10. Taxation of private pensions

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Summary

- In 2012, about £70 billion was contributed to funded private pensions, which had a total fund value in 2011 of over £2 trillion. The amount contributed is likely to rise as automatic enrolment goes forward. The way in which pensions are taxed, therefore, is crucially important. Yet this is an area beset by misunderstanding.
- One needs an appropriate benchmark with which to compare the current system. A good starting place would be a system in which contributions to private pensions are free of tax, no tax is levied on any returns, but tax is paid on all pension income when it is received.
- The current UK tax system is overly generous compared with this benchmark system in two ways. First, up to one-quarter of a private pension can be taken entirely free of income tax. Second, roughly three-quarters of pension contributions – those made by employers – escape National Insurance contributions (NICs) entirely. Two factors work in the opposite direction. First, limits apply to the amounts that can be saved in a private pension without penalty. Second, while returns are free of tax at the personal level, these returns are still likely to be affected by both corporation tax and stamp duties.
- HM Revenue and Customs (HMRC) estimates that the net cost of tax relief on pensions provided by income tax and NICs in 2011–12 was £38.3 billion. But this is relative to a benchmark where individuals are not able to benefit from tax-rate smoothing by only paying tax on pension income when it is received and where the system encourages individuals to spend rather than to save. A better estimate suggests the true cost of income tax and NICs relief on pension saving is less than half the official estimate. Taking into account the impact of taxes at the corporate level – corporation tax on normal returns and stamp duty on purchases of shares and property – would reduce this figure further.
- HMRC estimates also suggest that a disproportionate amount of tax relief goes to those on high and very high incomes. But these data are not a good guide to how reliefs are genuinely distributed: the fact that a large slice of up-front relief goes to high-income individuals purely reflects the fact that they make a large proportion of pension contributions and pay a large share of income tax revenues.
- Reducing the annual allowance or the lifetime limits, or restricting income tax relief on pension contributions in any other way, would be expensive to administer and arguably unfair and would inappropriately distort behaviour. Better ways to boost revenues would be to tackle the two elements of the system that look generous relative to a reasonable benchmark – i.e. the tax-free lump sum and the generous NICs treatment of employer pension contributions. As far as NICs are concerned, they could be imposed on employer contributions. But there is a case for, instead, introducing a small and increasing levy on pensions in payment.
- Consideration could also be given to offsetting some of the impact of corporation tax and stamp duties on the returns achieved by pension funds.

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10.1 Introduction[1]

In 2002, the last Labour government set out a consultation for a genuinely radical reform of the tax treatment of private pension saving in the UK. The resulting reforms, which came into force from April 2006 (known as 'A Day'), while not perfect, had much to commend them. As Gordon Brown and Ruth Kelly (then Chancellor and Financial Secretary to the Treasury, respectively) stated in their foreword to the initial consultation document, the reforms represented 'a radical simplification of the tax rules for pensions, sweeping away the existing pension tax regimes, and replacing them with a single lifetime limit on the amount of pension saving that can benefit from tax relief'.[2]

Another stated aim of the consultation was that 'these plans for reform are developed in partnership with those who will use the new rules so that they are simple, durable and readily understood'. Pension rules are rarely simple or readily understood (although the reforms did certainly help). Since pensions are a long-run saving decision, durability is important. The A-Day reforms have since proven anything but durable.

In order to increase tax revenues, and to do so in a way that hit the better off, the last Labour government announced a reform to reduce the generosity of private pension saving from April 2011. This particular plan was never implemented. But the coalition government has implemented its own (less complex and distortionary) reductions in the generosity of the way income tax treats private pensions.

Perhaps in part these reforms have been the result of a number of individuals and organisations making proposals to reform the pensions tax system either because of worries that it is currently 'unfair' or overly generous to high earners or as a way of raising additional revenue. While there is clearly a case for reform – and justifiable ways of carrying it out that would raise revenue mainly from those on higher incomes – it is equally clear that many of the proposals that have been put forward rest on an inadequate analysis of the actual structure and effects of the current system and, more specifically, fail to address the question of what a 'neutral' or a 'fair' system would actually look like.

The fact that a large proportion of the cost of tax relief as recorded by HM Revenue and Customs (HMRC) goes to those with the highest current incomes is not a sign of any 'unfairness' in the system any more than is the fact that the same group pay a very high proportion of all income tax. This should not guide reform proposals. What should guide proposals is a principled look at what an appropriate tax treatment of private pensions would be and how the UK's current system compares to that ideal. That is the objective of this chapter. Section 10.2 describes the principles of pensions tax design and how current UK practice operates. Section 10.3 examines reforms to the system of tax relief on

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[1] The author would like to thank Stuart Adam and Gemma Tetlow for advice and useful comments on this chapter. The chapter draws very heavily on the work of the IFS-led Mirrlees Review, in particular chapters 13 and 14. See J. Mirrlees et al., *Tax by Design*, OUP for IFS, Oxford, 2011, http://www.ifs.org.uk/mirrleesReview and section 9.8 of S. Adam, C. Emmerson and B. Roantree, 'Broad shoulders and tight belts: options for taxing the better-off', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2013*, IFS, London, http://www.ifs.org.uk/publications/6562.

