The Taxing Wealth Report 2024

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

Reforming income tax

Changing the conditions attached to pension tax relief

Brief Summary

This note proposes that in exchange for the tax relief given on qualifying pension contributions made to a UK pension fund that one quarter of the contributions made should be invested in investments that would fund:

- The required climate transition if net-zero goals are to be achieved.
- New social housing.
- Other new social infrastructure.
- Related training, education and support services.

A further object of this exercise is to provide the opportunity for UK pension funds, which now have a marked preference for bond investment, to do so in a way that permits active choice by the funds and their members in the activities in which they would wish such savings to be used when at present very few bond saving opportunities make any link between funds saved and activity in the real economy.

[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. © Finance for the Future LLP 2023

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Finance for the Future and

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Given that more than 77 per cent of the UK's financial wealth is saved in pension funds and at least 85 per cent is saved in tax-incentivised assets it is thought unlikely that there will be any significant adverse behavioural response to this proposal.

The proposal does not apply to any past sums invested.

It is thought that this proposal would release at least £35 billion per annum for investment in the activities noted, saving the government from having to do so as a result and providing it with a positive return on its own contribution to pension savings as a consequence. Without any other measure of the impact of this proposal being available, this sum is used for that purpose since it releases an equivalent amount for spending on alternative UK government budgets as a result.

The proposal	To require that in exchange for the tax relief given on qualifying pension contributions made to a UK pension fund that one quarter of the contributions made should be invested in investments that would fund: • The required climate transition if net-zero goals are to be achieved. • New social housing. • Other new social infrastructure. • Related training, education and support services.
Reason for the proposal	1. To make better use of the £65 billion of tax subsidies being given to pension savers each year in the UK at present when the return to society from the provision of this subsidy is, at present, very hard to establish. 2. To provide a source of capital for new infrastructure investment in the UK that will meet climate and social need. 3. To free up government budgets for expenditure on other social priorities as a consequence of investment spending on these issues being met from pension fund savings.

Estimated tax that might be raised as a result of the recommendation made	The tax that would be raised as a result of this change would result from the increase in investment activity that it would give rise to in the UK economy, the economic multiplier effects[2] of which would be large, meaning that the tax raised as a result of new investment might be significant. This is a complete reversal of the current situation where it is hard to estimate that any significant return to the UK economy arises as a result of a great deal of pension saving. Up to £35 billion per annum might be released for active investment in the UK economy each year as a result of this proposal. This is the suggested value of this proposal as it would directly relieve demand for expenditure on these issues by the government, freeing funds for other uses.
Ease of implementation	The changes proposed will take time to implement as they have a significant impact on the profile of pension saving in the UK. There will also be technical issues involved in defining the taxonomy of acceptable uses of investment funds that will take time to resolve. However, none of these issues represent significant technical problems to implementation.
Likely difficulties that might result from implementation	There will be resistance from the financial services industry to this change, but if they are given the opportunity to engage with and also market the resulting savings products, even if they are invested in government backed accounts, these problems should be overcome. Once introduced few difficulties should arise from implementation.

[2] A multiplier effect is a measure of the amount by which income is increased or decreased as a result of additional spending within an economy. If a multiplier effect is greater than 1 then the additional spending produced an increase in income of greater than its own amount, and vice versa. The largest multiplier effects are usually associated with healthcare spending and capital investment, where returns that are several times the size of the sum initially expended can result. In contrast, defence spending has very low multiplier effects. Some multiplier effects e.g. those resulting from spending on education are hard to measure because of the extended time periods involved.

Likely time required to implement the change	A reasonable time period for this change will be required. It could not take less than two years and three may be required.
Consultation period required.	As noted, generous consultation periods will be required to get all aspects of this change right.

Background

In a previous note in this series[3], it was suggested that the cost of pension tax relief to the UK Exchequer is about £65 billion per annum. Suggestions were made as result to restrict that relief in the case of higher rate taxpayers and to save more than £14 billion of that cost a year as a consequence.

In another note in the series[4], it was noted that the cost of tax relief given to those who save in ISA accounts did not give rise to a commensurate economic benefit to the government in exchange for the tax relief given. As a consequence, it was suggested that the tax relief given on ISA accounts should be made conditional upon the funds saved in such accounts being used for appropriate social purposes.

