The Taxing Wealth Report 2024

Every politician's guide to "How to pay for it"[1]

Income tax reform:

Restricting pension tax relief to the basic rate of income tax

Brief summary

This note suggests that:

1. The higher rates of tax relief on pension contributions made by those who are 40 per cent and 45 per cent taxpayers in the UK are inappropriate. Everyone should get tax relief on their pension contributions at the same rate of 20% that is now made available to basic rate taxpayers.
2. All such higher rate tax reliefs be abolished with some restriction on associated national insurance reliefs also being made.
3. As a result, £12.5 billion of tax reliefs might be withdrawn each year, plus maybe £2 billion of national insurance reliefs. As a result that much additional tax will be paid.
4. If this recommendation is adopted the cost of tax reliefs on pension contributions made by higher rate taxpayers in UK might still amount to approximately £24 billion a year, or £5,450 a year each, compared to approximately £8,750 a year each at present. The average basic rate taxpayer receives a subsidy of approximately £1,050 a year on their pension contributions at present.
5. Changing these reliefs will not seriously change the savings habits of the people impacted as pensions will remain by far the most attractive tax incentivised

[1] This note forms a part of 'The Taxing Wealth Report 2024' published by Finance for the Future LLP, which is UK LLP number OC329502, registered at 33 Kingsley Walk, Ely, Cambridgeshire, CB6 3BZ. See https://www.financeforthefuture.com/taxing-wealth/. This note was written by Richard Murphy FAcSS FCA FAIA (Hon), Professor of Accounting Practice, Sheffield University Management School, who is a director of Finance for the Future LLP.

savings arrangement available to them and more than eighty per cent of UK financial assets are held in tax incentivised savings arrangements.

The proposal	To restrict the rate of tax relief available on pension contributions to the basic rate of income tax, meaning that those on higher income will not enjoy additional tax relief as a result of the pension contributions that they make above the rate available to those paying tax at basic rate on similar sums. An additional suggestion is made to restrict national insurance tax relief on pension contributions for those earning in excess of £100,000 a year.
Reason for the proposal	1. To improve the horizontal equity[2] of taxation, which is currently undermined by the higher rate of tax relief enjoyed by those paying higher rates of income tax on the pension contributions that they make. 2. To increase the prospect of vertical equity[3] of taxation in the UK which is heavily undermined by the provision of higher rates of tax relief on pension contributions made by those liable to higher rates of income tax, which relief reduces their effective rate of tax paid by these people, impacting as a result on the progressive nature of the income tax system. 3. To reduce the tax spillover[4] effect that current rates of tax relief on pension contributions create within income tax rules. 4. To reduce the rate of tax avoidance[5] in the UK.

[2] Horizontal tax equity requires that all incomes of similar amount be taxed the same sum irrespective of where that income comes from.
[3] Vertical tax equity requires that as a person's income increases, the amount of tax paid on it will always increase irrespective of its source, with a progressive tax system resulting as a consequence.
[4] Tax spillovers are the consequences of the interactions between different tax systems or different parts of the same tax system that can often (sometimes unintentionally) reduce tax revenues and the size of a tax base.
[5] Tax avoidance is the term given to the practice of seeking to minimise a tax bill without deliberate deception (which would be tax evasion or fraud). The practice may be summarised as 'seeking to get around the law'.

	5. To consequently improve the rate of tax compliance[6] in the UK. 6. To raise additional tax revenues.
Estimated tax that might be raised as a result of the recommendation made	The behavioural response to this recommendation cannot be known, although it is likely to be small as pension arrangements will remain the most favourable tax incentivised savings arrangement in the UK even if these proposals were enacted. Assuming this to be the case then a sum of £12.5 billion of tax might be saved as a consequence of the proposal to restrict pension contribution tax relief to the basic rate whilst a further £2 billion or more of national insurance might be saved as a result of additional reforms.
Ease of implementation	Relatively straightforward. Tax relief at basic rate is already provided at source on many pension contributions. The changes to payroll and tax return systems that would be required would be quite straightforward. Changes to tax relief on national insurance contributions might be a little more complicated but the rules used for these contributions when made by company directors could easily be adapted for this purpose.
Likely difficulties that might result from implementation	Relatively few, although they will be politically unpopular.
Likely time required to implement the change	Months in the year preceding the year of actual change.
Consultation period required.	Relatively short. It is likely that the changes might be made within twelve months of any proposal being made.

Background

[6] Tax compliance is seeking to pay the right amount of tax (but no more) in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes.