[2] Source: HM Treasury and Inland Revenue, *Simplifying the Taxation of Pensions: Increasing Choice and Flexibility for All*, London, 2002, http://webarchive.nationalarchives.gov.uk/20100104203713/http:/hmrc.gov.uk/consult_new/pensions_consult.pdf. For a response to this consultation, see, for example, C. Emmerson and M. Wakefield, 'Achieving simplicity, security and choice in retirement? An assessment of the government's proposed pension reforms', IFS Briefing Note 36, 2003, http://www.ifs.org.uk/bns/bn36.pdf.

pension saving that would both improve the operation of the system and reduce the overall cost to the government. Section 10.4 concludes.

10.2 Principles and current practice

This section sets out the implications of different options for how pension saving could be treated by the tax system and describes how the current UK pension system operates.

Principles

There are, in general, 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 as to whether the tax treatment of pensions at the personal level should reflect this.[3]

Perhaps the obvious starting point, however, is to ask why private pension saving should not be taxed at the personal level just like saving in a deposit account, with the money going into the account being made out of after-tax income, with the returns received being subject to income tax and with the funds not being subject to income tax when they are withdrawn. This is known as a TTE (Taxed, Taxed, Exempt) regime.[4]

Personal level: TTE tax treatment

One problem with this form of taxation is that it is not neutral with respect to whether an individual chooses to spend their money today or whether they instead choose to save it in order to spend in the future. This is because the normal return to saving – that is, the real return that just compensates for individuals choosing to delay their spending plus the return that is purely compensating for inflation – is being taxed. In other words, this method of taxation will, relative to a neutral tax system, distort individuals' behaviour towards spending more now and less in the future, and this distortion will be worse the greater the rate of inflation. This argument applies to all forms of saving, so the normal return on funds held in deposit accounts should also not be subject to tax, but is particularly important for pensions simply because the amounts saved in private pensions are far greater.

Personal level: TEE tax treatment

This might suggest that the obvious way for the personal tax system to treat pension contributions is to have pension contributions being made out of after-tax income, to levy no income tax or capital gains tax on returns as they accrue in the pension, and have the funds not being subject to income tax when they are withdrawn. This is known as a TEE

[3] 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.

[4] For a more detailed explanation, see, for example, M. Wakefield, 'How much do we tax the return to saving?', IFS Briefing Note 82, 2009, http://www.ifs.org.uk/bns/bn82.pdf.

(Taxed, Exempt, Exempt) regime and is equivalent to how the UK tax system treats saving in Individual Savings Accounts (ISAs) or owner-occupied housing.

This approach would not tax the normal return to saving at the personal level. However, any returns that individuals made on their investments over and above this normal return would also be untaxed at the personal level. Therefore such a system would provide a distortion towards spending less now and more in the future among those individuals who expected to be able to generate a return in excess of the normal return. Given that those who expect to be able to achieve better than normal returns might well be doing so because of either a particular talent or the effort that they are devoting to their investment strategy, ideally such returns ought to be taxed in a similar way to earned income.

Personal level: TtE tax treatment

Given this, perhaps the next most obvious alternative is to have pension contributions being made out of after-tax income, to levy income tax and capital gains tax on any returns made that are over and above the normal rate of return, and then not to tax the funds when they are withdrawn. This would certainly achieve the objective of not taxing the normal return to saving but taxing any returns that accrue over and above this at the personal level. This is known as a TtE (Taxed, partially taxed, Exempt) regime. This form of taxation, despite having many attractions, is not applied to any assets in the UK.

Personal level: EET tax treatment

An alternative way for the tax system to treat pension saving is to give tax relief on contributions to pensions (or, equivalently, for the contributions to be made out of pre-tax income), to levy no income tax or capital gains tax on returns as they accrue in the pension, and for income from pensions to be subject to tax at the personal level. This is known as an EET (Exempt, Exempt, Taxed) regime. The way income tax and capital gains tax systems treat pension saving in the UK is, for most people, closest to this type of tax treatment. This is also the most common tax treatment of private pension saving at the personal level across industrialised countries.[5]

This type of treatment neatly achieves two objectives:

- First, 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. This feature comes from the fact that, if higher returns are generated, a greater amount of tax will be paid on the eventual pension income. In this respect, EET tax treatment works as well as TtE tax treatment.
- Second, it means that individuals who are 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 are able 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. In this respect, given that it is more common for tax rates to fall

[5] 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.

rather than rise on retirement, the EET tax treatment is arguably fairer than the TtE tax treatment.[6]

An EET regime is not, however, flawless. Those individuals who expect to face a lower marginal rate of income tax in retirement than they do at the moment will have their incentives to save distorted by the tax system: they will be incentivised to spend less today and to spend more in retirement than they otherwise would do. Specifically, under a pure EET system, this means that, for example, individuals who are higher-rate income tax payers during their working life but who expect to be basic-rate income tax payers in retirement will face a stronger incentive to save in a private pension than individuals who expect to be either basic-rate income tax payers or higher-rate income tax payers throughout their lives.

