

Press Release

A response to the Treasury consultation on restricting pensions tax relief

In response to the Treasury's consultation on the forthcoming restriction of income tax relief on pension contributions Carl Emmerson, IFS deputy director, said: "Implementing this reform will create complexity, unfairness and inefficiencies. The Government's goal is to raise money by reducing the subsidy that the wealthy enjoy on their pension contributions. But many people on high incomes will still be able to receive unrestricted income tax relief on their pension contributions – for example by making greater use of salary sacrifice arrangements. A better approach would be to reduce the amount that individuals can take tax-free from a private pension from its current level of £437,500."

His full response to the consultation is as follows:

The Treasury is consulting on how best to implement the planned restriction to income tax relief for high income individuals due to come into force from April 2011.¹ This consultation is welcome. But better would have been an initial consultation on the policy itself: as it stands the reform will create complexity, unfairness and inefficiencies.

The policy will affect individuals with a gross income (excluding employer pension contributions) above £130,000 a year whose gross income plus the estimated value of any employer pension contribution is worth more than £150,000. Currently these individuals generally enjoy income tax relief on pension contributions at their marginal rate of income tax (i.e. from this April, 40% for higher rate income tax payers and 50% for the one per cent of adults in the UK fortunate enough to receive a gross income above £150,000 a year). The new policy means that from April 2011 relief will be tapered down from 50% to 20% (equivalent to the basic rate of income tax) for those whose income, plus the estimated value of any employer pension contribution, exceeds £150,000 a year. The 20% rate of relief will apply to those whose income (measured including the estimated value of any employer pension contribution) is equal to £180,000 or more a year.

For many of those affected the impact of the reform is certainly large: the Treasury estimates that the reform will raise £3.6 billion a year and that 300,000 individuals will be affected. If correct, the average (mean) tax increase would be a whopping £12,000 per affected person per year.

Some argue² that it is unfair that higher income individuals currently receive relief at a more generous rate than lower income individuals. But this is not a good argument as it ignores the fact that tax is paid on pension income when it is drawn. Individuals who receive relief at the higher rate of income tax when they make pension contributions and who are also higher rate income taxpayers in retirement receive income tax treatment that is no more generous than individuals who are basic rate income taxpayers throughout their lives. This will be true of the majority of individuals who are affected by this reform since those with a gross income at some point during their working life in excess of £130,000 a year will typically be higher rate income taxpayers in retirement.

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It is true that those who are higher rate income taxpayers during their working lives, but who are basic rate income taxpayers in retirement, benefit from “tax rate smoothing” – that is receiving a rate of relief on pension contributions which exceeds the rate of tax paid on pension income. This argument could justify restricting relief (and the tax on pension income) to the basic rate of income tax for all individuals. But allowing individuals to benefit from tax rate smoothing is arguably fairer. This is because it allows an individual who happens to receive a large proportion of their lifetime income in relatively few years to spread that income over time, rather than face a higher income tax bill than another individual with the same lifetime income spread more evenly.

That is not to deny that the pension system is inappropriately generous to the wealthy. The most obvious anomaly is the fact that individuals can take up to 25% of their pension as a lump sum free of income tax up to a maximum of £437,500. A reform that placed a much smaller cap on the amount that can be taken as a lump-sum would improve value for money for the public purse as there is no obvious justification for providing such a generous amount tax-free.³ Another improvement would be to place employer National Insurance (NI) on employer pension contributions: not doing so gives an opaque and badly targeted subsidy in favour of employer (rather than individual) contributions.

The complexity of the Government’s reform comes from the need to assess the contributions of those in defined benefit pension schemes. The value of these pensions depends on things like the individual’s pensionable salary (often final salary), the ultimate duration of their scheme membership, their life expectancy, the longevity of any surviving partner or qualifying dependent when the member dies, investment returns and inflation. It also depends on the likelihood that the employer will be unable to honour the pension promise – specifically the chance that it goes bankrupt without enough in the pension pot to cover all of the commitments. All of these things are very uncertain when the individual is some way from retirement and therefore some rules of thumb will need to be drawn up (which is one of the things that the Treasury has been consulting on).

The trade off is between extremely complicated rules or ones that unintentionally (and arbitrarily) favour some groups relative to others and thereby create both inefficiencies (from unjustified distortions) and unfairness (from unintended redistribution). The Treasury is likely to try to err on the side of relatively simple rules – and therefore relatively more inefficiency and unfairness – in order to minimise the administrative burden on individuals, employers and pension funds. But even over the first five years these costs are estimated to average almost £500 per year per person affected by the reform.

