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**Research Report**

## A blueprint for a better tax treatment of pensions

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Institute for Fiscal Studies

**IFS Report R240**

Stuart Adam  
Isaac Delestre  
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# Preface

The abrdn Financial Fairness Trust has supported this project (grant reference 202107-GR000046) as part of its mission to contribute towards strategic change which improves financial well-being in the UK. Its focus is on tackling financial problems and improving living standards for people on low-to-middle incomes. It is an independent charitable foundation registered in Scotland. Co-funding from the ESRC-funded Institute for the Microeconomic Analysis of Public Policy at IFS (grant number ES/T014334/1) is also gratefully acknowledged. The authors would like to thank Mubin Haq, Paul Johnson and Helen Miller for comments on this report, and members of the project advisory group – and the many others that we consulted for this report – for their advice and support. None of these individuals or organisations bears any responsibility for the views expressed in this report, which – along with any errors and omissions – are those of the authors alone.

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# Executive summary

Pensions are the biggest component of household wealth and are treated favourably by the tax system. That means getting pensions tax design right matters. It matters for people's well-being in retirement, especially if it can support the pension saving of those at risk of undersaving for their retirement. It also matters for taxpayers. Overly generous tax subsidies will be expensive, while insufficient generosity could lead to undersaving placing upwards pressure on state support for pensioners in the future.

## The context

The UK pension system provides individuals with significant flexibility over how much, and in what form, to save for retirement. This has many advantages. But there are concerns about the adequacy of retirement incomes among private sector workers. Automatic enrolment has been successful in bringing large numbers of employees into pensions: prior to its introduction, fewer than half of employees were members of a workplace pension, with the proportion falling over time. Around eight-in-ten employees are now members of such schemes, and closer to nine-in-ten among those in the automatic enrolment target group. But many are contributing relatively small amounts.

Levels of saving vary substantially across groups:

- Of the 28% of employees who are members of a defined benefit pension (mostly in the public sector), 87% receive an employer contribution worth 12% of salary or more.
- Of the 51% of employees who are members of a defined contribution pension (mostly in the private sector), however, just 9% receive an employer contribution worth 12% of salary or more.
- Nor is it just private sector employees who risk undersaving for retirement. Of the 5 million self-employed in 2018 just 16% were contributing to a pension – a remarkable fall from the 48% twenty years earlier, with no evidence that the self-employed have become more likely to save in other forms.

Related to the well-publicised shift in the private sector away from defined benefit pensions to less-generous defined contribution pensions, the rates of return to a range of different assets have declined over time. This means that wealth accumulation has been, and could continue to be, more challenging for younger generations than it was for their predecessors. Those born in the 1960s or later are no longer experiencing substantial generation-on-generation wealth increases.

Older generations have benefited from capital gains on housing and from generous defined benefit pension arrangements in a way that younger generations are much less likely to. In turn, this raises the question of whether the tax system treats different generations fairly, and whether a better way of taxing pensions is needed. In short: it is.

### Principles

Any savings vehicle involves three main flows of funds that can potentially be subject to tax: contributions made, returns that accrue, and withdrawals. It is the combination of all three – the treatment of contributions, returns and withdrawals – that will determine how much support is being provided and to whom. In general, the tax system should be neutral – that is, it should treat similar things in similar ways. That is not to say there is not a role for the tax system to incentivise pension saving. But these incentives should be well targeted towards meeting clear objectives, such as supporting the saving of those who would otherwise be most at risk of undersaving for retirement, and minimise other distortions to behaviour and inequities.

Where individuals save in a deposit account, contributions are made out of after-tax income, returns are subject to income tax (above a substantial allowance) and withdrawals are untaxed. This is known as a taxed-taxed-exempt (TTE) regime. In general, this is not a good way to tax saving: for example, it means that even returns that are only compensating for inflation can be subject to tax and encourages spending now rather than saving for spending later. But most saving in the UK outside pensions is done in the form of ISAs and owner-occupied housing, both of which are (broadly) subject to a taxed-exempt-exempt (TEE) regime. And the income tax treatment of pensions is actually closest to an exempt-exempt-taxed (EET) regime – that is, one where contributions are made free of tax but withdrawals are taxed.

Where an individual's tax rate does not vary over time, and where everyone gets the same ('normal') rate of return on their investments, there is no difference between the overall generosity of a TEE system and that of an EET system. The only difference is in the timing of when the tax is paid. Those whose income tax rate is lower in retirement than when saving will, all else equal, do better under an EET regime. It allows such individuals to benefit from shifting their taxable income to later periods of life, which might be seen as fair and desirable, though the point is certainly debated. An advantage of an EET system is that where bigger investment returns are enjoyed, the spoils are shared between the individual and the Treasury; in contrast, under a TEE system, individuals who get bigger returns keep all of the benefit from them.

Any reform to pensions tax should be seen in the wider context of the UK tax system. Some of the most important features of the current system rely on discounts or exemptions from income tax or National Insurance contributions (NICs). The result is that when changes are made to these taxes, the generosity of the tax treatment of pensions changes too, even if this was not

intended by policymakers. Equally, where pensions tax reforms are proposed in order to help meet a specific distributional objective – for example, a desire to redistribute away from those on higher incomes – it could be that other changes, such as reducing the higher-rate threshold in income tax, would be more straightforward.

Other desirable features of a pensions tax system include simplicity and stability over time, as both should help enable individuals to respond to the incentives provided and to plan appropriately for the long term.

When implementing reforms, careful consideration needs to be given to how they should be phased in so that they do not distort behaviour inappropriately. And while reforms that change the tax that people might reasonably have expected to pay are never ideal, it should be remembered that some retrospection will often be impossible to avoid without extremely long transitions, and that this applies across all sorts of tax changes, not just taxes directly levied on savings and wealth. Retrospection is not binary; it comes in different types and degrees, and there are choices to be made as to what is acceptable in different circumstances. Where a reform is removing an overly generous tax relief, there will be a trade-off between a retrospective change and allowing the overly generous element to remain in place for longer, typically to the benefit of older generations at the expense of subsequent generations.

In determining the extent to which retrospective tax rises are appropriate, it should be remembered that some have enjoyed windfall gains from policy changes: for example, a 30-year-old who saved in a pension in the early 1990s might have done so in the expectation of paying income tax in retirement at 25%, as this was the basic rate in place at the time. Now aged around 60, they could be paying basic-rate income tax at the now lower rate of 20% on their pension income. Given this, and a context where, remarkably, pensioner incomes are now, on average, in line with those of the working-age population, there is surely a case for any reductions in generosity to apply, at least partially, to all generations.

## Support under the current system

The current income tax treatment of pensions is most similar to an EET system. But in terms of how the whole tax system works, the taxation of pensions differs from a pure EET regime in a number of respects including:

- Up to one-quarter of an accumulated pension can be withdrawn free of income tax and therefore does not attract income tax either on contributions or on withdrawals.
- Individuals' pension contributions are made out of income that has been subject to NICs, but no NICs are charged on pension income (a TEE regime).



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- Employer pension contributions, however, do not incur employer or employee NICs at any point and are therefore especially tax-advantaged (effectively EEE as far as NICs are concerned).
- Pension pots that remain at death are not counted as part of the estate for inheritance tax purposes, and for those who die before age 75 these funds escape income tax entirely.
- There are lifetime and annual limits on the amount that can be saved free of income tax in a pension.

We attempt to quantify the difference in the lifetime tax burden on contributions made in a single year under the current system compared with a TEE system and with an EET system, both of which could be considered reasonable benchmarks. Relative to the former, the current system is, according to our model, more generous to the tune of around £46 billion a year in today's terms (adjusting for risk in future revenue). This is largely due to the fact that far more people face a higher income tax rate in working life, compared with the average rate they pay on their pension income in retirement, than vice versa. This means that levying income tax on pensions in retirement will, all else equal, mean a lower lifetime tax burden than taxing them in working life. In terms of the distribution of this support, we estimate that, on average, relative to TEE, the current system benefits all earnings groups, with the gains increasing (as a percentage of earnings) as one moves up the earnings distribution.

In contrast, we estimate that, relative to an EET benchmark, the current system is more generous to the tune of £4.4 billion a year (risk-adjusted). The gains under the current system come in large part from the fact that 25% of pension withdrawals can be made free of income tax and that employers' contributions to pensions escape NICs entirely. Conversely, lower and middle earners making individual pension contributions receive harsher NICs treatment than they would under the EET benchmark as the latter would give them up-front NICs relief on their contributions and they would pay little or no NICs if they were applied to pension withdrawals. Overall, we estimate that the gains from the current system relative to an EET benchmark are focused towards the top of the earnings distribution with those in the middle of the earnings distribution actually being slightly worse off under the current system relative to EET.

It should be noted, however, that this modelling excludes the generous tax treatment of pensions at death and also the limits on how much can be contributed to, or accumulated in, a tax-favoured pension.

## Reasons to retain up-front income tax relief

It is often proposed that up-front income tax relief should be reformed: for example, by restricting it to the basic rate of income tax, or by having a flat rate of up-front relief – perhaps of 30% – available to all. Often such proposals are made on the basis that up-front income tax

relief disproportionately goes to those on higher incomes. HMRC statistics show that in 2020–21 52% of up-front income tax relief was given at the higher rate and 6% at the additional rate, whereas only 13% of income tax payers were higher-rate taxpayers and just 1.4% were additional-rate taxpayers. These figures do not include the fact that up-front employee NICs relief is of relatively less value to higher earners, and that higher earners will typically pay more income tax on their pension income. Nevertheless, relative to a system with no tax relief, higher earners do gain much more from the current system than lower earners.

That said, if one is going to have any system of tax relief for savings then it is always going to be the case that higher earners will gain the most. After all, they pay far more tax: 73% of income tax is paid by higher- and additional-rate payers, much more than the proportion of pensions tax relief that they benefit from.