Corporate level: taxes on corporate profits and stamp duties

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.[7] 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[8] – was being treated by the overall tax system in a way that was neutral between saving and spending.

A bonus for private pension saving

The starting point set out above is for the tax treatment of saving to be neutral between spending today or instead saving and spending in future. But if all saving were taxed in such a way, there would be no incentive from the tax system to save in a private pension as individuals could instead save in a more liquid form for their retirement. If public policy wants individuals to choose to lock away their savings until they retire, and then be compelled to use that pot of savings to secure a retirement income of at least a certain level (usually through the compulsory purchase of an annuity), some incentive needs to be provided.

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[6] Some might expect to face a higher tax rate in retirement than they do in their working life. For these individuals, TtE tax treatment would allow them to tax-rate smooth. One possibility is to give individuals the choice between a TtE and EET tax treatment. 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.

[7] 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.

[8] 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.

There are two good public policy reasons to want individuals to save privately to build an adequate retirement income. First, there may be concerns that, otherwise, some individuals might actively choose to save less and then fall back onto means-tested benefits in retirement. Second, there might be a worry that, without an additional incentive to save for retirement, individuals might unintentionally undersave and, when they get to retirement, regret that they had saved too little.

This suggests that generous tax treatment of private pension saving, relative to the benchmark EET system set out above, could be appropriate. This is because for those who expect to be basic-rate income taxpayers throughout their lives (and therefore do not wish to save in a private pension in order to smooth their taxable income), the EET system will be neutral between saving and spending. This provides a potential justification for an additional incentive to save in a private pension.

Any such bonus should be tailored to the problem it is trying to solve. If the issue is that individuals would otherwise actively choose to save too little from society's point of view because of the presence of means-tested benefits, then it would make sense to target the incentive towards those who are likely otherwise to end up on means-tested benefits in retirement. If the issue is a concern that individuals might be saving too little from their own point of view, then it would make sense to target any incentive towards potential undersavers. In both cases, the incentive – relative to EET tax treatment – should be designed in a way that encourages individuals to respond to it (for example, a transparent and simple incentive is likely to be more effective than an opaque and complicated one) and potentially it should only be targeted towards those who are actually likely to respond.

Current UK practice

The UK's income tax and capital gains tax regime for pensions is closest to the EET regime described above. Contributions are made free of income tax, investment returns accumulate free of income tax and capital gains tax, and the pension in payment is subject to income tax. There are three obvious ways in which UK practice deviates from a pure EET treatment: the presence of a tax-free lump sum, limits on the amounts that can be contributed to and held in private pensions, and the treatment of pension saving by the system of National Insurance contributions (NICs). Furthermore, the returns to saving will potentially be affected by both corporation tax and stamp duty on share transactions. We now describe each in turn.

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 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 £1.25 million in a private pension (the maximum on which tax relief will be granted from 2014–15; see below) would be able to receive £312,500 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

There are two limits that apply to private pension contributions. First, individual contributions (i.e. not including those formally made by an employer) in a single year are not allowed to exceed the greater of 100% of an individual's earnings in that year or

£3,600 if their earnings are below this level. Second, 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 £50,000, but is due to fall to £40,000 from 2014–15 (and is significantly lower than the £255,000 annual limit that was in place when the current government took office in 2010–11). 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 due to be introduced in 2014–15. 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.[9] 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.[10] Career average defined benefit pensions typically accrue more gradually over an individual's lifetime than final salary pensions and therefore this will make it less likely that individuals will be constrained by a given level of annual allowance in future.

There is also a cap on the total amount that can be accumulated in a private pension, known as the lifetime limit. This is currently set at £1.5 million and is set to fall to £1.25 million from 2014–15. To get a feel for how big a £1.25 million 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 £312,500 and receive an RPI-linked annual pension of about £30,000 (or an annual pension fixed in cash terms of about £50,000).[11] For someone in a defined benefit pension arrangement, a £312,500 lump sum and an annual RPI-linked pension of £46,875 – some 50% higher than the maximum defined contribution pension – is deemed to be equivalent to a pension pot of £1.25 million (since defined benefit pension schemes are deemed to have a pot size 20 times the annual pension).

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,

[9] 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.

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

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

Exempt (TEE) treatment[12]). 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[13] – 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 (which in 1992–93 was 25%). This was reduced by the then Chancellor Norman Lamont (now Lord Lamont) to 20% in his Spring 1993 Budget, and then abolished completely by Mr Brown in his first Budget in July 1997.[14] In addition, in his March 2001 Budget, Mr Brown introduced 'individual pension accounts', which were exempt from stamp duty on share transactions. However, these accounts never became widely available, with reports suggesting that they were only offered by one provider.[15]

Cost of UK pensions tax relief and who benefits

Official estimates suggest that in 2012 about £70 billion was contributed to funded private pensions, which had a total fund value in 2011 of over £2 trillion.[16] The scale of these contributions and accumulated funds makes it particularly important that they are treated appropriately by the tax system. For this policymakers need to know how much revenue is raised under the current system and – more difficult – how this would

[12] 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.