The UK does, like many other countries, provide tax relief on the contributions that a person makes to a pension fund during their working life to provide them with an income in retirement.

The logic for providing this relief is fairly straightforward. In the first instance, a government wishes to encourage those within its population who are able to do so to make provision for the own cost of living in retirement, which, as a consequence, reduces the obligation on the state to do so. There is, as a consequence, a return to a government from providing this relief.

Secondly, there is a supposed economic logic to this relief. This logic is that if a person defers their consumption at the time that they make a contribution to a pension fund, which contribution will then provide a return to them in the form of an income in retirement, then they have, in effect, deferred recognition of their income for taxation purposes from the present until such time as they receive that payment during their retirement. However, this logic does presume that the pension paid in retirement will be taxed in broadly similar fashion and at broadly similar rates to those that the income that would have been subject to in the period when pension saving takes place and this is not guaranteed to be the case with regard to rax reliefs currently available in the UK.

Third, many governments still wish to promote economic growth. As such they also seek to promote investment and the creation of capital markets based upon savings and wealth, which market, they presume, will provide the source of funding for that investment activity. Governments then hope that this investment activity will generate returns that might provide the funds to make payment of the hoped for pension that will reduce their obligation to support ageing populations. In addition , they hope that the same capital markets will create capital assets that might deliver intergenerational transfers of wealth in due course that might in turn support the payment of basic state payments pensions on a universal basis out of the income generated.

As data on the distribution of UK wealth shows[7], most of those taking advantage of the tax reliefs available upon contributions to pension funds are those with high income or wealth, or both. The following table breaks down pension wealth by decile in the UK in March 2020 (the most recent data available) and also provides average data from 2006 to 2020:

[7] https://www.ons.gov.uk/releases/totalwealthingreatbritainapril2018tomarch2020

Aggregate private pension wealth in the UK 2006 - 2020

Great Britain, July 2006 to March 2020		£ million			
		April 2018 to March 2020	**Average 2006 - 2020**	**Per cent 2020**	**Per cent average 2006 - 2020**
Aggregate private pension wealth (£ millions)	Total Wealth Decile 1 (lowest)	3,982	2,689	0.06%	0.06%
	Total Wealth Decile 2	18,660	11,249	0.29%	0.24%
	Total Wealth Decile 3	64,609	45,672	1.00%	0.98%
	Total Wealth Decile 4	133,185	95,034	2.07%	2.03%
	Total Wealth Decile 5	199,385	143,937	3.09%	3.08%
	Total Wealth Decile 6	308,049	221,718	4.78%	4.75%
	Total Wealth Decile 7	514,231	358,572	7.98%	7.68%
	Total Wealth Decile 8	778,434	561,389	12.08%	12.02%
	Total Wealth Decile 9	1,346,107	975,122	20.89%	20.88%
	Total Wealth Decile 10 (highest)	3,078,409	2,255,487	47.76%	48.29%
	Total	6,445,051	4,670,868	100.00%	100.00%

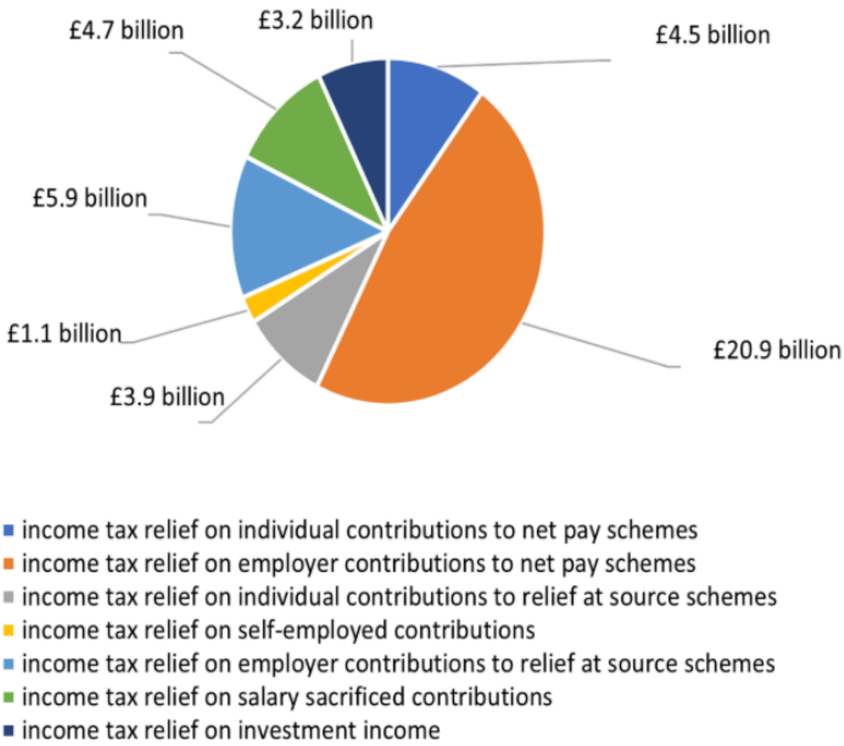
Source: Office for National Statistics and author calculations.