One might not want to limit up-front relief in any case. To do so would mean that those with high incomes in working life and low incomes when retired would pay more tax than individuals with the same income over their life but more evenly spread out. Up-front relief allows people to smooth their taxable income across years, which avoids this inequity. The attractiveness of facilitating tax-base smoothing is not entirely clear-cut because some are not able to take advantage of it. Given this, both the current system and one that limited the rate of up-front relief would exhibit some inequities and there is room for reasonable disagreement on the best way forward. But note that the (far larger) group who receive basic-rate income tax relief on contributions and pay no income tax on their pension income are also benefiting from tax-base smoothing. If it is considered ‘unfair’ to get higher-rate relief and then pay only basic-rate tax in retirement, it would seem equally ‘unfair’ to get basic-rate relief and then pay no tax in retirement – yet would-be reformers seem unconcerned by the latter. The logical conclusion if one wishes to prevent tax-base smoothing would be to have flat-rate relief on contributions *and* flat-rate tax on withdrawals. If the goal is not that, but simply to raise taxes from individuals with high incomes, increasing rates and reducing thresholds of income tax would achieve this aim without reducing people’s ability to smooth their taxable income.

For those who believe that limiting up-front relief would be an improvement on the current system, there is a crucial practical issue of how employer contributions to defined benefit arrangements could be accurately attributed to specific individuals in order to be taxed. This is genuinely hard. Contributions could be made by an employer to fill a pension deficit created by retired members living longer than expected. One would not want to tax current members for that. On the other hand, not taxing this contribution would create a bizarre incentive to try to underfund pensions. In addition, the pension contribution made in respect of new accrual among active members might be more valuable to some than others – for example, because they are closer to drawing their pension, or because they expect to live for longer or, in a final salary arrangement, because they expect a big future promotion. With half of up-front income tax relief

going to those in defined benefit arrangements, getting this attribution right would be extremely important, and far from easy, to do well.

While we do not recommend reforms to up-front income tax relief, we show that restricting relief to the basic rate of income tax would in the long run represent a £15 billion a year increase in taxation, with almost all of this increase coming from the top 20% of earners. We also show that imposing a 30% flat rate of up-front income tax relief – a £3 billion long-run tax rise – would redistribute the burden of taxation from the bottom 80% to the top 20% of earners.

## Reform package proposed

We propose a package of specific measures that would, at least, reduce the problems we have identified with the current system.

- 1 The 25% tax-free component needs reform.** It currently provides an additional tax subsidy to those who have already accumulated big pensions, provides a more generous rate of subsidy to those who are higher-rate taxpayers in retirement than to those who are basic-rate taxpayers and is of no value at all to those who have the lowest incomes in retirement: non-taxpayers. This is hard to justify. At the very least it should be capped so that it only applies to 25% of, say, the first £400,000 of accumulated pension wealth. Going further, **we propose providing the equivalent of a capped 25% tax-free component for basic-rate taxpayers, but designed in a way that increases the after-tax value of everyone's pension (up to the cap) by the same proportion – basic-rate, higher-rate and non-taxpayers alike.** A 6¼% taxable top-up on all pension withdrawals would achieve this. There would be a case for providing a bigger top-up on withdrawals made via an annuity (which provides a secure retirement income) and a smaller one for other withdrawals.
- 2** The EEE employee NICs treatment of employer pension contributions should be ended. **We propose that all individual pension contributions should receive up-front relief equivalent to the rate of employee NICs and, in return, we should gradually move to a system where pension withdrawals are subject to employee NICs.** This EET approach would align the employee NICs treatment of pension saving with that of income tax. For employer pension contributions it would represent a clear reduction in the generosity of tax treatment, moving from full exemption (EEE) to taxation at withdrawal (EET). For individual pension contributions the change would be one of timing, moving from a TEE to an EET approach. Because the employee NICs rate falls from 12% to 2% at the upper earnings limit, this treatment would benefit low and middle earners who make individual contributions (who would get up-front relief at 12% and would typically have only part of their pension income above the NICs threshold in retirement) relative to higher earners who

make individual contributions (who would get up-front relief at just 2% but would often pay an average rate of NICs far above that in retirement).

- 3** The EEE employer NICs treatment of employer pension contributions should also be ended. **We recommend applying employer NICs to all employer pension contributions alongside introducing a new subsidy on all employer pension contributions.** Employer NICs would be levied on pension contributions on a TEE basis, with the largely flat-rate structure of employer NICs meaning this is practical for defined benefit and defined contribution arrangements alike. This change would end the current state of affairs whereby the effective subsidy on pension contributions is arbitrarily altered whenever the employer NICs rate changes and ensure a uniform incentive for all employers, including those not currently liable for employer NICs (such as small employers) for whom the current NICs exemption is worthless. Policymakers would be forced to determine actively the right rate of subsidy and, once it was in place, would be free to adjust it independently of the NICs rate. Below we model a subsidy set at 13.8% – the current main rate of employers NICs – which would mean no employer would immediately lose out from the reform.

We estimate the revenue effects of these reforms. For policies that apply to future pension income (where it is necessary to make an assumption about the value of risky future pension incomes in today's terms), we estimate the risk-adjusted present value of tax payments. Our modelling suggests that implementing these reforms would be close to revenue-neutral in the long run, although there is a lot of uncertainty around this estimate. If pension returns turn out to be strong (as they have been in the past), more (and possibly substantially more) revenue would be raised from policies that increase taxes on those future returns.

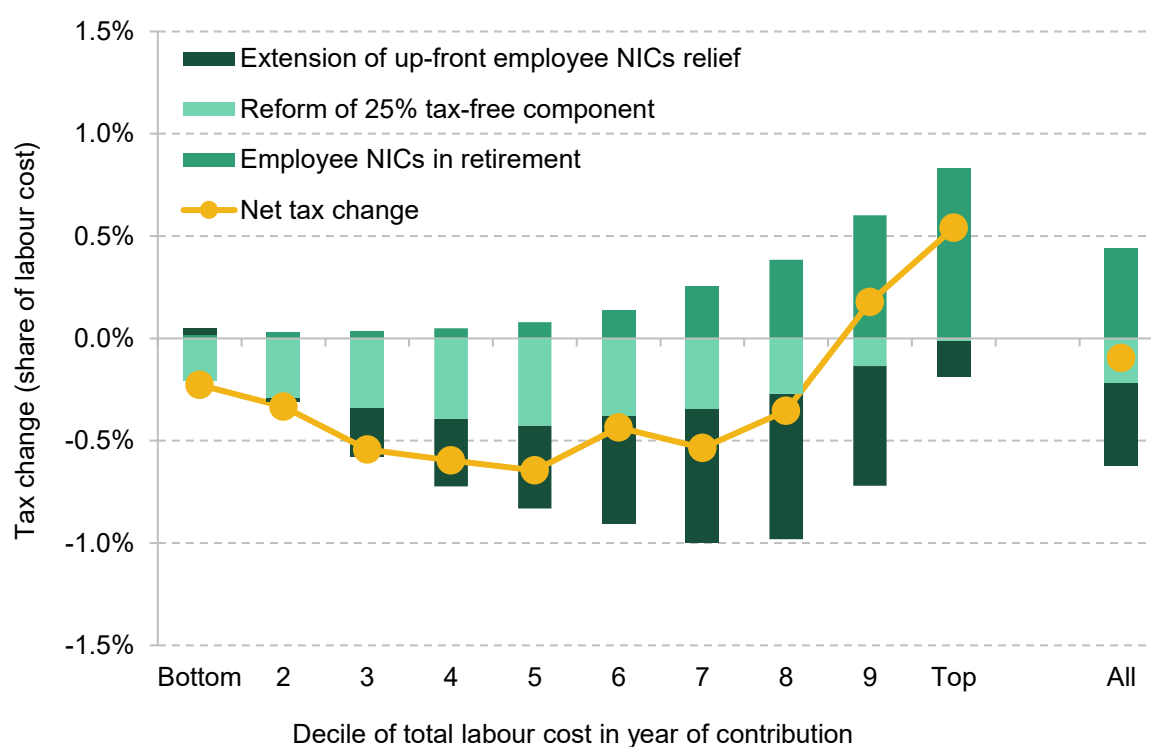
Providing any transitional protection from the application of employee NICs to pension withdrawals would reduce revenue in the near term. The up-front cost of the package would be £3.3 billion, less any revenue raised from imposing NICs on the pension income of those currently drawing pensions (which would raise around £¾ billion for every 1 percentage point of NICs charged).

The government could easily adjust how much revenue was raised overall by adjusting the proposed new subsidy on all employer pension contributions (for example, a rate of 10% rather than the 13.8% we assume in our modelling would save around £3½ billion a year immediately) or the size of (or cap on) the income tax top-up on withdrawals, and there are two other tax measures that we set out below that could raise revenue.

The estimated long-run distributional impact of these three reforms among current workers is shown in Figure ES.1. Overall, the bottom eight deciles of earners would (in the long run) gain from these reforms – and see their incentives to save in a pension strengthened – while the top two deciles would lose and see their incentives weakened. Low and middle earners, who fare

worst under the current system relative to an EET benchmark, would gain because up-front employee NICs relief is worth more to them than the cost of having to pay employee NICs on pension withdrawals (even though employee NICs would apply to pensions generated by employer contributions – which are currently fully exempt – as well as employee contributions) and because our reforms extend the equivalent of basic-rate relief on 25% of pension withdrawals to those who do not pay tax in retirement. The losses among higher earners – who currently fare best relative to an EET benchmark – are driven primarily by the change to employee NICs. Excluded from the modelling is any cap on the replacement of the 25% tax-free element which, as well as reducing the overall cost of the package, would also slightly increase the losses at the top of the distribution.

**Figure ES.1. Impact on working-age earners of implementing the key income tax and NICs changes from our proposed pensions tax reform package**



Note and source: See Figure 7.7.

There would need to be a careful transition towards this long-run position. Specifically, where reforms would affect how already-accumulated pension wealth would be treated on withdrawal, there would be a trade-off between implementing a better system more swiftly and taxing some more heavily than they might have anticipated when they made the decision to save in a pension.

Some further reforms should be introduced alongside the three measures set out above. As set out in our recent report, *Death and Taxes and Pensions*, the tax system is currently more generous for the use of pensions as a vehicle for bequests than as a vehicle for providing a retirement income. This bizarre situation arises for two reasons. First, when an individual dies

before age 75, funds that remain in a pension escape income tax entirely. Instead, we propose **income tax should apply on withdrawals from inherited pensions regardless of the age of death**. Second, in all cases, pension pots at death are typically not counted as part of the deceased's estate for inheritance tax purposes. We propose that **if we are to have an inheritance tax, it should apply to all forms of wealth and therefore pension pots should be included in estates**. Together, these measures would raise additional revenue, with the inheritance tax change in particular falling predominantly on wealthier individuals and their heirs. If the government did not want to increase inheritance tax overall, it could use the revenue raised from that measure to reduce the inheritance tax rate or increase the threshold.