[13] 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%).)

[14] 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.

[15] See, for example, Money Marketing, 'Will IPA ever go to the ball?', 21 March 2002, http://www.moneymarketing.co.uk/will-ipa-ever-go-to-the-ball/62993.article.

[16] In 2011, the value of assets held in UK funded pensions is estimated by ONS at £2,040.7 billion (135% of GDP), while total contributions to self-administered pensions in 2012 amounted to £49.6 billion. Source: Figures 9.1 and 9.5 of Office for National Statistics, *Pension Trends*, http://www.ons.gov.uk/ons/dcp171766_305526.pdf. In 2011–12, £20.1 billion was contributed to personal pensions, retirement annuity contracts and free-standing additional voluntary contributions. Source: Table PEN1 of http://www.hmrc.gov.uk/statistics/pension-stats.htm. This gives total contributions to these schemes of almost £70 billion, but also omits contributions to the relatively small group of occupational pensions administered by insurance companies.

compare with the revenue that would be raised under a sensible benchmark system. Where the current system involves a net cost compared with the alternative system, policymakers would need to know who was benefiting in order to help ensure that the giveaway was appropriately targeted. This subsection describes the official HMRC estimates of the cost of pensions tax relief and of how it is distributed and explains why, unfortunately, in neither case do they provide a good guide to the true answer.

HMRC's estimates of the cost of tax relief

Calculating correctly what the total cost of tax support for pension saving is and how much different types of individuals benefit is not straightforward. The right way to do it is to calculate, 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.

In addition to being computationally difficult, the answer will also be sensitive to what alternative pensions tax regime it is compared with. If we compared the current system with one where pension saving was never taxed (i.e. EEE in the notation above), we would conclude that the current UK system of taxing pensions is raising revenue for the exchequer and that much of the burden is falling on individuals with higher incomes over their lifetime. At the other extreme, we could compare the tax paid under the current system with the tax paid under a system where pension contributions were made out of after-tax income, returns on funds held in a private pension were subject to tax, and pension income was also subject to tax (TTT). This would lead us to the conclusion that the current system for taxing private pensions comes at a considerable exchequer cost and that higher-income individuals are disproportionately benefiting. But both these conclusions would be wrong as the counterfactual system is obviously silly: having no tax at any point on pension saving would clearly be inappropriately generous, while trying to tax contributions to pensions and income from pensions would in practice surely lead to no one choosing to save in a pension.

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 differs from that set out above as it 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 very 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.

The final key thing to note is that HMRC chooses to compare the current tax treatment of pension saving in the UK with a system where contributions to pensions were made from taxed income, where returns on funds held in pensions were taxed (although capital gains tax is not included in its calculation anyway) and where income from pensions is not taxed. This is a Taxed, Taxed, Exempt (TTE) regime. As discussed above, this is not a 'neutral' system and would disincentivise pension saving.

With these important caveats in mind, the latest HMRC estimates for 2011–12 are presented in Table 10.1. Because it is looking at how income tax and NICs treatment

Table 10.1. 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.

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.

How these figures evolve going forwards will depend on underlying trends in pension contributions, pension returns and pension income. In addition, three reforms will also affect these numbers slightly. First, the likely boost to pension contributions as a result of most employees being automatically enrolled into workplace-based pensions will increase the cost of tax relief. Second, recent reductions to the annual allowance and lifetime allowance will tend to reduce the amount of tax relief. Third, the reduction in the top rate of income tax from 50p to 45p that came into force from April 2013 will reduce the cost of tax relief to pension savers with incomes in excess of £150,000. HMRC has produced projections for the cost of income tax relief (i.e. not including the cost of NICs relief on pension contributions formally made by employers). This is projected to fall from the £23.3 billion in 2011–12 shown in Table 10.1 (i.e. the £38.3 billion total net cost less NICs relief of £15.0 billion) to £22.8 billion in 2012–13 and £22.6 billion in 2013–14.[17]

HMRC's estimates of the distribution of tax relief

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). Furthermore, this calculation makes no allowance for the amount of tax that will eventually be paid on the pension income. It is therefore unsurprising that individuals with a higher current income are, on average, estimated to receive more up-front tax relief than individuals who have a lower current income.

[17] Source: HMRC, 'Estimated costs of the principal tax expenditure and structural reliefs', http://www.hmrc.gov.uk/statistics/expenditures/table1-5.pdf. This table also states that the cost of *employer* NICs relief on pension contributions is estimated at £10.4 billion in 2012–13, rising to £10.8 billion in 2013–14, but unfortunately does not give an estimate of the cost of *employee* NICs relief.