Those in the top decile of UK wealth owners in the UK own, on average, more than 48 per cent of the UK's pension wealth. It might, as a consequence, be presumed that those in this same decile enjoy 48 percent of total overall pension tax reliefs. That, however, is not the case as the reliefs that they enjoy are provided at higher tax rates than those made available to those who are subject to basic rate tax charges on their earnings.

HM Revenue & Customs now suggests[8] that the cost of pension tax relief per annum was £67.3 billion in the tax year 2020/21, which is the most recent year for which data is available.

They suggest that the income tax element of this cost can be broken down as follows:

[8] https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary-september-2022, section five

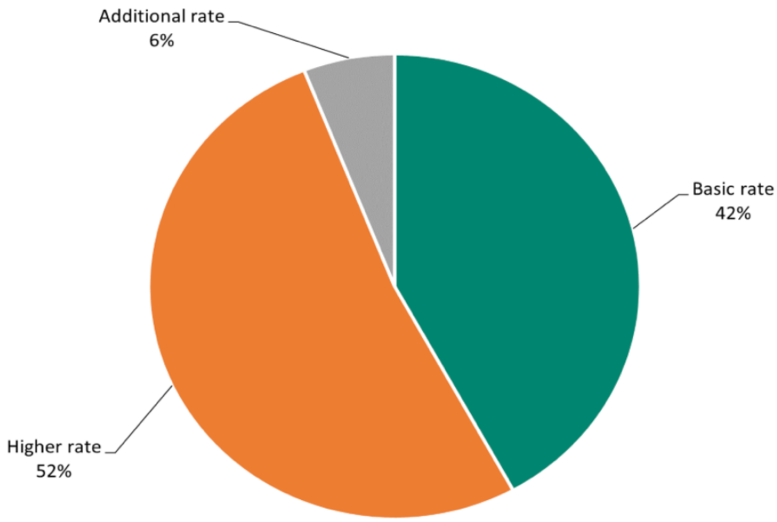


These totals come to £44.2 billion, implying that national insurance reliefs arising as a consequence of pension contributions made cost £23.1 billion a year.

This data cannot simply be apportioned by decile on the basis of the wealth statistics. There is superficial appeal to doing so but this might not take into sufficient account the fact that the tax relief provided to those in the highest decile of income earners might be provided to them at their highest marginal income tax rate, which is likely to be at least 40 per cent (and maybe 45 per cent) in the year in question given the profile of UK earnings. This contrasts with the tax relief provided to all other contributors to such pension arrangements, who will also be provided with tax relief at their highest marginal tax rate, which rate is however likely in those cases to be at no more than 20%, again given the normal profile of income for taxation purposes within the UK.

HMRC have reviewed this issue and have suggested[9] that in the tax year 2020/21 the marginal rates of tax at which tax relief for pension contributions was claimed were as follows:

[9] https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary-september-2022 , section 6



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In other words, whilst those with the highest levels of income in the UK are likely to own about 48 per cent of pension wealth, they claim 58 per cent of pension tax reliefs.

Taking these facts together, the likely cost of pension tax reliefs for those in the highest decile of income earners in the UK are likely to amount to at last £25.6 billion. Of this sum almost exactly £23 billion relates to higher rate (40 per cent) taxpayers, meaning that if their relief was restricted to 20% the saving would most likely be £11.5 billion per annum.

Because of the interaction of tax rates, a precise estimate of the saving as a result of restricting relief to the basic rate of income tax for those paying tax at 45% is harder to estimate but is likely to be not much less than £1.5 billion per annum, giving rise to a total saving of at least £12.5 billion.

It is also appropriate to question whether national insurance relief should be given on pension contributions for those on higher pay. It might also be appropriate to restrict that relief. Precise estimates of the sums saved cannot be made but given the remarkable proportion of income relief attributable to those with taxable earnings of more than £150,000 per annum it is likely that constraining national insurance relief on pension contributions for those earning over £100,000 per annum might result in savings of maybe £2 to £3 billion per annum.