The lifetime and annual limits on the amount that can be saved free of income tax in a pension have been cut sharply since 2011, raising taxes by an estimated £8 billion a year. Implementing the reforms set out above would allow policymakers to be more relaxed about these limits. We therefore propose that, as part of this package of reforms, pension limits should be redesigned, with distinct approaches for defined benefit and defined contribution arrangements (although with an eye to making them of roughly equivalent generosity). For defined benefit arrangements, it would make sense to use regulation to place a cap on the pension *benefits*. For defined contribution arrangements, we propose replacing the current lifetime allowance with a lifetime *contribution* cap. This would have the advantage of not distorting the investment decisions of those with large pension pots. **This restructuring of lifetime limits could be coupled with an increase in their generosity. There is an even stronger case for a substantial increase in the annual allowance, and in particular the policy of tapering the annual allowance for very high earners should be ended.** This would have the benefit of equalising incentives to save across extremely high and merely very high earners.

## Conclusion

Taken together, the package of changes we propose would, once fully in place, boost the retirement incomes of low and middle earners and provide greater encouragement for them to save more in a pension. It would also reduce some of the overly generous tax subsidies provided to those groups who are not in danger of undersaving for retirement, such as those who already have large pension pots and high earners receiving large employer pension contributions. This evening-out of tax support for pension saving would be more equitable and more economically efficient, and would allow the current set of poorly designed limits on what individuals can save in a pension to be relaxed.

Crucially, the new parameters in our proposed system – in particular, the rate of subsidy on employer contributions and the rate of taxable top-up on pension withdrawals – would be decoupled from rates of NICs and income tax. This would leave policymakers with a free hand to make explicit and transparent decisions about how generous they wish the system of pensions

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taxation to be and how much to subsidise employer versus employee pension contributions – a marked improvement on the current opaque and unwieldy arrangement whereby this generosity is a function of the income tax and NICs rates an individual and their employer happen to face.

The current system of pensions taxation has too many features that are arbitrary, wasteful or unfair. It is long past time we retired them.

# 1. Introduction

Private pensions in the UK are a big deal. Private pension wealth is the largest single component of UK household wealth, making up 42% of its total.<sup>1</sup> In 2021, 22.6 million individuals (and their employers) contributed a total of £115 billion to workplace pensions.<sup>2</sup>

Pension saving is given preferential tax treatment. The degree, design and distribution of that preference can be controversial and, in at least some cases, are hard to rationalise. For example, it is hard to justify the degree of tax preference associated with employer contributions or that this rises when rates of National Insurance contributions (NICs) are increased. Most pension contributions and all pension income is given relief from NICs; in contrast, income tax relief is given on contributions (subject to limits) and 25% of the money withdrawn from a pension can be taken free of income tax (with the rest being taxed). While the correct way to define and measure the ‘subsidy’ to pension saving is a point of debate – and will be addressed more fully in this report – there is no doubt that there are significant sums (running into the many tens of billions) at stake for the exchequer, much debate about the distributional consequences of pensions taxation design and significant scope to improve the targeting of saving incentives.

There is a concern that some groups are not saving enough for their retirement.<sup>3</sup> Rates of private pension saving remain low for the self-employed. While automatic enrolment has successfully brought large numbers of private sector employees into workplace pensions, many are saving at the low minimum default rates. When automatic enrolment was designed, the Pensions Commission (2005, p. 283) thought that a median earner would need to save roughly the same amount on top of their proposed default minimum rate of 8% of band earnings to get to a reasonable retirement income. More recently, in the foreword to DWP’s 2017 Automatic Enrolment Review, the then Secretary of State for Work and Pensions David Gauke wrote that ‘we recognise that contributions of 8 per cent are unlikely to give all individuals the retirement to which they aspire’ (Department for Work and Pensions, 2017). In this context, it should not be a surprise that projections of future retirement incomes suggest that significant proportions will not meet the retirement income adequacy benchmarks set out in the Pensions Commission report. Indeed recent reports, including Pensions and Lifetime Savings Association (2022) and the Resolution Foundation’s Cominetti and Odamtten (2022), have concluded that relatively few

<sup>1</sup> <https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/bulletins/totalwealthingreatbritain/april2018tomarch2020>.

<sup>2</sup> <https://www.gov.uk/government/statistics/workplace-pension-participation-and-savings-trends-2009-to-2021/workplace-pension-participation-and-savings-trends-of-eligible-employees-2009-to-2021>.

<sup>3</sup> For example, see the evidence set out in chapter 2 of House of Commons Work and Pensions Committee (2022).



workers were saving sufficiently in pensions to reach what they deemed to be reasonable levels of retirement incomes.

Pensions taxation has already seen significant reform in recent years. Since 2010 there have been huge reductions in the amount that can be saved each year, and over a lifetime, while still benefiting from tax relief. The revenue raised from these reductions totals an estimated £8 billion a year. The new regime of flexible access to defined contribution pensions raises questions about the appropriateness of existing tax subsidies, what resources will be needed in retirement and how policies, including taxation, affect people's decisions about how to draw down pension wealth.

Despite the change that has taken place, core concerns about the system remain – in particular, whether the system of taxes and reliefs applicable to pension saving offers the right level of incentives to make pension contributions to the right sort of people through the right means. Are there particular groups who benefit 'too much' from the current system? Are there others who are not given sufficient support? This is an area that policymakers are likely to consider returning to because of potential need to raise revenue or perceived need to make the system fairer or more conducive to saving for some groups.

When considering reforms to the system of pensions taxation, it is important to be informed by both principles about the design of taxation and empirical evidence on the likely effects of different reforms. This report sets out how pensions are taxed and where there are principled reasons for reform. It also quantifies the distributional effects of potential reforms (including those we propose and others often discussed) on those with different levels of earnings, in different tax brackets and with different characteristics, and how reforms would affect different individuals' incentives to save in a pension.

We begin with an overview of the context relevant to pensions taxation (Chapter 2), before turning to describe the current system (Chapter 3), principles to guide policy (Chapter 4) and our methodology for quantifying the impacts of reforms (Chapter 5, with more details in Appendix A). We then turn to compare the current system of pensions taxation with two benchmark tax systems (Chapter 6) and to some options for reform, including some that we recommend (Chapter 7). Finally, Chapter 8 concludes.

## 2. Background

This chapter gives a brief outline of the UK private pensions system and relevant recent changes to policy and the economic environment.

### 2.1 Private pensions in the UK

Private pension saving is a crucial component of retirement saving in the UK. The new state pension, worth £9,654 per year in 2022–23, is set at a level that means many need significant private income to avoid an uncomfortable drop in living standards at retirement.

Private pension provision can come in various forms. One broad distinction is between defined benefit pensions and defined contribution pensions. An individual who has a defined contribution pension can choose to contribute some of their income to that pension and can choose how they wish it to be invested. If the defined contribution arrangement has been facilitated by their employer, then that employer is likely to contribute too. From age 55 (rising to age 57 from 2028), the individual can access that pension and use it as they see fit, including using it to provide themselves with a pension income after they have partially or fully retired from paid work. While workplace defined contribution pensions are common, it is also possible for an individual to set up a defined contribution pension in an arrangement directly with a pension provider (for example, using a self-invested personal pension). This type of arrangement is more likely to be taken up by those without an employer, most obviously the self-employed. The key feature of a defined contribution arrangement is that the funds available at retirement will depend on how much is paid in and how successfully it is invested, with contributions made earlier having more chance to benefit from compound interest. Individuals are then free to choose how to draw the funds down through retirement (and indeed can bequeath any remaining funds at death).

In the case of defined benefit pensions, an employer runs a pension in which the member accrues entitlement to a future pension income by paying contributions. Ordinarily, the pension income received depends on the member's level of earnings (while still in the job) and the number of years of contributions made. For example, members of the Teachers' Pension Scheme get an annual pension worth  $1/57$  of their average (uprated) earnings for each year they are in the arrangement. Employers providing these types of arrangements have a responsibility to pay out the pension income for the duration of the individual's life from a normal pension age, with

payments increasing in line with a measure of inflation, which in the private sector is often up to some limit.

In order to pay for the pension, employees must contribute a proportion of their salary while employers contribute whatever more is needed to keep the arrangement as a whole solvent, i.e. to pay for the pensions promised to existing and future retirees. For example, in the Universities Superannuation Scheme, members make contributions of 9.8% of their salary, while their employers are currently being asked to contribute 21.6%. A key issue for tax policy is that whereas employer contributions to a defined contribution arrangement can be straightforwardly attributed to an individual, this is not the case with defined benefit arrangements.

## 2.2 Changing context

### The shift from defined benefit to defined contribution pensions

Recent decades have seen a decline in the accrual of defined benefit pension rights outside the public sector. Increased longevity, declines in asset returns, and a series of legal and regulatory changes have made it much more expensive to fulfil defined benefit pension promises and have therefore made private sector employers increasingly unwilling to keep arrangements open to new members and to new accrual.<sup>4</sup> Data from The Pensions Regulator suggest that as of March 2022 only 9% of private sector defined benefit arrangements were open to new members, with a further 37% closed to new members but in which existing members could continue to enjoy new accrual. Half of arrangements were closed to new accrual entirely, while the remaining 4% were winding up.<sup>5</sup> The 1986 Social Security Act encouraged the take-up of defined contribution pensions and, in particular, led to growth in individually arranged ‘personal pensions’. Growth of defined contribution pensions was accelerated dramatically by the government’s policy, rolled out from 2012, of requiring employers to enrol most employees automatically into a workplace pension. This policy reversed a decline in workplace pension participation over the 2000s and workplace pension participation amongst employees now sits at around 80% (and closer to 90% among those in the target group for automatic enrolment).

