter 2, 1997

Abolition of Tax Relief at the Higher Rate

Some commentators have recently suggested that higher rate tax relief on contributions should be abolished[7]. Many combine that suggestion with the so-called "BOGOF" proposal. The idea of BOGOF is that the system of tax relief should be replaced by a system of subsidies so that the government would match money put into a pension scheme but only up to a limit. Reference to abolishing higher rate tax relief was also made in the 1998 Pensions Green Paper[8] although the paper did not express an intention to go ahead with any such abolition. Academic articles have also made the case for abolition of tax relief at the higher rate[9]. The argument of those suggesting the removal of tax relief at the higher rate is that tax relief is, in effect, an implicit subsidy and that, due to the existence of tax relief at the higher rate, higher earners are receiving a greater subsidy than lower earners.

If higher rate tax relief were abolished, it would produce a system of $E^{\text{basic rate}}T^{+}T^{\text{partial}}$ i.e. contributions would only be exempt from basic rate tax with the contributor having to pay tax at the difference between the higher rate and the basic rate on contributions made to a pension fund. However, if the intention is to restrict the benefit of deferring tax until retirement to the basic rate of tax by collecting the higher rate tax upfront, it would be necessary, for consistency, also to abolish the higher rate of tax on pension benefits. In other words, $E^{\text{basic rate}}T^{+}T^{\text{basic rate}}$ would be necessary to produce the desired effect. That is, tax should only be charged at the basic rate on pension income because tax would have already been charged at the difference between the higher rate and the basic rate on earnings used to fund contributions. The abolition of higher rate tax relief on its own would produce an entirely arbitrary result.

BOGOF-type proposals would fundamentally change the nature of the pensions tax system. Rather than money invested in pensions not being taxed until a pension is received, BOGOF would be allowing the government to determine some "optimal" rate of subsidy for pension provision. The authors would argue that, insofar as there is a disincentive to save, faced by lower earners, caused by means-tested benefits in retirement, this problem should be attacked at its root, not by developing a complementary system of subsidies for pension provision to match the system of subsidies that exists in retirement for those who do not make pension provision. It should also be noted that BOGOF would be

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[7] See, for example, reports of Ross Altman's proposals in Sunday Times, 20th October, 2002.

[8] Department of Social Security, (1998), *A New Contract for Welfare: Partnership in Pensions*, Cm 4179, London: The Stationery Office.

[9] See, for example, Le Grand J. and Agulnik P. (1998), Tax Relief and Partnership Pensions, *Fiscal Studies,* Volume 19, No. 4.

impossible to implement at the defined benefit level without a very long transition period and might well lead to the double taxation of pensions savings.

The Impact of Restricting Tax Relief on Pension Fund Contributions to the Higher Rate

The proposals to restrict tax relief fundamentally misunderstand the nature of the pension-fund tax system. Its purpose is not to provide a subsidy but to remove pension saving from the tax system and tax them on an expenditure tax basis. Pension fund contributions reduce taxable income in work but increase taxable income in retirement. The current system has advantages for those on volatile incomes that would otherwise be lost. Such people are able to reduce their taxable income in years when their earnings are high by making pension contributions that will raise their taxable income in years when their income is low (i.e. after retirement). This is entirely appropriate. Progressive tax systems penalise those on volatile incomes causing them to pay more tax than those on less volatile incomes but who receive the same lifetime earnings.

It is also difficult to envisage the practical operation of a tax system that did not give tax relief at the marginal rate of tax, including higher rates, where applicable. Pension contributions made by employers would have to be assigned to employees as taxable benefits. Otherwise, individuals would gain by not making contributions themselves but, instead, entering labour market contracts to receive a lower salary with the employer making pension contributions (that could then be written off against employer costs). However, whilst assigning contributions to employees and treating them as taxable benefits could be done easily in a defined contribution scheme the structure of a defined benefit scheme is such that it would be impossible to assign employer contributions to individual employees.

Furthermore, as has been noted above, it would be wholly inequitable to not give tax relief at the higher rate on pension contributions and then tax pension income at the higher rate: this would lead to the double taxation of income. However, if tax were to be charged at the basic rate only on pension income, it would lead to two insurmountable practical difficulties. First, pension income accumulated under the existing system (on which tax would have to be paid at the higher rate) would have to be separated from income accumulated under the proposed new system. Secondly, pension income would somehow have to be separated from other income with each being taxed under different codes.