The HMRC estimates suggest that in 2010–11 income tax relief for those with taxable income below £20,000 was 7%, for those between £20,000 and £45,000, 29%, £45,000 to £75,000, 26%, £75,000 to £100,000, 7%, £100,000 to £150,000, 8%, while those with a taxable income above £150,000 received 22%.[18]

It is often claimed that these numbers demonstrate that a disproportionate amount of pensions tax relief goes to high-income individuals.[19] For example, the 1% of income tax payers fortunate enough to have a taxable income of over £150,000 made 16% of all pension contributions and yet received an estimated 22% of all up-front tax relief.[20] But this is not obviously unfair; and neither is the fact that this group also paid 24% of all income tax revenue,[21] which perhaps helps show why it is not surprising that HMRC's estimates suggest this group receives such an apparently large slice of pensions tax relief.

It is worth reiterating that these calculations overstate the generosity of income tax relief for higher-income individuals for two reasons. First, individuals who have a higher lifetime income will typically have higher pension incomes and these calculations take no account of the income tax that will eventually be paid on that income. Second, some individuals will have high incomes only temporarily and may be making greater pension contributions in order to benefit from tax-rate smoothing. As set out earlier in this section, to the extent that this leads to individuals with the same lifetime incomes paying the same amount of tax over their lifetimes, this would seem fair.

An assessment of the distribution of income tax relief, relative to a benchmark of a pension system where tax relief was given on pension contributions, returns were not taxed, but pension income was taxed, would still show that those with higher lifetime incomes received a disproportionate share of income tax relief relative to the contributions that they made. This would arise because of the tax-free lump sum being more generous to those who pay higher-rate income tax in retirement than the majority who pay basic-rate income tax in retirement (although this would be offset by the extent to which individuals are constrained by the annual allowance and lifetime limit). But the distribution would not be anywhere near as skewed as the HMRC data suggest.

The other large omission is the cost of up-front NICs relief on contributions to private pensions that are made on individuals' behalf by their employers. Since NICs are not paid on pension income, it is more reasonable to classify this as relief, but HMRC does not attempt to do this as it only looks at contributions formally made by individuals. The distribution of this relief could well differ from the distribution of up-front income tax relief that HMRC estimates. For example, it could be that employer pension contributions are more skewed towards those on higher incomes than individual contributions are. Unfortunately, decent data on how employer and employee pension contributions vary across the income distribution are not available.

[18] 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.

[19] 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&.

[20] Source: Author's calculations using data from HMRC Statistics, table 3.8, http://www.hmrc.gov.uk/statistics/income-by-year/table3-8.xls.

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

Summary

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 for policymakers to have a good estimate of how much this relief costs. Unfortunately, the figures produced by HMRC, which suggest that the net cost of pension relief provided by income tax and NICs in 2011–12 was £38.3 billion, do not provide a good guide to this. This is because they are relative to a benchmark where individuals are not able to benefit from tax-rate smoothing and where the system encourages individuals to spend rather than to save. A better estimate would be the cost of NICs relief – estimated by HMRC at £15.0 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.[22] This suggests that the true cost of income tax and NICs relief could be less than half the official HMRC estimate that was set out in Table 10.1. If the impact of taxes at the corporate level – corporation tax on normal returns and stamp duty on purchases of shares and property – were taken into account, then the figure would be reduced further still.

Furthermore, policymakers ought to want to know how this cost of relief is distributed across different individuals. Again, the HMRC data are not a good guide to this. Relative to a benchmark of EET tax treatment, individuals who are higher-rate taxpayers while working but basic-rate taxpayers in retirement are simply tax-rate smoothing and it is far from clear that this is overly generous, or unfair, treatment. Unfortunately, analysis of how pensions tax relief is distributed relative to the EET benchmark is not available, although 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. However, even without these data, there are still changes that could be made to the way in which the UK tax system treats pension saving that could make the system more coherent and, potentially, also raise revenue.

10.3 Options for reform

This section considers some possible options for reforming pensions tax relief, in particular looking to see if there are ways that would improve the structure of relief and also reduce the generosity of the system in order to boost tax revenues.

Reduce the annual or lifetime allowance

The simplest way to raise more money would be to reduce the annual and/or lifetime limits on what can be contributed to a pension tax-free. This would be in keeping with recent reforms, repeating what was done in the June 2010 Budget and the 2012 Autumn Statement. We are not aware of any estimates of the yield from further reductions; the government estimates that the reduction of the annual limit from £50,000 to £40,000 and the reduction of the lifetime limit from £1.5 million to £1.25 million will together raise

[22] See footnote 29.

£1.1 billion in 2017–18[23] and more thereafter, but further reductions of the same size would raise significantly more than that because far more people would be affected.

Tightening limits on what can be saved in tax-privileged forms over a lifetime may not be the worst way to reduce the generosity of the pensions tax system. But the further you go down the route of cutting the lifetime limit, the more you move away from the relatively desirable EET system of taxation. This would increase the risks that people will be incentivised to undersave and that more effort will be put into securing tax advantages by using more complex schemes. Perhaps more importantly, there are better options available, which we discuss below. In particular, rather than preventing people with very large pension pots from saving any more in a registered pension scheme at all, it would be better to let them save in a pension but without the large subsidies they currently receive through the tax-free lump sum and the NICs exemption of employer contributions.