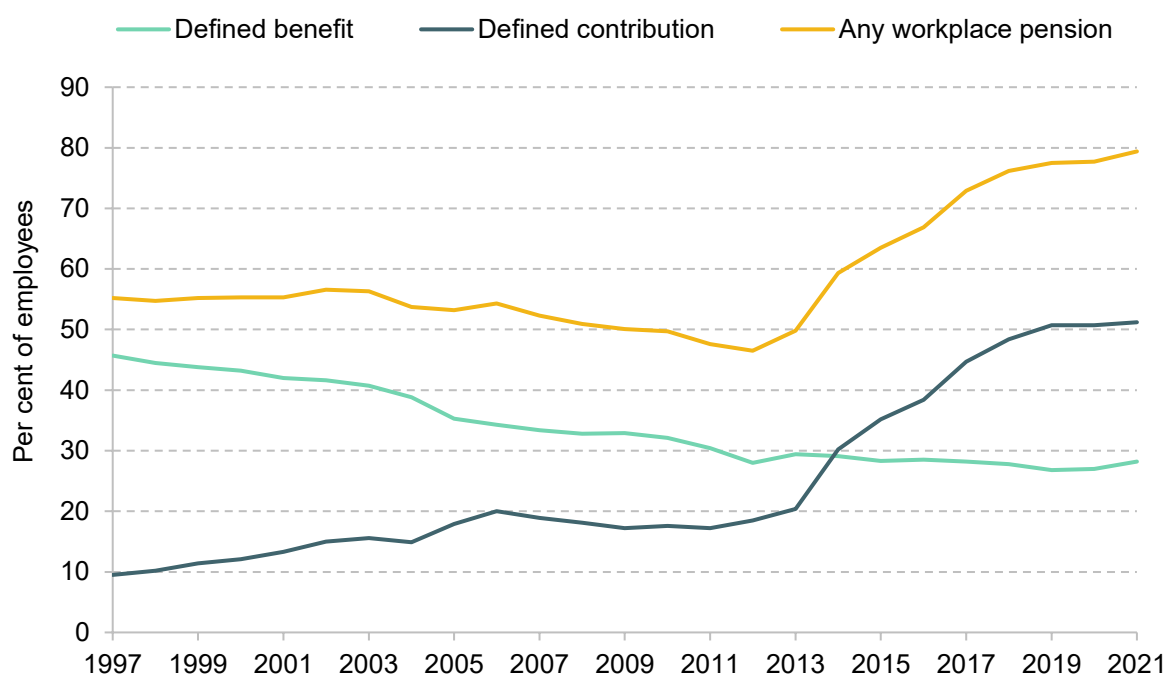
Figure 2.1 shows the percentage of employees who contribute to a workplace pension, split into those who have a defined benefit pension and those who have a defined contribution pension. The share of employees contributing to a defined benefit pension has fallen gradually from 46% of employees in 1997 to 28% in 2021. The share of employees contributing to a defined contribution pension (and not a defined benefit arrangement) rose from 10% to 19% between

<sup>4</sup> For a fuller discussion, see Pensions Policy Institute (2016).

<sup>5</sup> <https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/db-pensions-landscape-2022>.

1997 and 2012 but the numbers contributing to any type of pension still declined over that period. The effect of automatic enrolment after 2012 was a large rise in the proportion of people with a defined contribution pension. In 2021, 51% of employees had a defined contribution pension (including occupational defined contribution and group personal, stakeholder or self-invested personal pensions), compared with 28% with a defined benefit pension.

**Figure 2.1. Percentage of employees contributing to a defined benefit pension, a defined contribution pension (and not a defined benefit arrangement) and any workplace pension, by year**



Source: ONS 'Employee workplace pensions in the UK', based on the Annual Survey of Hours and Earnings.

These trends are different across the public and private sectors. Even before automatic enrolment, 83% of public sector workers had a workplace pension, compared with just 32% of private sector workers. This gap has narrowed, with these rates now standing at 91% and 75%, respectively. In the public sector, defined benefit pensions dominate, with 82% of employees having this type of pension. This compares with just 7% with a defined benefit pension in the private sector.<sup>6</sup> The decline in membership of defined benefit pension arrangements and the rise in defined contribution pensions is therefore a story about private sector provision.

<sup>6</sup> <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/workplacepensions/bulletins/annualsurveyofhoursandearningspensionables/2021provisionaland2020finalresults#membership-by-sector>.

In addition to the withdrawal of defined benefit pension provision in the private sector, public sector defined benefit arrangements have been reformed in ways that, on average, make them less generous. Reforms include changing new accrual of pension benefits to be related to career average salary rather than final salary, increasing the age at which the pension can first be drawn without penalty (often from 60 to the state pension age, which is a big increase: for example, it means some now pay in for seven more years to get the same annual pension for seven fewer years), changing the measure of inflation used to uprate pensions in payment (from RPI to CPI), and increasing employee contributions in particular for higher earners. Despite these changes, these arrangements are typically much more generous than those available in the private sector.

This shift away from defined benefit pensions and towards defined contribution pensions represents a dramatic shift in the UK pensions landscape. Over time, this will lead to a declining share of individuals relying on defined benefit pensions for their retirement income. In turn, this has led to a greater focus on whether individuals are saving appropriately for their retirement. One reason for this is that individuals with defined contribution pension arrangements have much greater discretion over how much to contribute to their pension. In addition, employer contributions to defined contribution pensions tend to be substantially less generous than the defined benefit provision they replaced. For example, in 2021 87% of members of defined benefit pensions received an employer pension contribution of 12% of salary or more, whereas this was true of just 9% of those in defined contribution pensions. The difference at higher rates of employer contributions is even greater: 49% of those in defined benefit arrangements received an employer contribution of 20% of salary or more compared to just 3% of those in defined contribution arrangements.<sup>7</sup> Further, individuals face the risk that the investments in their defined contribution pension will change in value, whereas this investment risk is borne by employers (at least formally) in defined benefit pension arrangements. Indeed, it is the employer costs, and the risks borne by employers, that have led to many private sector employers choosing to move away from offering defined benefit arrangements.

### Concerns about retirement income adequacy

While the rising workplace pension participation rates of recent years are in many respects a policy success and will bolster the retirement incomes of many, there are concerns about the adequacy of future retirement resources. The minimum rate of contributions under automatic enrolment is currently 8% of qualifying earnings (those between £6,240 and £50,270), with at least 3% of qualifying earnings coming from the employer. Research has found that while automatic enrolment did lead to a big boost in workplace pension membership, most brought into pensions as a result are making relatively low rates of contribution (Cribb and Emmerson,

<sup>7</sup> Source: authors' calculations using data from table P9.1 of <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/workplacepensions/datasets/annualsurveyofhoursandearningspensionableemployercontributionbandsbyagegroupandbypensiontypep9>.

2019; Department for Work and Pensions, 2019). Furthermore, employees tend not to increase their rate of saving as they age, despite there being good reasons to think this would be appropriate (Crawford and O'Brien, 2022). There is also particular concern about the self-employed, who are not covered by automatic enrolment and who have much lower, and falling, rates of participation in pensions. Of the 5 million self-employed, just 16% were saving into a pension in 2018, compared with 48% in 1998, and the same was true for 76% of employees in 2018, with no evidence that the self-employed have become more likely to save in ISAs, housing, or directly held savings or equities over this period (Crawford and Karjalainen, 2020).

The Pensions and Lifetime Savings Association (2022) and the Resolution Foundation (Cominetti and Odamtten, 2022) have both made projections of future retirement incomes given current state and private pension coverage and assuming contributions at the total automatic enrolment minimum of 8% of qualifying earnings. These conclude that the majority of individuals will have pensions that fail to meet the replacement rates of working-life income (i.e. retirement income as a percentage of end-of-working-life income) deemed appropriate by the Pensions Commission (2005). In particular, there is projected to be a generation – approximately those born in the 1970s – for whom defined benefit pension provision is much lower than for preceding generations but who have also had a substantial proportion of their working life in the years prior to automatic enrolment. While any projections of future pension incomes are very uncertain, Finch and Gardiner (2017) found that mean income at retirement for men would fall relative to average earnings between those born in the 1950s and those born in the 1970s, before rising again for the 1980s-born generation due to the roll-out of automatic enrolment. For women, pension incomes were projected to rise slowly across generations as a fraction of average earnings.

Findings of this kind have been behind calls to increase the default rate of saving under automatic enrolment and to reduce, or even eliminate, the lower limit for qualifying earnings. However, there are multiple reasons why this may not be advisable. First, consideration should be given not just to the level but also to the timing of retirement saving (Crawford, O'Brien and Sturrock, 2021). Increasing default contribution rates at all ages may mean increased saving in early adult life when earnings are relatively low and costs – for example, from children – are high, which may not be desirable. So an alternative could, for example, be to consider increasing employee contribution rates at older ages. Second, prior research has suggested caution in using the replacement rates for adequate retirement income suggested by the Pensions Commission as yardsticks against which to assess whether retirement incomes, and the saving rates that achieve them, are appropriate (Crawford and O'Dea, 2020).<sup>8</sup> This research has suggested that, for many,

<sup>8</sup> One reason for this is that a given replacement rate of earnings immediately before retirement will for most individuals correspond to a higher replacement rate of average lifetime earnings, since earnings tend to rise with age.

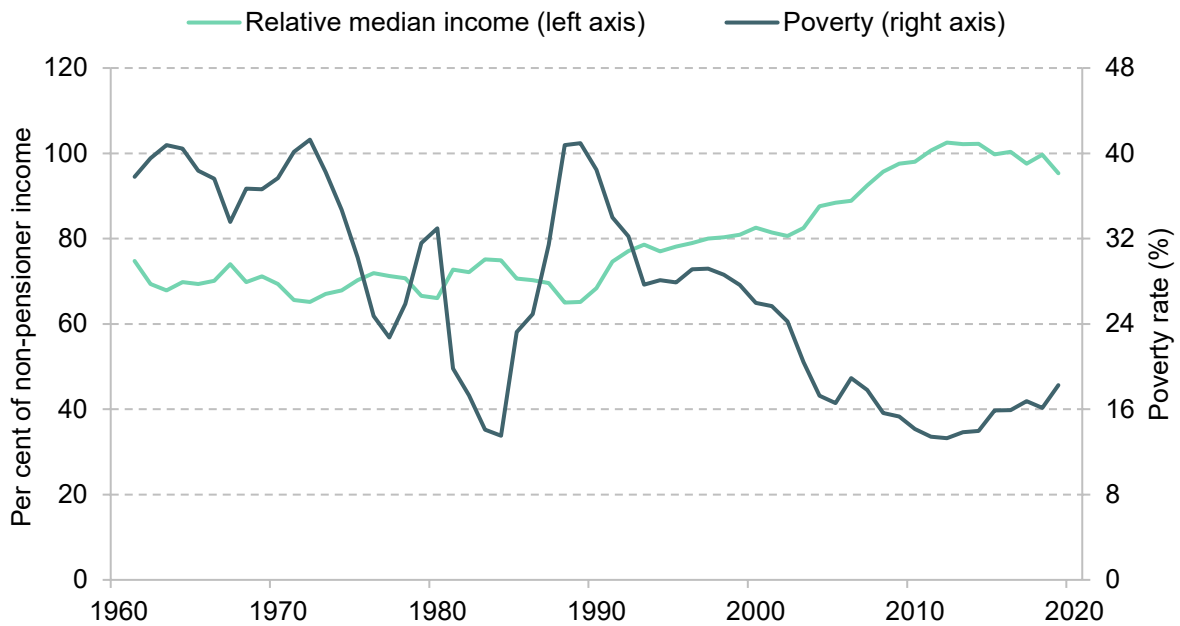
smoothing their living standards over their lifetime would imply lower replacement rates than these commonly used benchmarks. A key driver of this is that returns available to more recent generations might be lower – not least due to the reduced availability of defined benefit arrangements. Third, automatic enrolment has led to high pension participation rates even among those classified as ‘least financially secure’ (Bourquin, Cribb and Emmerson, 2020). It is apparent that some who are saving into a pension ought not to be saving at that time, and that increasing default contribution rates could put further pressure on their precarious living standards.