A movement to a TEE system for taxing pensions[10] would be feasible and would remove a number of benefits for higher rate taxpayers. However, the Altman proposals, which also involve giving explicit subsidies for pension provision to those on low incomes, are unworkable in practice. They are also flawed in

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[10] This was proposed by the Conservative government just before the 1997 general election in Department of Social Security (1997), *Basic Pension Plus,* DSS, London, UK.

principle. They would move the pensions tax system from one under which pension funds are accumulated outside the tax system to one in which the Treasury would be determining the explicit amount of subsidy for groups of people on different incomes. It would be another step towards the "micro-management" of individual's incomes through the tax system and would further exacerbate the problem whereby individual tax burdens were rising whilst sums of money were returned to individuals through the tax system, ring-fenced in extremely complex ways.

To conclude this section, neither the current pension fund tax system, nor proposals to abolish higher rate tax relief and move to $E^{\text{basic rate}}T^{+}T^{\text{partial}}$, have any obvious economic rationale, unlike EET, TEE (the ISA regime) or TTE (the comprehensive income tax regime).

The Cost of Incoherence

We now resume consideration of the existing tax system for pension funds, assuming that tax relief on contributions will remain at the marginal rate of tax. We will assume that the benchmark system is the EET system under which it has been intended that pension funds should operate.

Clearly the use of a system that deviates unfavourably from the benchmark will lead to a cost borne by employers and employees. There are other indirect costs of complexity and of not having economically coherent tax systems. We concentrate on calculating the direct cost of pension provision under different tax systems. The authors set up a model defined benefit scheme based on principles discussed in detail in Booth and Cooper (1999)[11]. A contribution rate is computed so that, at the expected rate of return, given the assumed distribution of assets between different investment classes, the contributions would be sufficient to meet the benefits, calculated on a final salary basis. Most of the assumptions underlying the model scheme do not affect the cost that different tax regimes impose on the scheme. However, the investment return assumptions and the asset allocation assumptions are important. Three different tax regimes are considered. The first is the current tax regime. The second is the pre-July 1997 tax regime. That regime allowed part of the corporation tax that had been paid by a company on its profits to be reclaimed, insofar as the company's equity was held by a pension fund or other non-taxpayer. The amount of the reclaim was limited to the "advanced corporation tax" paid on the dividend declared which was itself limited to the lower rate of income tax[12]. The pre-1997 regime effectively allowed about two thirds of the corporation tax to be reclaimed by a pension fund on roughly half the earnings per share. It helped to reduce the tax discrimination against equity investment and also helped to restore the "middle E" of pension funds tax treatment. The third regime that we consider is one in

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[11] Reference to come

[12] Until 1992, it was limited to the basic rate of income tax.

which all tax on investment returns (including that assumed to be paid through the corporation tax system on equity returns) is reclaimed (that is a genuine EET regime).

The asset allocation for the scheme was assumed to be as follows:

Investment Category	Proportion of fund invested in category
UK Equities	55%
US Equities	15%
Property	10%
Index-linked bonds	6%
Conventional bonds	10%
Cash	4%

Table One: Assumed Asset Allocation for Model Pension Fund

This is close to the average investment distribution for UK defined benefit schemes (slightly less is invested in property in practice and for simplicity we assumed that all overseas equity investments were invested in US equities).

The rates of return from different investment categories under different tax regimes were assumed to be as follows:

Investment Category	Post-97	Pre-97	Pure expenditure
UK equities	6.9%	7.55%	8.63%
US equities	7.15%	7.15%	7.15%
Conventional bonds	5.2%	5.2%	5.2%
Index-linked gilts	4.95%	4.95%	4.95%
Property	8.1%	8.1%	8.1%
Cash	4.7%	4.7%	4.7%

Table Two: Investment Return Assumptions

These follow historical norms and relationships but were adjusted for current yield levels. Of more importance than the absolute returns are the relative returns from different tax regimes. UK equity returns are significantly higher under the expenditure tax regime because, under the other two regimes, they are taxed through the corporation tax system. According to our assumptions, the change to the tax regime in 1997 reduced UK equity returns for pension funds by nearly 0.7%. Whilst the precise impact of the tax change on equity returns for pension funds is arguable, a reduction in returns of 0.7% seems reasonable. We do not consider the effect of taking overseas equities outside the tax system for UK

pension funds as this does not seem to be a practical possibility. Thus the pure expenditure tax regime that we consider does, in fact, assume that overseas equity investments are taxed. The cost of funding a pension scheme under the three tax regimes is shown in the table below.