In this note, those two observations are combined to make suggestion that in addition to pension tax relief being restricted to the basic rate of tax, irrespective of the income tax rate paid by the person making the contribution, the receipt of pension tax relief on contributions made by a person to a pension fund should be conditional upon at least part of the contribution that they make being made available to fund investment for social and economic programmes consistent with the objectives of the government granting such relief. In this way, the exceptional cost of pension tax relief (which is at present almost exactly equivalent to the current spending on schools in England[5]) could, at least give rise to a commensurate return for the sum expended.

There is another reason for suggesting this reform. It is already Labour and Conservative Party policy to encourage greater direct investment by UK pension funds in the UK economy, both having noted how little direct engagement between pension funds and the underlying economy that there is. This is not least because of the marked preference of most pension funds for bond-based investment, little of which can be directly related to investment activity in the real economy, which is an issue that needs to be addressed.

[3] https://www.taxresearch.org.uk/Blog/wp-content/uploads/2023/09/Restricting-pension-tax-relief-published-1.pdf
[4] https://www.taxresearch.org.uk/Blog/wp-content/uploads/2023/11/The-use-of-ISAs-published.pdf
[5] Based on data here: https://www.gov.uk/government/publications/autumn-statement-2023/autumn-statement-2023-html

Proposal

It is suggested that in exchange for pension tax relief being provided on sums saved in tax incentivise pension accounts that at least twenty five per cent of all new pension contributions should be invested in the types of project described in the note on reform ISA saving. This would mean that investments in the following would be considered acceptable:

- The required climate transition if net-zero goals are to be achieved.
- New social housing.
- Other new social infrastructure.
- Related training, education and support services.

As suggested in that note on ISA savings this could be achieved by investing in:

- UK government green saving bonds of the type now issued through NS&I, which is the government's own savings bank. The use of these funds is noted by the government in occasional reports[6].

- Green gilts issued by the UK government, which are now becoming more common place.

- Bonds issued by a UK government owned national investment bank that had as its purpose investment in the above noted categories of assets, on which returns could be paid by their users.

- Private sector funds meeting the above noted required specification for investment could be used for this purpose. A very clear taxonomy requiring strong evidence of the actual investment of funds raised for green purposes would be required for any company to qualify to raise funds in this way.

It is stressed that no suggestion is made that past contributions must be redirected in this way.

It is also the case that no conditions would be attached to the use of the remaining seventy-five per cent of contributions made by taxpayer to their pension fund during a period. They would have complete freedom to suggest the way in which these funds might be invested so long as their choice was compliant with the rules of their chosen pension fund.

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[6] https://assets.publishing.service.gov.uk/media/651446cdb1bad4000d4fd916/HMT-UK_Green_Financing_Allocation_Impact_Report_2023_Accessible.pdf

Impact

Data published by the pension industry, the Office for National Statistics and dedicated pension publications are universally unclear as to the total of value of pension contributions made in the UK each year. That is because of the wide variety of ways in which such savings can be made by those who are in both employment and self-employment, and the wide variety of funds that are available for people to choose from to save in, whether organised by their employer or of their own choice. However, presuming that the rate of subsidy to pension contributions made each year does not exceed 50% of the sum saved (and this would appear to be a high end estimate) then it is reasonable to assume that not less than £140 billion per annum is saved in tax incentivised pension arrangements each year. In that case this proposal would make available £35 billion per annum for investment in the programmes noted above. As a consequence, the need for the UK government to raise similar sums to invest in those programmes would be removed because they would be funded by pension contributions instead. For that reason, it is suggested that the £35 billion that might be raised in this way can be treated as in indirect contribution to the UK Exchequer.

It is stressed that the majority of UK financial savings are held in pension arrangements. It is likely that in 2020, when the most recent data with regard to this issue was published[7], that seventy-seven per cent of all UK financial assets were represented by pension savings. If ISAs are taken into account, it is likely that at the same date approximately eighty-five per cent of all financial assets were held in some form of tax incentivised savings arrangement[8]. It is therefore very unlikely that there would be a significant behavioural reaction to this proposal with people withdrawing their savings from pension arrangements as a result of it.

That said, there is no obligation on a person to save for their retirement in the tax incentivised accounts, and if they did not wish to do so as a consequence of this proposal there would be no reason why they should not save in another way if that was their preferred choice of action. They would simply lose tax relief as a result.

[7] https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/datasets/totalwealthwealthingreatbritain

[8] ibid