The fact that the lifetime limit is more generous for those in defined benefit (DB) schemes than for those in defined contribution (DC) schemes is hard to justify. Therefore if the government was minded to reduce the lifetime allowance again, it should do so in a way that equalises it for members of defined benefit and defined contribution pensions.[24]

Reducing the annual allowance makes less sense than reducing the lifetime allowance. For a given level of lifetime contributions, it is not clear why we would want to penalise making occasional large contributions rather than frequent smaller contributions. In practical terms, reducing the annual allowance is more problematic, as valuing annual contributions to defined benefit pension schemes is difficult; the lower the annual limit, the more of these difficult valuations must be done. Indeed, there is actually a strong case for abolishing the annual allowance (and the cap on individual contributions of the greater of £3,600 and 100% of annual earnings) and simply allowing individuals to place as much as they like in a private pension as long as the total value of their pension pot does not exceed the lifetime limit. (If the annual allowance is retained, there is a strong case for the three-year carry-forward to apply to all individuals and not just to those who were a member of a scheme in those years. The allowance should also be reviewed to ensure that it is neutral between DC and DB schemes at all ages.)

Restrict income tax relief to the basic rate

The restriction of income tax relief on pension contributions to the basic rate is frequently proposed (including in the Liberal Democrats' 2010 general election manifesto). The government says that in 2011–12 this would have reduced the cost of tax relief on pension contributions by around one-third, implying a yield of about £9.4 billion.[25] However, as the government notes, this ignores the substantial change in behaviour that this reform would be likely to engender. In fact, if people's main response

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[23] Source: Table 2.1 of HM Treasury, *Autumn Statement 2012*, http://cdn.hm-treasury.gov.uk/autumn_statement_2012_complete.pdf.

[24] The calculation on page 227 suggested that about 50% more RPI-linked income, on top of a tax-free lump sum, could be received from a tax-relieved DB pension than from a tax-relieved DC pension. This suggests that the factor of 20 applied to convert DB pension income into DB pension wealth should be increased by something like 50% to 30.

[25] Yield from restricting relief from Written Answer by David Gauke MP to a Parliamentary Question, 6 July 2011 – 'If relief on pension contributions were limited to the basic rate of tax, the amount of this relief would fall by approximately one third. This estimate does not take account of behavioural effects, which are likely to be large' (*Hansard*, column 1249W, http://www.publications.parliament.uk/pa/cm201011/cmhansrd/cm110706/text/110706w0002.htm).

was to reduce their pension contributions, this would tend to increase the yield in the short run by saving the cost of basic-rate relief as well as higher-rate relief, but in the long run this would be offset by reduced revenue from taxing pension income.

It is often argued that it is 'unfair' that a large proportion of income tax relief goes to those on relatively high incomes. As discussed in Section 10.2, it perhaps looks less unfair when put in the context that, despite this tax relief, they still pay a large proportion of all income tax.

More fundamentally, the idea that income tax relief should be restricted to the basic rate is misguided. The error stems from looking at the tax treatment of pension contributions in isolation from the tax treatment of the pension income they finance. Pension contributions are excluded from taxable income precisely because pension income is taxed when it is received: in effect, the tax due on earnings paid into a pension is deferred until the money (plus any returns earned in the interim) is withdrawn from the fund. It is hard to see how it can be unfair for higher-rate taxpayers to receive 40% relief when basic-rate taxpayers receive 20% relief, yet at the same time *not* be unfair for higher-rate taxpayers to pay 40% tax on their pension income when basic-rate taxpayers pay only 20%.

Proponents of the restriction point out that many of those receiving relief at the higher rate will only pay basic-rate tax in retirement.[26] The arguments here are more complex. The current system certainly provides an additional incentive for higher-rate taxpayers to save in a pension if they expect to be basic-rate payers in retirement. But 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 by taking more tax from people whose incomes are volatile than from people whose incomes are stable. But even if receiving higher-rate relief and then paying basic-rate tax is seen as unfair, that does not diminish the case for accompanying any restriction of tax relief on contributions with a restriction of the tax on pension income. The tax system should treat pension contributions and pension income in a symmetric way.

Restricting the tax relief would also be complicated, for the same reason as reducing the annual allowance would be. It would require the valuation of pension promises made by employers through defined benefit schemes. And this requirement would be much more widespread if it applied to all higher-rate taxpayers rather than just people making exceptionally large pension contributions.