### Generational differences

In the latter half of the 20<sup>th</sup> century, pensioners had incomes that were, on average, lower than those of working-age people. From around the turn of the 21<sup>st</sup> century, policy became increasingly focused on retirement income adequacy and tackling pensioner poverty was a key policy aim (whereas earlier pension reforms – most notably in 1980, 1986 and 1995 – had been focused on improving the long-run sustainability of the public finances). Policy changes – including increases in means-tested benefits targeted at lower-income pensioners (in 1999 the minimum income guarantee and then, from 2003, pension credit), from 2002 the expansion of state pension entitlements for lower earners and those with certain formal caring responsibilities under the state second pension, and from 2011 ‘triple lock’ indexation – all boosted state support for pensioner incomes. Furthermore, while the new state pension, which came into effect for those reaching the state pension age from April 2016, will in the long run be on average less generous than the system it replaced, in the near term it represents a further increase in state support. At the same time, successive cohorts of pensioners were arriving at retirement with greater private pension entitlement and were increasingly likely to own their own homes outright. The resulting growth in incomes after housing costs for pensioners has stood in contrast to stagnant incomes for those of working age since the financial crisis.

As a result of these trends, since around 1990 pensioners’ income position has improved relative to people of working age. Figure 2.2 shows the ratio of median pension income to median working-age income since 1960. The average pensioner had an income worth around 70% of someone of working age for much of the period from 1960 to 1990. From 1990 to 2000, this rose to 80%. There was then a rapid rise to over 100% in 2011, putting pensioners ahead of those of working age in terms of incomes. This rise in the relative incomes of pensioners has meant a fall in pensioner poverty (defined here as having income below 60% of contemporaneous median income), from scandalously high peaks of over 40% in the 1960s, early 1970s and late 1980s, to 18% in 2019. This fall in pensioner poverty rates means that pensioners are, on average, no more likely to be in poverty than those of working age. It is also true, however, that recent years have seen slightly weaker growth in pensioner incomes than among working-age incomes alongside increases in pensioner poverty rates.

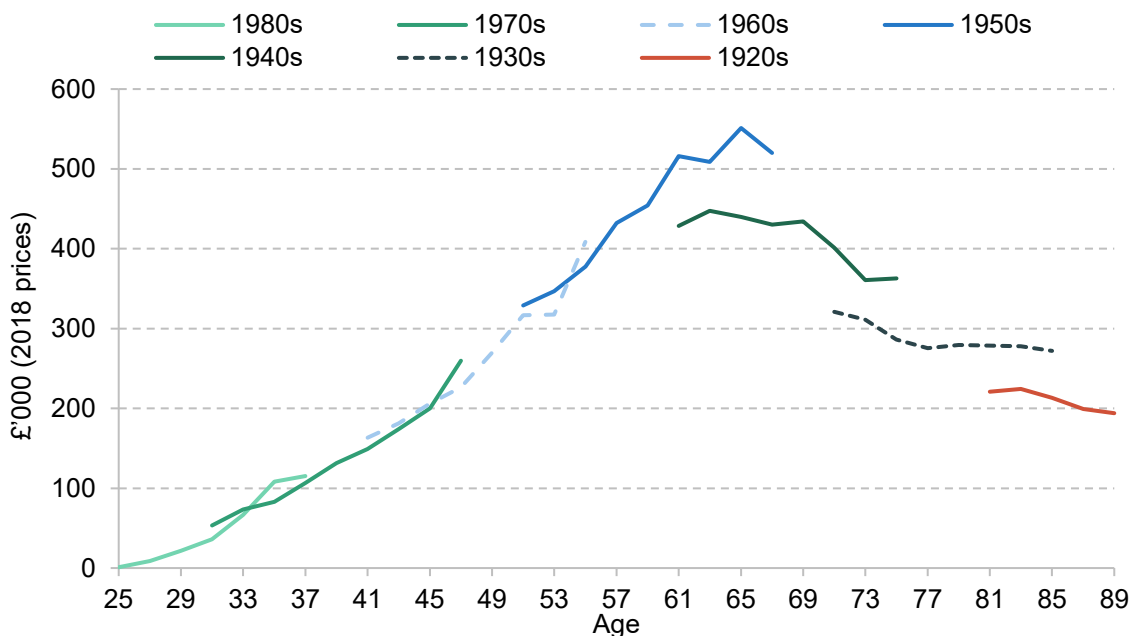
**Figure 2.2. Ratio of median pensioner income to median working-age income, and pensioner relative poverty rate, by year**



Note: Figure shows the relative income of pensioners (median income of pensioners divided by median income of working-age individuals) and the relative income poverty rate among pensioners. Relative poverty is defined as having income below 60% of contemporaneous median income.

Source: Family Expenditure Survey and Family Resources Survey.

**Figure 2.3. Median household net wealth, by age and decade of birth**



Note: Figure shows the median level of household net wealth among households with two or fewer adults. Households are classified into generations based on their mean of the adults' years of birth. Age is the mean age of the adults in the household. Wealth is total household net wealth excluding physical wealth.

Source: Wealth and Assets Survey, waves 1 to 5 and round 6.



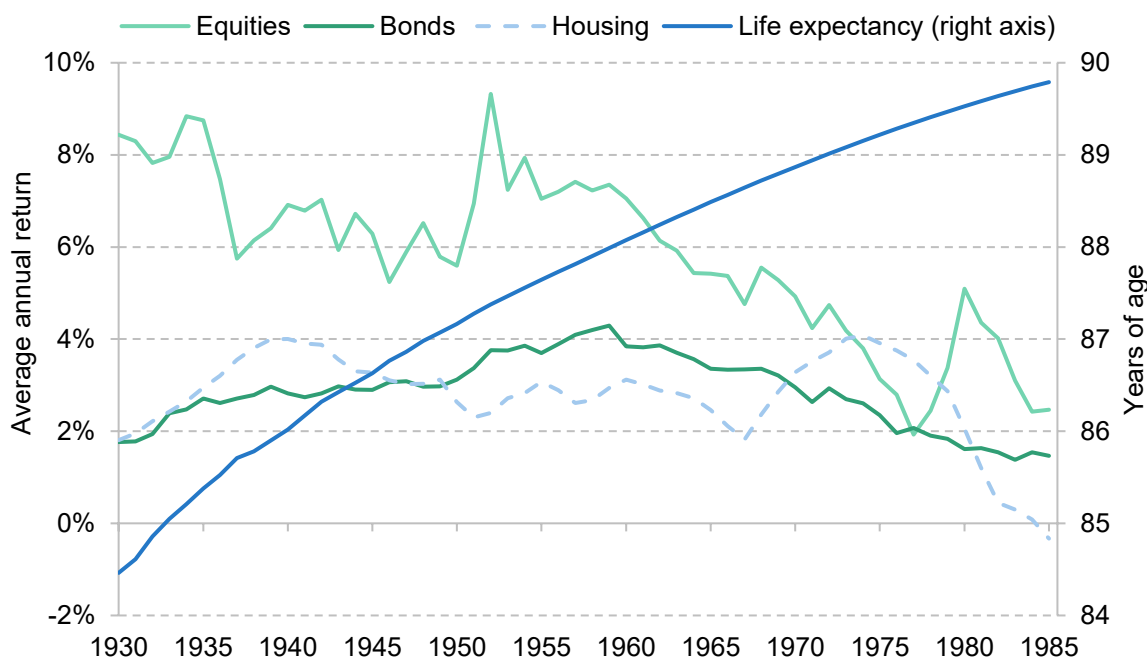
Successive generations of pensioners have seen rapid increases not only in their incomes but also in their wealth. Figure 2.3 shows median household net wealth by birth decade and age. At any given age, the 1930s-, 1940s- and 1950s-born generations are each significantly wealthier than their immediate predecessors. This is driven not only by higher pension wealth of subsequent generations but also by higher levels of property and other financial assets. In contrast, household wealth accumulation appears to be following a similar path to the preceding generation for all generations born from the 1960s onwards, with no substantial generation-on-generation wealth increases. These patterns in fact reflect falling levels of property wealth, at given ages, across these younger generations, which are offset by increasing defined contribution pension wealth.

As well as the projections of future pension income of younger generations, it is also these wealth trajectories that have led to concerns about whether younger generations are building up sufficient resources to achieve an adequate standard of living in retirement. There are reasons to think that wealth accumulation has been, and could continue to be, more challenging for younger generations than it was for their predecessors. In addition (and related) to the shift away from defined benefit pensions to less generous defined contribution pensions, the rates of return to a range of different assets have declined over time. Figure 2.4 shows the average annual real return to equities, government bonds and the average annual real increase in house prices, between ages 22 and 65 (or up until the year 2020, if earlier) for those born in different birth years. Returns to safe assets such as government bonds and riskier assets such as equities have been highest over the working lives of those born in the 1950s and declined for those born later. The house price boom of the 1990s and 2000s drove real house price increases averaging around 4% for those born in the 1970s, but those born later missed out on some or all of that boom period. Of course, the increase in house prices would have been a greater boost to the wealth of those who were homeowners (and those who owned more valuable homes) at the time it took place, i.e. those further through working life. While there are ongoing debates over the ultimate drivers and therefore likely persistence of these trends in returns, financial markets do not expect a continuation of the decline in interest rates that drove much of the increase in asset valuations that bolstered returns.