When these savings in national insurance relief are combined with the saving in the tax cost of providing pension tax relief at rates above 20% for those with the highest earnings in the

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UK, total savings arising as a result of restricting pension tax reliefs for the highest earners in the UK might be not less than £14.5 billion per annum, and may be higher.

Discussion

In total tax and national insurance contribution relief on pension contributions by the highest earners in the UK are likely to amount to £38.6 billion per annum (£13 billion of national insurance and £25.6 billion of tax per annum). The remainder of the population enjoy a subsidy of £28.7 million between them. In other words, the wealthiest enjoy a subsidy of more than £8,750 per annum on average towards their pension savings each year and the rest of the population enjoy a subsidy of almost exactly £1,050 per annum each based on the number of taxpayers[11] in 2020/21.

To put these figures in context, the basic universal credit allowance a year is £4,416 per annum[12] in 2023/24 for a person over the age of 25 and the basic old age pension in that year is[13] £10,600 per annum, or not much more than the subsidy given each year to increase the value of the pension of the top ncome earners in the country, on average.

Recommendation

It is suggested that those paying the higher 40 per cent and 45 per cent income tax rates in the UK should not enjoy higher rate tax relief on the pension contributions that they make[14].

Instead, it is suggested that the rate of tax relief on all pension contributions made by a person to a UK pension fund should be at the basic rate of income tax applicable at the time that the contribution is made. This would mean that higher rate income taxpayers would still get tax relief, but only at the basic rate of tax, like everyone else.

There are a number of compelling reasons for making this suggestion. Firstly, horizontal tax equity requires this. As far as possible, any tax relief must be available to all within the income tax system on an equal basis.

This is most, especially true when the vast majority of the pension income that will be taxed

[11] https://www.gov.uk/government/statistics/number-of-individual-income-taxpayers-by-marginal-rate-gender-and-age
[12] https://www.gov.uk/universal-credit/what-youll-get
[13] https://www.gov.uk/new-state-pension/what-youll-get
[14] It should be noted that some restrictions on relief for those with the very highest level of earnings in the country do already apply and that there is some logic to these restrictions given that the provision of tax subsidies to those already wealthy makes little economic sense.

as compensation for this relief being made available at the time that the contribution was made will be taxed at the basic rate of income tax. That is because most people have lower income during the course of their retirement when compared to the income that they enjoyed during their working lives. It is in that case, wholly appropriate for the creation of horizontal tax equity that the relief given should match the most likely rate of tax payable on a pension in due course.

This proposal is also necessary for the purposes of creating vertical tax equity. Existing reliefs reduce the progressive nature of the UK's income tax and that is inappropriate.

There is also sound economic logic for restricting the amount of tax relief provided, most, especially when there is little economic evidence available to suggest that UK capital markets do in practice provide much of the necessary funding for investment in the UK economy. Almost all of that funding is now provided is by way of bank and other loan arrangements, few of which involve pension funds. It is, therefore, appropriate to restrict the scale of relief for this purpose. That is because most of the funds contributed to pension arrangements on which tax relief is claimed are in fact used for the purposes of financial speculation and not investment in real economic activity. There is no gain to society from that speculation, and as such the scale of tax relief provided should be restricted.

Finally, this change is suggested within the context of other proposals made as part of the series of proposed tax reforms of which this note forms a part. Another of those suggestions proposes that pension contribution tax relief should only be available in future if part of the sum contributed is used to directly generate new activity directly related to the development of a sustainable economy, preferably within the UK. Since that proposal is made for the benefit of all people within the UK economy, it is appropriate that the tax relief to be made available for that purpose is applied consistently to anyone making contribution, and that requires that tax relief on pension contributions only be made available at the basic rate of income tax.

The tax revenue benefits that might arise as a consequence of this proposal have already been noted.

Although there may be some behavioural response to this restriction in relief, they might also be small. Since over 80% of all financial assets within the UK economy are saved in tax incentivised arrangements of some sort[15], and presuming that recommendation made elsewhere in this series of potential tax reforms to restrict the level of ISA contributions on

15 https://eprints.whiterose.ac.uk/153627/10/modern_monetary_theory_and_the_changing_role_of_tax_in_society.pdf

which tax relief might be available are accepted, then it is likely that pension savings will remain the favoured tax incentivised savings mechanism for those looking to make long-term arrangements to secure an income in retirement, meaning that the overall behavioural reaction to this restriction in the relief might be small.

Taking all the above factors into consideration it is likely that £12.5 billion of income tax relief will be saved as a consequence of making this change to pension tax relief whilst a further approximate £2 billion or more of national insurance might be saved.