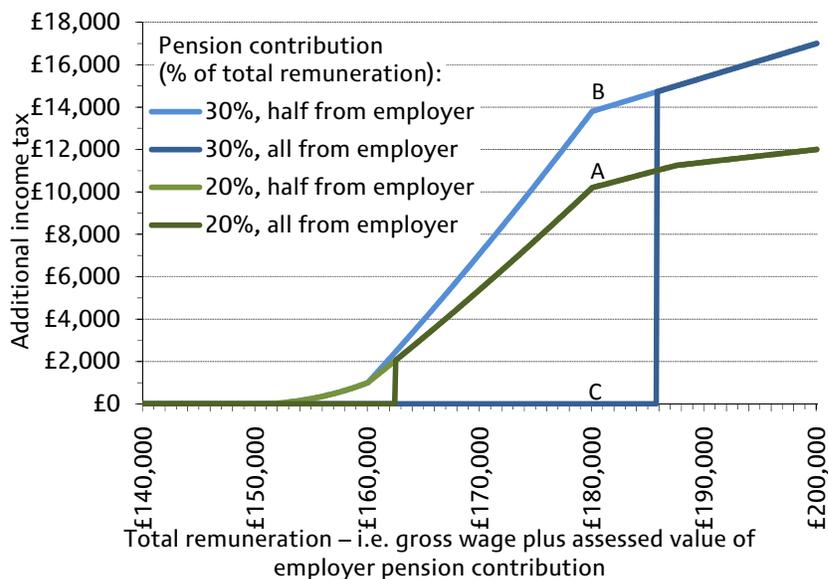
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Further unfairness and inefficiency comes from the reform leading to some individuals paying a lot more income tax compared to other individuals in broadly similar situations, as shown in the Figure below. Take, for example, individuals who have an income, including the estimated value of employer pension contributions, of £180,000 a year. The Figure shows that those who have a remuneration package consisting of 80% current pay and 20% pension contribution will face an increase in their income tax bill of £10,200 a year (point A). Those whose remuneration package constitutes 70% current pay, 15% employee pension contribution and 15% employer pension contribution will face an increase in tax of £13,800 a year (point B). The fact that they pay more in tax than the person who makes a smaller pension contribution is unsurprising: they have higher pension contributions and these are being more harshly treated. But there is a third potential group who will be wholly unaffected by the reform: those with the same £180,000 of income (measured including employer pension contributions) whose remuneration package consists of 70% current pay and 30% employer pension contribution (point C). These individuals are unaffected because their gross current wage, i.e. excluding the employer contribution, is £126,000 (i.e. below the £130,000 a year threshold and so these people are not caught by the Treasury's new test).

Another example of the unfairness, and inefficiency, created by the reform is that an individual with a gross income (excluding employer pension contribution) of just below £130,000 a year, who also receives a substantial employer pension contribution, would see a very large increase in their tax bill if their income rose to just above £130,000 a year. To take one example, the dark blue line in the Figure shows that an individual earning £129,000 plus an employer pension contribution of £56,800 would face an increase in their tax bill of £15,000 if their current wage were to rise to £130,000 (as indicated by the vertical line at £185,800).

Impact of proposed restriction of income tax relief on pension contributions



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Individuals could respond to the reform by reducing the amount that they save in a pension and instead increasing their spending or by increasing the amount they save in other vehicles. Those only eligible for income tax relief of 20% on pension contributions who expect to be a higher rate tax payer in retirement will find that employee contributions to private pensions receive less generous tax treatment than, for example, investing in ISAs or in owner-occupied housing.

But perhaps the most likely responses are those that simply change the form or the timing of pension contributions, rather than the total amount placed in pensions over individuals' lifetimes. First, individuals could make more use of salary sacrifice arrangements in order to keep their gross income (excluding the employer pension contribution) below £130,000 while receiving employer pension contributions that attract unrestricted relief (for example individual C in the Figure above has the same income plus employer pension contribution as individual B, but pays £13,800 a year less in income tax; they would also find that they paid less employee NI, and their employer paid less employer NI, as NI is not applied to employer pension contributions). Second, individuals could make their pension contributions in periods of life when their income was below £130,000 – something made easier now that individuals can put 100% of their earnings (up to a maximum of £255,000 a year from this April) into a private pension each year. By responding in either of these two ways individuals would receive the same amount of tax relief as they enjoy at the moment – and therefore there would be no Exchequer gain from the measure.

Some might find it difficult to do this because, for example, the rules of their final salary pension scheme offer little scope to change the form or timing of pension contributions in order to minimise a tax bill. High flying senior civil servants, doctors and surgeons might be in this position. However, Treasury figures suggest that nearly two-thirds (63%) of the 300,000 individuals potentially affected by this reform are members of defined contribution schemes, which are inherently more flexible. The scope for some individuals to respond to this reform in a way that minimises its impact on their lifetime tax bill must mean that estimates of the Exchequer gain from the reform are subject to a large degree of uncertainty.

Previously when reforming pensions the Government has sensibly chosen not to implement this change and, also sensibly, pointed to the importance of a stable pension environment. For example, it did not make this reform in its 1998 Green Paper that stated "This is our New Insurance Contract for pensions. This Contract will deliver the security we all want, now and for the future"; nor four years later in its 2002 Green Paper that stated "Pensions policy has to be for the long term. If we want people to plan for the future, stability in the framework of pensions policy is a key component"; nor four years later in its 2006 White Paper that stated "These reforms set the direction for the long-term future of pensions and retirement savings. They will create a system that is coherent, comprehensive and which will stand the test of time" and had followed the lengthy enquiry by the Pensions Commission.⁴ Four years later, in 2010, this reform still does not seem sensible. Maybe the lack of stability suggests that in four years time it will be undone? This prospect provides another reason why high flyers might want to delay their pension contributions for a while.

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Notes to Editors:

1. For details of the Treasury consultation see http://www.hm-treasury.gov.uk/consult_pensionsrelief.htm and, in particular, the presentation at http://www.hm-treasury.gov.uk/d/pensionstaxrelief_dbworkshop.ppt
2. See, for example, <http://www.guardian.co.uk/politics/2009/apr/21/high-earners-pensions-protests>
3. More details on this can be found in <http://www.ifs.org.uk/publications/1784>
4. These four documents can be found at <http://www.tsoshop.co.uk/parliament/bookstore.asp?Action=Book&ProductId=9780101417921> , <http://www.dwp.gov.uk/docs/gp.pdf> , <http://www.dwp.gov.uk/policy/pensions-reform/security-in-retirement/white-paper/> and <http://www.webarchive.org.uk/wayback/archive/20070801230000/http://www.pensionscommission.org.uk/index.html>