At the same time as conditions for wealth accumulation have arguably become more difficult, individuals are living for longer. Figure 2.4 also shows female life expectancy, for those who reach age 65, by year of birth. This has seen a dramatic rise, from 84.5 for those born in 1930 to 89.8 for those born in 1985: i.e. almost one extra year of life for each successive decade of birth. The increase in male life expectancy has been even more dramatic. While the last three decades have seen a trend of men working more at older ages (albeit with a recent partial reversal), across generations, men born later are set to spend a greater number of years in retirement. All else equal, supporting this retirement period will require a larger amount of accumulated resources, whether in pensions or in other forms of saving. And all else might not be equal: for

example, additional years of life spent in poor health could mean additional sums needed to pay for care needs.

**Figure 2.4. Average annual return and average annual real house price growth over working life (ages 22 to 65) to date, and female life expectancy at age 65, by birth year**



Note: Real returns to equities and bonds are inclusive of income (dividends and interest) and capital gains net of inflation. Equities returns until 1963 are based on the largest 30 companies on the London Stock Exchange and since 1964 are based on the FTSE All-Share Index. Return to bonds is based on 15- and 20-year government bonds. Real house price growth is the annual change in the Nationwide house price index, net of inflation. Average annual returns over working life are the geometric mean of the annual real returns between ages 22 and 65 (or 2020, if earlier).

Source: Returns to equities and bonds are from the Jordà et al. (2019) Macrohistory database (accessed January 2023). House price growth is from Nationwide and deflated by CPI (and before 1989 an adjusted version of the RPI). Female life expectancy at age 65 is from the ONS 2018-based cohort survival curves for England and Wales.

## Increased flexibility over the use of pension wealth in retirement

Prior to 2015, those with defined contribution pension wealth generally had to use this to buy an annuity (guaranteed income until death), unless they had particularly high income from other sources or a particularly small pension pot. The ‘pension freedoms’ reforms, announced in the 2014 Budget, gave those aged 55 and over much greater flexibility over the use of this wealth. Those starting to draw on their pension can still choose to purchase an annuity if they so wish, but they can also now choose to keep their pension pot invested and draw sums from the pension at a rate of their choice, either through a structured ‘drawdown’ arrangement, which uses the pension pot to provide a regular income, or through ad-hoc lump-sum withdrawals.

Whereas the income from an annuity is guaranteed for life, those continuing to hold their pension in unannuitised form face investment risk, the risk of exhausting their funds before they die, and the risk of running their pension pot down too slowly and then dying having forgone spending unnecessarily. In return, they can receive income in a more flexible way, and potentially gain from investment returns through retirement. Defined contribution pensions now represent a fairly general tax-advantaged savings vehicle, with no requirement to use accumulated wealth to provide pension income.

Consumers have responded to pension freedoms by shifting away from purchasing annuities and towards the use of drawdown and lump-sum withdrawal. In 2020–21, among those with pension pots worth £30,000 or more accessing their pension for the first time, 16% of individuals purchased an annuity, whereas 58% moved at least some of their pension into drawdown, with the remainder taking out part or all of their pension pot as a lump sum.<sup>9</sup> There is some evidence that interest rate rises in the last year have led to increased annuity sales, though it remains to be seen how long lasting this will prove to be.<sup>10</sup>

Pension freedoms have proved popular among pension holders (Financial Conduct Authority, 2018). Yet there is evidence that some individuals may not have the information and financial acuity to trade off the costs and benefits of the different options they allow and to weigh the risks from uncertain longevity and investment returns that come with drawdown or lump-sum withdrawal arrangements (Association of British Insurers, 2019).

<sup>9</sup> Source: Authors' calculations using Financial Conduct Authority retirement income market data (2020–21).

<sup>10</sup> See, for example, 'Savers look to pension annuities as rates soar', *Financial Times*, 6 January 2023, <https://www.ft.com/content/95bdfd82-a599-4cca-9d39-348d68550441>.

## 3. Current system

This chapter outlines the tax treatment of pensions. A fuller explainer can be found on the IFS Taxlab website.<sup>11</sup>

### 3.1 The UK pensions tax system

Any savings vehicle involves three main flows of funds that can potentially be subject to tax: contributions made, returns that accrue, and withdrawals. Where individuals hold funds in an ordinary savings account, the contributions are made out of taxed income, returns – interest income – are subject to income tax (although only above a large tax allowance), but funds can be withdrawn free of tax. This is known as taxed-taxed-exempt (TTE) treatment and this tax treatment also applies to many other directly held investments such as shares or buy-to-let properties (again with special features in each case). Most other assets are taxed differently. Of particular note, Individual Savings Accounts (ISAs) and owner-occupied housing are treated more generously as there is no tax on returns (but it is still the case that contributions are made from after-tax income, and there is no tax on withdrawals). In other words, they are subject to taxed-exempt-exempt (TEE) tax treatment.

Pensions are different. Their income tax treatment is closer to one where contributions are made from pre-tax income, returns left untaxed as they accrue, and then withdrawals are subject to tax. This is known as exempt-exempt-taxed (EET) treatment. So, like investments held in ISAs or owner-occupied housing, tax is levied at only one point, but instead of being levied up front it is levied on withdrawals. In effect, income tax on earnings paid into a pension is deferred from the time the contribution is made until the time the earnings (along with any returns accrued in the meantime) are withdrawn from the pension. It is as if individuals, rather than receiving their earnings in full now, agree to get part of their earnings in future instead, and income tax is levied when that deferred remuneration is actually received.<sup>12</sup>

<sup>11</sup> <https://ifs.org.uk/taxlab/taxlab-taxes-explained/taxation-private-pensions-explained>.

<sup>12</sup> There are some other taxes relevant to savings that we do not discuss further here. Stamp duty land tax is levied on property transactions, while council tax is levied on occupiers of residential properties (regardless of whether they own or rent the property, though where properties are empty owners can be liable). Stamp duty reserve tax is levied on transactions of certain shares in UK listed companies (with this being due regardless of whether the shares are purchased directly or within an ISA or a pension), while corporation tax is levied on the profits of companies in which shares may be held. Finally, inheritance tax is levied on estates at death (and gifts made in the seven years before death), although funds that remain in a pension at death are not counted as part of the estate.

Where an individual's tax rate does not vary over time, and where everyone gets the same ('normal') rate of return on their investments, there is no difference in the overall generosity of a TEE system (as we have for ISAs) from that of an EET system (to which the tax treatment of pensions is most similar). For given levels of pre-tax income, the same levels of spending are achievable under both systems. The only difference is in the timing of when the tax is paid.

The systems vary in their overall generosity where individuals face different tax rates at different points in their lives. Many individuals have a lower income in retirement than when working and therefore might face a lower rate of tax (this lower income might be appropriate and not entail any difference in living standards compared with working life if, for example, they have paid off a mortgage, have lower commuting and childcare costs, and are no longer making pension contributions). A system of taxing pension income when it is withdrawn therefore allows such individuals to benefit from shifting their taxable income to later periods of life. This might be seen as fair and desirable, though the point is certainly debated (for example, Tax Justice UK (2020) argues that it would be fair if the rate of up-front tax relief were the same for all individuals, regardless of their marginal tax rate).

The extent to which income tax payers can benefit from shifting their taxable income will depend on the rates of income tax that they will end up paying when they retire. This will depend on how growth in pensioner incomes compares with growth in tax thresholds. While this is not known, a sense of possible scale could be gleaned by looking at the income tax rates faced by the current generation of pensioners. A large minority of pensioners do not have sufficient income to be liable for any income tax; fewer than 60% of pensioners paid any income tax in 2022–23. This suggests that even many getting basic-rate relief on their pension contributions could benefit from being able to shift their taxable income to when they are retired. In addition, few pensioners have an income sufficiently high to pay the higher or additional rates of income tax. For example, in response to a parliamentary question, HMRC stated that in 2018–19 508,000 pensioners paid higher-rate income tax and 37,000 paid additional-rate income tax: these equated to just 4% and 0.3% of pensioners – and combined just 8% of income tax paying pensioners – in that year.<sup>13</sup> Overall, 18% of income tax payers pay income tax at either the higher or additional rate of income tax: this suggests that many in this group could benefit from being able to shift their taxable income until they are retired.

<sup>13</sup> HMRC statistics show that 7,320,000 pensioners paid income tax in 2022–23 (table 2.1 of <https://www.gov.uk/government/statistics/number-of-individual-income-taxpayers-by-marginal-rate-gender-and-age>), with the number of higher-rate and additional-rate taxpayers coming from <https://questions-statements.parliament.uk/written-questions/detail/2019-07-02/HL16863/>. Number of pensioners approximated using DWP statistics on the number receiving a state pension (<https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2022>); note that this is not quite the same as the number of pensioners in the UK since some will not qualify for any state pension while, working in the other direction, some recipients of the state pension now reside overseas.

The two different systems will also vary when some individuals receive above ‘normal’ returns on their investments (i.e. returns that exceed – adjusting for risk – what one could attain on a safe asset such as a government bond). Under the method of taxation applied to ISAs or owner-occupied housing, individuals who get bigger returns benefit from those entirely free of tax. This form of taxation has led to generations that, with hindsight, have done very well through investment in the UK housing market, receiving gains that have been entirely untaxed. Pensions are taxed differently in this regard: where bigger returns are enjoyed, the spoils are shared between the individual and the Treasury.

We can already see a deviation in how pensions are taxed relative to other assets. For better or worse, this will (all else equal) mean that those who expect their tax rate to be lower in retirement than it is now will find that the tax system incentivises them to save for their retirement in a pension rather than an ISA. In contrast, those who expect to make bigger returns from their investments will (all else equal) find the tax treatment of ISAs relatively more attractive than that of pensions.

In practice, the taxation of pensions differs from a pure exempt-exempt-taxed regime in a number of respects including:

- Up to one-quarter of an accumulated pension can be withdrawn free of income tax and therefore does not attract income tax either on contributions or on withdrawals.
- Individuals’ pension contributions are made out of income that has been subject to NICs, but no NICs are charged on pension income (so this is a taxed-exempt-exempt regime, akin to the income tax and NICs treatment of ISAs).
- Employer pension contributions, however, do not incur employer or employee NICs at any point and are therefore especially tax-advantaged. They receive EEE treatment with regards to NICs.
- Pension pots that remain at death are not counted as part of the estate for inheritance tax purposes, and for those who die before age 75 these funds escape income tax entirely (no income tax is paid on withdrawal despite contributions also being tax relieved).
- There are lifetime and annual limits on the amount that can be saved free of income tax in a pension, both of which have been reduced significantly since 2011.