Table Three: Standard Contribution Rates Under Different Tax Regimes

Tax regime	Standard Contribution Rates
Post-97	12.1%
Pre-97	11.2%
Pure Expenditure	8.9%

The contribution rate, to fund a given level of benefits increased by about 8% as a result of the 1997 tax changes and would fall by nearly 30% if there were a movement to a pure expenditure tax regime. Such a pure expenditure tax regime would involve removing corporate profits from the tax system, as far as pension funds were concerned, but would also involve abolishing the tax-free lump sum. A move to a pure expenditure tax system would be difficult to administer. A full imputation system for company profits would be required so that pension funds reclaimed all tax on the earnings per share that was imputed to the fund. A compromise would be to provide a tax credit equal to the rate of corporation tax paid by the company on dividends remitted to pension funds. In effect, this would restore the pre-1997 system but with a higher rate of tax credit. This would create an incentive for the dispersion of earnings through dividends but this is arguably preferable to the current system that creates significant incentives to finance companies through debt rather than equity capital. Further calculations were not undertaken, but it seems reasonable to assume that moving to a system where the rate of tax credit on dividends was equal to 30% would reduce the standard contribution rate to about 10.7%. Further calculations, undertaken in Booth and Cooper (1999) suggest that the contribution rate under a comprehensive income tax system (where there was no tax relief on pension contributions, all interest income and capital gains were taxed but pensions were received tax free, i.e. TTE) would be 15%. Thus the current system is a little nearer a comprehensive income tax system than an expenditure tax system. This is completely contrary to popular wisdom, even amongst economists. The pre-1997 system was a little closer to a TEE expenditure tax system than to a TTE comprehensive income tax system.

One change that would make the pension fund tax system more coherent would be to make the pragmatic adjustment to the system for taxing equity returns proposed above (that is restore dividend tax credits at the full rate of corporation tax) and abolish the tax-free lump sum. We have not performed detailed calculations for defined benefit schemes but the calculations for defined contribution schemes in Booth and Cooper (2002) suggest that this would not change the contribution rate for a pension fund significantly, if the same net

benefit were to be funded. The tax cost of losing the lump sum would be roughly the same as the benefit from restoring the partial tax-free status of equity investment. The contribution rate would still be roughly half way between that necessary for a scheme in a pure EET regime and that for a scheme in a pure TTE regime. Nevertheless, the tax framework for pensions as a whole would be more coherent and there would be less of a bias against equity investment and financing corporations through the issue of equity capital than at present and less bias against using the fund to buy an annuity. There would be less incentive for corporations to gear up and avoid tax in other ways by making their balance sheets more opaque. Thus the proposal of this paper would be to move from the current system that is, in effect, $ETT^{partial}$ to $ET^{partial}T$. This is demonstrably closer to the ideal of EET, both with regard to the treatment of investment returns ($T^{partial}$ being closer to E than is T) and the treatment of the proceeds of pension fund investment.

The conclusions from this analysis are clear. The current tax regime for pensions is economically incoherent; it became less coherent as a result of the actions taken in the 1997 budget; the deviation of the system from the expenditure tax system adds considerably to the cost of funding pensions. The easiest practical change to the pension fund tax regime would be to remove the tax-free status of the lump sum and restore the tax-free status of dividends. This would remove the distortion caused to the relative cost of debt and equity capital by the current system and remove the incentive that exists for debt finance and increased corporate gearing under our current tax system.

Legal Complexity

The arguments above might be more important for the applied economist than the "everyman". Whilst the incentives for pension provision are weakened by any move away from the EET system, the economic incoherence of the system may be regarded as an esoteric issue. In fact, the tax-free lump sum balances some of the costs of not receiving equity returns fully gross. Pension contributions are irrevocable and therefore the fact that one element "cancels out" the other may not matter over the lifetime of a scheme[13]. However, the legal complexity of the pension fund tax system imposes serious time costs on individuals, companies, the National Insurance Contributions Office and the Inland Revenue and may lead to a significant reduction in pensions saving because so many individuals regard the current system as impenetrable.