The Labour Party has revived a proposal originally made in the then Labour government's 2009 Budget, but never implemented because it was dropped by the incoming coalition government in favour of a reduction to annual and lifetime allowances designed to raise the same amount of money. The proposal is to restrict tax relief on pension contributions to the basic rate, but only for those with incomes above £130,000 and whose gross incomes plus employer pension contributions are above £150,000. This policy would involve much additional complexity in measuring the value of employer pension contributions for those potentially affected. It would also mean that some with large employer pension contributions would face a substantial increase in their income tax bill if their income rose from just under to just above the £130,000 threshold. To take

[26] Though the snapshot statistics of the income tax rates facing current pension savers and current retirees often used to illustrate the point are somewhat misleading – those currently contributing may not necessarily face the same tax rates in retirement as current retirees, not least because of ongoing fiscal drag.

one example, an individual earning £129,000 plus an employer pension contribution of £40,000 would face an increase in their annual income tax bill of over £10,000 if their current wage were to rise to £130,000 (assuming a top rate of income tax of 50%). While targeting the policy on only those with such high incomes has the merit of limiting a bad policy to a smaller group of people, it has even less of a coherent rationale than a more general limit on tax relief. It is hard to see why it should be unfair for those above £150,000 to get tax relief at their marginal rate, but not for other higher-rate taxpayers to do so. Indeed, these very-highest-income individuals are less likely to be only basic-rate taxpayers in retirement, removing one of the principal arguments for restricting relief.[27]

In summary, then, restricting the rate of income tax relief on pension contributions would be expensive to administer, be unfair and inappropriately distort behaviour. There are far better ways to raise money from well-off people, or to reduce the generosity of pensions taxation, or even to do both at once.

Cap 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 £1.25 million lifetime allowance, this means that £312,500 can be taken tax-free. While there are good reasons that we might actively encourage people to save a certain amount for their retirement, it is less clear that people who already have, say, a £1 million pension fund ought to be subsidised for saving yet more, at the expense of other taxpayers. There is therefore a powerful case for introducing a cash limit on the amount that can be taken as a tax-free lump sum, at a level considerably below £312,500.[28] Unfortunately, no reliable current estimate exists of the revenue that this would raise.[29]

More fundamentally, while the case for providing a 'bonus' for saving in a pension is strong, a tax-free lump sum seems like a singularly ill-designed form for such an inducement to take. Encouraging withdrawal of a tax-free lump sum seems a perverse way of encouraging people to build up a pension, if one of the pension's main purposes is to provide a regular retirement income (and keep people off means-tested benefits). The current system also provides a significantly bigger bonus for higher-rate taxpayers than

[27] See C. Emmerson, 'A response to the Treasury consultation on restricting pensions tax relief', IFS Press Release, 1 March 2010, http://www.ifs.org.uk/publications/4773.

[28] 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.

[29] 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.

for basic-rate taxpayers. As the Mirrlees Review notes, there are many alternative ways of incentivising pension saving that do not have these features.[30] For example, the government could simply top up pension funds at the point of annuitisation, again subject to a cap: a 5% top-up would be broadly equivalent in value to the tax-free lump sum for a basic-rate taxpayer (20% of 25%).

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 (as shown in Table 10.1). Some might argue that encouraging saving through workplace pensions is a particularly effective way of raising personal saving. But it is not clear that this warrants net saving incentives of the magnitude currently in the tax code, or such 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.[31] 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 10.1).

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; as mentioned above, that is difficult for defined benefit pension 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.[32]

While charging NICs on employer contributions would be a major improvement on the current system, the Mirrlees Review argued that, in principle, it would be even better 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).[33] However, to avoid retrospective double taxation – levying NICs on pension income despite having already levied NICs on employee contributions to that pension, undermining the legitimate expectations of those who have saved up to now – careful transition arrangements would be needed. Such a transition could take decades, opening up the political risk that future governments might not follow through with the plan. And

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[30] Pages 340–1 of J. Mirrlees et al., *Tax by Design*, OUP for IFS, Oxford, 2011, http://www.ifs.org.uk/mirrleesreview/design/ch14.pdf.

[31] 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).

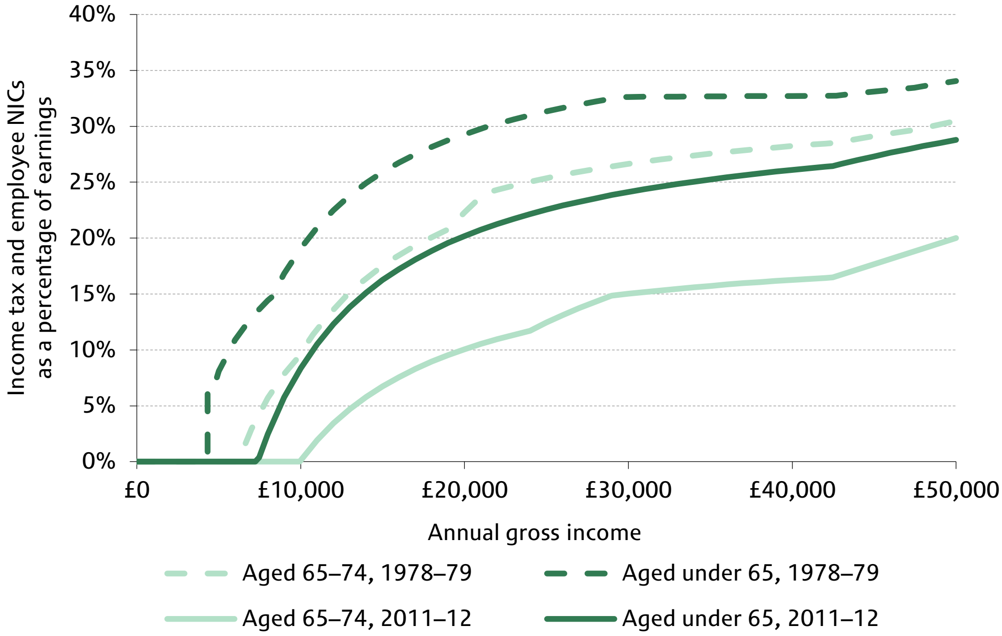
[32] Source: HMRC, 'Estimated costs of the principal tax expenditure and structural reliefs', http://www.hmrc.gov.uk/statistics/expenditures/table1-5.pdf.