Perhaps the most salient of these is the first, the fact that up to one-quarter of an accumulated pension can be taken free of income tax. This will provide an incentive for those who expect to be income tax payers in retirement to save in a pension (but will not provide an incentive for the potentially large number of individuals who do not expect to pay income tax in retirement).

The NICs treatment of employer contributions is also generous. As well as giving an incentive to make more pension contributions overall, it will provide a strong incentive for those who can to

ensure that any contributions they wish to make are formally made on their behalf by an employer – for example, through a salary sacrifice arrangement. The tax treatment of pensions at death is particularly – and oddly – generous. This will provide an incentive for those who wish to make bequests and who think that they might die before age 75, or that they might die with an estate that makes them subject to inheritance tax, to save in a pension and pass this on as a bequest. Recommendations of reform in this area were made in an earlier report published as part of this same programme of research (Adam et al., 2022).

Finally, the annual and lifetime limits on the amounts that can be saved in a pension operate in the opposite direction in that they result in less generous tax treatment than that implied by a pure exempt-exempt-taxed vehicle. The current annual allowance is £40,000 (although any unused allowance can be carried forwards for up to three years) and the lifetime allowance is £1,073,100. These limits are much lower than they were in 2010–11 (when they stood – in nominal terms – at £255,00 and £1,800,000, respectively) and, as a result, now affect many more individuals, although it remains the case that most pension savers will be unaffected by them throughout their lives.

The annual allowance is also lower for some individuals.

- Those who have taken money out of a defined contribution pension have their subsequent contributions to defined contribution pensions limited to the money purchase annual allowance. This is currently set at £4,000 per year. The intent is to limit the ability of individuals to ‘recycle’ their pension – i.e. withdrawing funds (of which they could take 25% free of income tax) and then returning them to the pension before withdrawing them again.
- Those who have annual taxable income over £200,000 and annual taxable income plus pension contribution (known as ‘adjusted income’) over £240,000 have a reduced annual allowance. Specifically, it is reduced by £1 for every £2 of additional adjusted income above £240,000, down to a minimum annual allowance of £4,000 for those with an adjusted income of £312,000 or more. From 2016–17 to 2019–20, the tapering applied at a much earlier point (£110,000 and £150,000, tapering down to a minimum of £10,000 for those with an income of £210,000 or more) but was made more generous in response to ludicrously high marginal tax rates it imposed on (in particular) some relatively well-paid NHS workers who were doing overtime while members of inflexible defined benefit pensions.

There are penalties in place for those who exceed the annual allowance and the lifetime allowance, which provides an incentive to avoid breaking them. In the case of the annual allowance, the amount of pension contribution in excess of the limit is counted as taxable income. This means this part of the contribution – and the subsequent pension withdrawal (aside

from the tax-free component) – are both subject to income tax; essentially TET income tax treatment. Withdrawals from pensions valued at more than the lifetime allowance are taxed at 55% if taken as part of the tax-free component or 25% if then subject to income tax (which equates to 55% tax for a higher-rate taxpayer). In 2020–21, 41,000 individuals reported making contributions that exceeded the annual allowance, while 8,600 pensions were subject to charges for exceeding the lifetime allowance.<sup>14</sup>

The clear motivation for the substantial cuts to the annual allowance and lifetime allowance since 2010, and the tapering of the annual allowance for those on high incomes, is that they will raise significant sums from relatively well-off individuals. Indeed, adding up the measures across successive Budget scorecards suggests that the cuts implemented since 2010 will, in 2022–23, raise £8 billion in tax (mostly from income tax, but with NICs also boosted).

### How is income tax on pension withdrawals collected?

Tax on pension income is collected as tax on employment income: pension providers deduct income tax through the Pay-As-You-Earn (PAYE) system before making pension payments, but many pensioners have to fill in a tax return each year to ensure that the correct amount of tax is paid.

## 3.2 How much does pensions tax relief cost?

HMRC publishes widely cited estimates of the cost of pensions tax relief.<sup>15</sup> HMRC highlights that this is not the tax yield that would be expected from withdrawing tax relief or changing the tax treatment of pensions, as there would be significant changes in behaviour. However, even with that caveat, these figures are easily misinterpreted and should be used with care. In Chapter 6, we make estimates of the cost of pensions tax relief based on our empirical modelling. These estimates attempt to overcome some of the issues that we highlight here.

The cost of NICs relief is relatively straightforward, at least assuming a fixed level of pension contributions. HMRC estimates that in 2020–21 the government gave up £23 billion that it would have collected if the employer pension contributions made in that year had been subject to employer and employee NICs, with £14.9 billion coming from reduced employer NICs and £8.4 billion from reduced employee NICs.

<sup>14</sup> <https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary-september-2022>.

<sup>15</sup> For example, <https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics>.



Income tax is more complicated. HMRC estimates that in 2020–21:

- income tax relief on pension contributions was £41 billion; of this, just over half (£21.5 billion) went on contributions to defined benefit arrangements and just under half (£19.4 billion) went on contributions to defined contribution arrangements;
- income tax relief on investment returns within pension funds was £3 billion;
- income tax collected on pension income was £19 billion.

HMRC concludes that, overall, the net cost of pension income tax and NICs relief is £48 billion (23+41+3–19). However, there are a number of caveats and limitations which ultimately make that £48 billion figure more misleading than enlightening.

First, the HMRC figures compare the income tax relief given to today's savers with the income tax levied on today's pensioners. That provides an estimate of how much income tax revenue the government is forgoing in a particular year, but it is not a good estimate of how generous the system is to either the current generation of savers or the current generation of pensioners. Ideally, one would want to calculate, for each individual, the total amount of tax they would pay on their pension saving over their entire lifetime given the current tax system, and compare that with how much they would pay under an alternative (benchmark) system. Or, more modestly, one could consider the pension contributions made in one year and quantify the tax paid on those contributions at the point of contribution, and the expected tax that might be paid on the resulting accumulation of returns and on drawdown as income. By instead comparing tax relief for current savers with tax from current pensioners, the HMRC figures ignore the fact that the number of people in each birth cohort, the size of their pension funds and the tax policies in place at different times in their lives are very different. If pension income will be higher in future (for example, because there will be more pensioners than there are today), these figures will overstate the cost of pensions tax relief.

Second, the HMRC figures compare the current income tax treatment of pensions with one particular alternative. Specifically, they are calculated compared with a system in which tax is levied on earnings paid into a pension and on investment returns within a pension, but not on pension income (TTE treatment). That is one reasonable benchmark, albeit a benchmark system that is harsher than the treatment applied to most other savings. But, as we have noted above, there are other reasonable benchmarks (for example, one could compare with a system in which income was only taxed when it was available to be spent (an EET system) or one in which earnings were taxed but the return to savings not (a TEE system)). Different comparisons would yield very different estimates: we discuss a comparison with both TEE and EET in Chapter 6. The HMRC figures do not disentangle the cost of allowing 25% of a pension to be accessed tax-free or of the income tax exemption for pensions inherited from under-75s, both of which would be counted as reliefs against any alternative benchmark.

Third, £3 billion is an underestimate of the tax forgone on investment returns within pension funds. It is calculated assuming income tax relief at the basic rate of tax, while in reality many of the returns will accrue to higher-rate taxpayers. It also does not include capital gains tax relief on capital gains made within pension funds; that is a big part of the relief on investment returns, but the government produces no estimate of it.

Finally, note that the government does not publish estimates of the cost of exempting bequeathed pension pots from inheritance tax. The cost of that will be small at the moment, as most of those now dying either have defined benefit pensions or had already used their defined contribution pension pot to buy an annuity before the introduction of ‘pension freedoms’ in 2015 removed the requirement to do so. But as this new and tax-advantaged option grows in popularity, its cost will rise rapidly.

### The distribution of benefits from pensions tax relief

HMRC also publishes a breakdown of how up-front relief from income tax and NICs is distributed. In 2020–21 – the most recent year for which statistics are available – an estimated 42% of the £40.9 billion of up-front income tax relief was given at the basic rate, 52% at the higher rate and 6% at the additional rate. This compares with the fact that in the same year just 13% of income tax payers were higher-rate taxpayers and just 1.4% were additional-rate taxpayers. It is worth reiterating that these calculations can be seen as overstating 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-base smoothing: if taking a longer-term perspective, these individuals therefore may not be seen as having such a high income. It is also not surprising that an income tax relief benefits those who pay relatively more income tax: about one-third of income tax revenue comes from each of basic-rate, higher-rate and additional-rate income taxpayers.

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, at least across the bulk of the population who are not constrained by the annual and lifetime pension contribution limits. This would arise because of the tax-free lump sum being more generous to those who pay higher-rate income tax in retirement than to those who pay basic-rate income tax in retirement and of less – or no – value to those who do not pay income tax in retirement. But the distribution would not be anywhere near as skewed as the HMRC data suggest.

And adding in up-front NICs relief on employer pension contributions will also change the picture. Since they are not paid on pension income, it is more reasonable to classify this as relief. In 2020–21, all of the £14.9 billion of up-front employer NICs relief was at the main rate, as there is only a single rate of employer NICs (currently 13.8%). This will be of more benefit to those who receive relatively bigger employer pension contributions, likely to be disproportionately higher earners. In contrast, of the £8.4 billion up-front employee NICs relief, an estimated £7.5 billion was given at the main rate, while £0.9 billion was given at the additional rate. Because the additional rate of employee NICs is lower than the main rate (2% compared with 12%), this will mean this up-front relief is of relatively less value to higher earners.

## 4. Principles for the taxation of pensions

### 4.1 Context of the overall tax system matters

Reforms to pensions tax are often considered and discussed in isolation. But moving to a better system for the taxation of pensions requires clarity over how it fits within the overall system of taxes and benefits. It will be the system as a whole that will determine the incentives that individuals face to save in general, and to save in a pension in particular. The overall tax system will also be what matters when considering how best to meet the government's revenue and distributional objectives. Where a particular part of the pensions tax system, or a potential reform to the pensions tax system, is seen as inappropriately favouring a particular group, it might be that addressing this through the pensions tax system would be appropriate. But it could be that a reform elsewhere to the tax system would be better. For example, if the tax system were seen as being too generous to higher-rate income tax payers, one could decide to reform pensions tax relief. But alternative – and potentially simpler – reforms might be to increase the higher-rate of income tax or reduce the higher-rate threshold. Essentially, the key difference would be whether the objective was to tax higher-income pension savers more, or whether higher-income non-savers should also be paying more in tax.