In summary, the tax codes for pension schemes work as follows. In the case of occupational schemes, *whether defined benefit or defined contribution*, full tax relief is given on employer's contributions but there are limits on benefits and these limits have to be administered by the scheme. Employees receive tax relief on contributions up to 15% of capped earnings for that tax year (higher at older

[13] Although the authors would argue that the incentives to finance company operations using debt rather than equity capital could be of fundamental importance.

ages). The 'earnings cap' is £97,200 in 2002/3 and is usually uprated in line with prices. Employees can also make "additional voluntary contributions" (AVCs) as long as the total contribution does not exceed 15% of earnings and as long as total benefits do not breach benefit ceilings. Thus an employee can be in an occupational defined benefit scheme, or occupational defined contribution scheme or both (through the use of AVCs). The benefits are capped and the contributions are separately capped.

Employees who are not in an occupational scheme can be in defined contribution personal pension schemes. Such a scheme would have a maximum contribution of 17.5%[14] of capped earnings. Stakeholder schemes operate by a parallel set of rules and allow a contribution of up to £3,600 (including basic rate tax relief), regardless of earnings. An increment to the pension contribution equivalent to basic rate tax relief can therefore be received by somebody even if they are not paying tax. Thus defined contribution occupational schemes operate under a different tax regime than that for defined contribution personal schemes, despite the fact that there is no inherent difference between the two types of scheme. It should be noted that, in respect of an individual employment, concurrency (that is the membership of a personal pension scheme and an occupational scheme) is allowed for those earning less than £30,000. For individuals who have more than one employment (possibly one employment with a firm that has an occupational scheme and one employment with a firm that does not) the complexities are even greater. We will not discuss the relationship between pension schemes and the national insurance system, which is even more complex.

There are specific anomalies and difficulties that arise from this multiplicity of tax codes. In the case of an occupational defined contribution, for example, there is a contribution limit for the employee but not for the employer. Because there is no contribution limit for the employer there is a benefit limit that has to be administered and monitored. Meanwhile, AVC schemes have benefit limits that are considered in conjunction with the total benefit that individuals will receive from the occupational schemes of which they are members. As a result of the multiplicity of systems, there are transfer regulations to limit occupational benefits being moved to personal schemes in such a way that individuals could avoid both contribution limits and benefit limits, and various sets of regulations that dictate the types of scheme of which an individual can be a member concurrently.

Creating One Defined Contribution Tax Code[15]

It is easy to see why the current position has arisen. The Inland Revenue wishes most individuals to be a member of either an occupational arrangement or a personal arrangement so that benefits, and contributions on which tax relief is

[14] This maximum contribution is age related and is higher at older ages.
[15] These proposals were previously outlined in Booth with Arthur (2002), Making Pensions Simpler, Adam Smith Institute, London, UK.

received, are limited. However, we have noted above that the tax system does not favour pensions nearly as much as is commonly supposed. Furthermore, the restrictions on benefits and contributions were developed at a time when marginal rates of tax were up to 83%, not 40% as is the case now[16]. The tax benefit for "abusing" pension fund tax relief, used to be significant: now it is not. The discontinuation of these separate tax codes would reduce employer and employee costs considerably.

A single tax code could be created for all defined-contribution schemes and individuals could be allowed to be members of both a defined benefit and a defined contribution scheme with no interdependence between the benefit and contribution limits. If contribution limits are kept in the defined contribution regime, then those limits currently applying to personal pensions could be applied to all defined-contribution schemes but with a minimum allowable contribution for all individuals of £3,600, regardless of taxable income. In the case of a define contribution scheme run by an employer, the contribution limit should apply to the employer and employee contribution combined.

This approach would collapse three tax regimes into one regime and considerably simplify the personal affairs of workers who were members of more than one type of scheme during their working lives. It would also enable removal of the transfer regulations, concurrency regulations and the benefit limits in respect of occupational money-purchase schemes. The concept of AVCs, with their separate tax rules, would be redundant, as would the concept of an occupational defined contribution scheme. However, that would not stop employers setting up defined contribution schemes that would operate under the unified tax code.