[33] 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.

the transitional arrangements would mean that, while the reform generated significant revenue in the long run, it would actually cost money up front.

To avoid such a long transition, a government could decide 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.[34] One could argue that such a change could help to spread the government's fiscal consolidation plan more evenly across the generations since the tax and benefit reforms announced to date have, on average, reduced the incomes of pensioners by less than those of working-age individuals.[35] Moreover, the extent to which it would genuinely be double taxation is unclear for two reasons. First, the majority of pension income will reflect contributions to private pensions made on individuals' behalf by their employers and therefore will never have been subject to NICs. Second, the shift from income tax to NICs that has occurred under the last Conservative and Labour governments, and continued under the coalition government, means 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 10.1, 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.

Figure 10.1. 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.

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[34] 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.

[35] 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.

Credits for corporation tax; exemption from stamp duty

As set out in Section 10.2, corporation tax does, in part, tax the normal rate of return, while stamp duties apply to purchases of UK shares and property. At the moment, there is no recognition of either in the way the personal tax system treats private pension saving. Ideally, there would not need to be, as corporation tax would be well designed so that it only taxed real excess returns, and stamp duties on mutually beneficial trades with no spillovers to the rest of society would not exist.

However, given that this is not the case, consideration could be given to whether the tax system should compensate those with funds in private pensions for the impact of these other taxes. Doing so could help ensure that a significant proportion of overall UK wealth – that held in private pensions[36] – was being treated by the overall tax system in a way that was neutral between saving and spending. The data we have available make it difficult to produce a costing for such a change; it would most likely be several billion pounds.

10.4 Conclusion

It is often asserted that the UK's pensions tax system is in need of reform because it is 'unfair', because it is overly generous to those on high incomes or as a way of raising additional revenue. While there is clearly a case for reform, it is equally clear that many of the proposals rest on an inadequate analysis of the actual structure and effects of the current system and, more specifically, fail to address the question of what a 'neutral' or a 'fair' system would actually look like.

HMRC suggests that the cost of pensions tax relief in 2011–12 was £38.3 billion. But this is calculated in an odd way against an inappropriate counterfactual. A better estimate suggests that the true cost is less than half this amount. The HMRC calculations are also likely to be a poor guide to how relief is distributed. In particular, allowing those who are 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 to smooth their income is fair in the sense that it would be unfair for them to pay more tax over their lifetime than an otherwise-equivalent individual who has an income that, on average, is at the same level but which is less variable.

The tax treatment of pensions does, most likely, come at a net cost to the exchequer relative to a neutral system. There may be good reasons to use the tax system to encourage people to save a certain amount in a private pension; therefore, the fact that the system has a direct net cost need not suggest that it is overly generous. But it is clear that the incentives that the tax system currently provides are not well targeted either at encouraging individuals to save sufficiently so they are not reliant on means-tested benefits in retirement or at getting those who would otherwise undersave for retirement to save more.

It is often proposed that we should restrict the rate of tax relief on pension contributions. This would undermine the logic of pensions taxation and would be complex, unfair and inefficient. Reducing the annual allowance makes less sense than reducing the lifetime

[36] 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.

allowance since for a given level of lifetime contributions, it is not clear why we would want to penalise making occasional large contributions rather than frequent smaller contributions. Reducing the lifetime limit is perhaps not the worst way to reduce the generosity of the pensions tax system, but there are better options available.

It is hard to justify the extraordinarily generous NICs treatment of employer pension contributions. Making employer pension contributions subject to employer NICs could raise an estimated £10.8 billion a year. On grounds of intergenerational 'fairness', it might be preferable to charge some NICs on pensions in payment, which would raise an estimated £350 million for every percentage point of tax.

It is also hard to see why people with very large pension pots should be able to draw a lump sum of as much as £312,500 tax-free. The tax-free lump sum could be subject to a much tighter overall limit or the implied subsidy could be used more effectively.

One aspect of pensions taxation is actually less generous than the ideal benchmark system: the real returns on pensions saving are affected by corporation tax and stamp duties. Consideration could be given to offsetting some of this impact.