If this approach were adopted, then clearly some individuals would obtain a higher pension than would currently be allowed under any of the tax codes. As already noted, we do not believe that this is a likely problem or potential area of tax avoidance. The only real danger for the Inland Revenue would be with regard to individuals who took two tax-free lump sums (they could receive tax relief on their contributions and then receive a tax-free lump sum). This could easily be dealt with either by changing the system for taxing pensions in the way proposed above, so that the tax-free lump sum was removed or by a particular regulation that limited the tax-free lump sum. For example, such a regulation could prevent any individual from taking (say) more than 1.5 times their average taxable income over the last three years of their employment as a tax-free lump sum whilst also preventing more than 25% of any defined-contribution 'pot' being taken as a tax-free lump sum.

It is worth making a comparison of our proposals with those in the Pensions

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[16] This is particularly so with some of the very detailed regulations used to implement that tax codes that we have not discussed here. Benefit limits, for example, can involve very complex calculations that could not possibly be understood by most pension scheme members.

Green Paper (2003). The Green Paper proposed one tax regime for pensions. At first sight, this would might less complex than our proposal for two tax regimes. However, the Green Paper suggests an overall lifetime limit on pensions saving. In order to enforce this it is necessary to find a “rate of exchange” to transform defined benefits into cash equivalents. Also, the limit relates not just to the contributions made to any schemes (which *are* under the control of the saver) but to the total cash-equivalent value of any funds. The value of pension funds is not under the control of savers, as it will be increased by favourable investment returns. Individuals may pay tax at the end of their working life, on pension contributions invested in a fund, simply because of favourable investment returns. The proposals here, keep two separate tax codes for two fundamentally different types of scheme but each having a very simple set of rules, with individuals allowed to accumulate funds under both tax regimes simultaneously.

Annuitisation rules

Currently, there are restrictions on the financial purposes to which a defined-contribution pension ‘pot’ can be put and also restrictions on the annuity structure in defined-benefit schemes. These provide yet more pages of detailed regulation. There are two economic reasons for these restrictions:

- To prevent moral hazard (for example, individuals spending all their retirement income savings at the point of retirement and then claiming minimum income guarantee from the state).

- To prevent individuals from ‘over-providing’. The rationale here is that pensions are tax privileged, to help people provide an annuity in old age and prevent people becoming a burden on the state. If people want to save more than for this basic requirement, they should use non-privileged savings vehicles.

As noted already, the second reason is barely significant given that the tax system for pensions is not the EET system commonly supposed. However, the first reason remains important: indeed, with the growth in the extent of means testing, the first reason has become more important than hitherto. When the restrictions on pension provision were developed, the key objective was to limit tax relief. The moral hazard issue was much less important. That situation has now reversed and the rules for annuitisation should change accordingly.

Rules could easily be developed regarding annuitisation that take account of these changed circumstances and that are less prescriptive. The following principles could be used, for example:

- Assuming the tax-free lump sum remains as a feature of the pension system, individuals may take tax-free lump sums on the basis suggested above (that is, up to a maximum of 1.5 times taxable final earnings).

- Individuals must use their remaining pension savings to purchase insured, price index-linked annuities such that their insured, annuity income (including basic state pension) is (say) 1.5 times the state's minimum income guarantee.

Non-annuitised parts of pension 'pots' could be taken at any time but income tax would be payable on any income withdrawn at any time (or on any money left in the fund at death). Housing benefit and council tax benefit (and pension credit above the minimum income guarantee level) would not be paid to an individual until the total pension pot had been annuitised.

Conclusion

In the first part of this paper, we outlined the problems with the existing pensions tax system. The system is economically incoherent and does not provide the favourable tax treatment of pensions that is commonly supposed. We suggested proposals for dealing with this that would involve restoring the partial tax-free status of equities within a pension fund but removing the tax-free status of the lump sum. In the second part of the paper we looked at the legal complexities of the tax system. These impose considerable direct and indirect costs on individuals, companies and taxpayers. These complexities arise as a result of an unreasonable fear, by the Inland Revenue, that tax revenue will be lost. The two sections of the paper are related because the demonstration that pensions are not as tax-favoured as is thought should provide comfort to the Inland Revenue that abuse of a less complex legal environment is less likely than they may presume. We also note that the economic case against removing higher-rate tax relief from pensions is overwhelming and that such a policy would be impossible to operate in practice without hastening the demise of defined benefit schemes.