Pension reforms are often proposed in the context of a Chancellor who wants to strengthen the public finances considering making pensions tax relief less generous. But an extension of the above argument is that if a well-designed pensions tax system has been implemented then making it less generous in order to raise revenue would likely be the wrong course of action. An increase in general taxes, rather than increasing taxes only on pension savers, would seem to be more appropriate. If the argument is instead that the pensions tax system is badly designed – for example, if it provides a too generous incentive to some groups – then there would be a good case for reform regardless of the state of the government's finances at any particular moment in time. In a similar vein, reforms to the pensions tax system should not be rejected (or selected) on the basis of their overall impact on government revenues or on their distributional effects, as the overall tax (and benefit) rate schedule can be adjusted to offset the revenue and, at least on average, the distributional consequences of a reform. We should not generally change the tax treatment of one particular form of income, spending or saving as a way to raise revenue or redistribute, when we have other tools – principally the tax and benefit rate schedule – that can do so in a way that treats different forms of income, spending and saving equally.

This logic assumes that it is possible to adjust everything else. If that is not possible for whatever reason, and we are constrained to consider reform of pensions taxation holding everything else constant, the policy conclusions would change, perhaps dramatically. There would, for example, be a much stronger case for progressive or revenue-raising pensions tax reforms if other ways of increasing the progressivity or yield of the tax system were deemed, for whatever reason, impossible. In addition, where reforms change the taxation of existing wealth, there would be windfall gains or losses, and distributional consequences across generations. These would arguably be less straightforward for the government to offset (though it still has quite a few tools for intergenerational redistribution – less so for offsetting windfall gains/losses other than in how it deals with transition to a new system).

The reform of pensions taxation (and indeed other parts of the tax system) does often seem to be considered in isolation. Sometimes there might be political obstacles to offsetting the effects of a reform with other parts of the system. Sometimes a government may not even make a conscious connection between how one part of the tax system is, or could be, affected by reforms elsewhere. But there is no economic reason that a government should be constrained to reforming only one part of the tax system in isolation, and good joined-up government would not be.

However, while ideally revenue and distributional consequences would not drive the choice of pensions tax system, it is still important to understand what those consequences are. They tell us what adjustments would be needed elsewhere in the system to offset the revenue and distributional impacts – whether or not the government actually makes those adjustments – and the consequences if it does not. In Chapters 6 and 7 of this report, we quantify those where possible.

## 4.2 Use well-targeted incentives for retirement saving

One rule of thumb for good tax design is that similar things should be treated by the tax system in similar ways, unless there is a very good reason to deviate from this. A completely neutral tax system would, for example, treat equally:

- spending today and saving in order to spend in the future;
- different assets in which a person might save;
- defined benefit and defined contribution pension arrangements;
- remuneration in the form of salary and in the form of pension contributions;
- pension contributions made by an employer and by an employee.

That is not to say the tax system should be neutral between all these things. Neutrality should be a benchmark against which departures are measured and should be justified. Other things equal, a neutral system will tend to be simpler, fairer and more economically efficient. But there are good reasons in principle for the government to incentivise pension saving. Without any government intervention, some people may save too little for their retirement, either from their own perspective or from society's perspective. From the perspective of maximising the individual's own well-being over their lifetime, undersaving could happen for a number of reasons, including individuals':

- finding it difficult to resist the temptation of immediate consumption, even though from a retrospective, or more removed, standpoint the individual would say they should have saved the money rather than using it for current consumption;
- shying away from seemingly difficult, time-consuming or complex financial decisions and therefore not making active decisions – for example, over whether to start a pension or whether to increase contributions when earnings rise;
- having inaccurate information and/or beliefs or, for example, operating a simple 'rule of thumb' that leads to an inappropriately low rate of saving, such as expecting to live to a similar age as their parents or grandparents.

Even if, given correct information and a detached distance, individuals would think they were saving enough, a government could, paternalistically, take a view that they would be better off saving more. For example, some individuals might discount the future benefits from saving quite heavily, and a paternalistic government might decide that there is too great a chance the individual will regret this once retirement has been reached.

It is also possible that individuals could save appropriately in terms of doing what is best for them, but for this saving to be too low from society's point of view. Perhaps the most obvious reason why this might occur is if individuals save relatively little due to the presence of means-tested support for low-income pensioners.

Related to the risk that people save too little is the risk that they spend the money they have saved too soon. For this reason, the government sets a minimum age for withdrawing pension savings without large penalties (currently 55 and set to rise to be 57 by April 2028). This in itself provides a further rationale for subsidising pension saving. Without any tax incentive, some might value the self-control device that a pension provides, but most might rather save in a form that would be accessible were they to need the funds at an earlier stage.

All this suggests that there are good reasons for the tax system to treat saving in a pension more favourably than either spending today or saving in other forms. But the case for tax incentives has to be assessed alongside the case for other – alternative or complementary – policy levers the

government has at its disposal. There are lots of ways that the state can – and indeed does – intervene in order to try to reduce the extent to which individuals are at risk of undersaving for retirement. These include providing:

- state pensions;
- financial education;
- substantial regulation of the pensions industry – for example, over the products it can offer and the information it provides to individuals;
- financial information directly to individuals or mandating others, such as employers, to provide it;
- employers with a requirement to default employees into a workplace pension with, at least, minimum contribution rates.

Tax subsidies to save in a pension are thus just one tool that can be used to tackle undersaving for retirement. There are reasons to think that tax incentives might be more effective when the concern is that individuals might be undervaluing the benefits from pension saving, or where the issue is that means-tested support for pensioners is disincentivising pension saving. In contrast, providing pensions tax incentives is less likely to be effective with individuals who are undersaving due to a lack of good information.

Of course, it is likely that a combination of policies would work well together. For example, the policy of automatic enrolment into workplace pensions might be considered more appropriate – and may be more effective – when pensions tax incentives are in place.

Any tax incentive should be targeted at those for whom more pension saving was deemed desirable, and should seek to avoid affecting behaviour except where that is the specific policy goal. In some cases, there will be practical constraints making neutrality difficult to achieve. For example, while it is desirable in principle to have equivalence in how the tax system treats saving in defined contribution and defined benefit pensions, in practice the differences in how these arrangements operate can make this hard to achieve precisely.

Even where there are good reasons for departing from neutrality, it is likely to lead to undesirable distortions, manipulation and complexity at the boundaries between differently taxed activities. For example, the tax system currently treats employer pension contributions more generously than other pension contributions (in that the former are not subject to either employer or employee NICs). This might be justifiable: it could be that a tax incentive for employer contributions leads to a bigger boost in pension saving among those who would otherwise undersave for their retirement than an equivalent tax incentive for individual contributions. But a consequence of such a system is that effort is expended ensuring that pension contributions are made by employers rather than by employees (for example, via salary sacrifice arrangements or

by designing remuneration packages that are tilted more towards employer pension contributions than employee contributions). This effort, from the point of view of society as a whole, is not productive.

When using the tax system to target retirement saving, one also has to think carefully about the implications of the specific tax lever that is used. It is fairly clear that favouring employer contributions over individual contributions will not benefit those who do not have an employer, most obviously the self-employed. But it also interacts with other features of the National Insurance system. For example, it provides less of an incentive to make employer pension contributions for those who are aged under 21, apprentices aged under 25, new employees earning less than £25,000 in Freeports, certain veterans, or those aged over the state pension age. The decision to provide less of a tax subsidy to employer contributions made by the employers of those in these groups has clearly not been actively made.

## 4.3 Try to keep it simple and stable

Other desirable features of a pensions tax system include being simple and stable. Both would be good features of any tax. Simple taxes will be easier to understand and to operate, aiding compliance and fairness. Incentives that are easier to understand are also more likely to lead to the desired behavioural change.

Stable taxes also tend to be better understood. And where the tax system is trying to encourage long-term decision-making, such as with pensions, stability is particularly desirable. For example, a low rate of tax on pension income might do little to induce younger workers to save more for retirement if the system is constantly being reformed such that they do not trust that the current low tax rate on pension income will endure. One strength of the policy that allows individuals to take up to one-quarter of their pension pot free of income tax is that it has proven remarkably durable, so working-age individuals may feel more able to rely on its still being in place when they reach retirement.

## 4.4 Consider the whole saving cycle

When considering how the taxation of pensions works, it is important to take into account the whole system: how it treats contributions, returns and the eventual drawing of income. It is the combination of these that will determine the relative generosity of different systems which individuals gain/lose from them. Unfortunately, discourse around pensions taxation often treats contributions and withdrawals in isolation. Often the impact of up-front income tax relief on contributions is examined and discussed without considering the fact that income tax is typically levied on pension withdrawals. Saving decisions are inherently about trading off spending now



against saving in order to spend in the future. Therefore, good tax design needs consideration of how to tax throughout the process: when contributions are made, while returns accrue and when money is taken out to spend. The challenge is to do this in such a way that the overall impact of taxation across all these points is contributing in the best way to meet a clear set of objectives.

Consideration of the whole life cycle is also important when assessing the distributional effects of alternative pensions tax systems. Naturally, a clear focus will be how tax payments (or reliefs) are spread across the income distribution. One can assess how the system affects individuals according to their income (or spending) at a particular point in time. As described in Chapter 3, this is often done with a focus on the extent to which the benefits from up-front income tax relief on pension contributions accrue to those who are currently higher- (or additional-) rate income tax payers as opposed to those who are basic-rate (or who are not) income tax payers. But this needs to be considered both alongside the tax that will be levied when they come to withdraw the money from their pension and alongside their income over their life as a whole.

A person's income at a particular point in time is not necessarily representative of their income over their lifetime. People's incomes evolve through their lives, and in many cases can be volatile from year to year (or even from month to month). A lot of low income is temporary – for example, people temporarily not working while ill, caring for someone, studying or between jobs, or self-employed people simply having a bad year. So it is always helpful to think about people's lifetime income alongside their current income; but it is particularly important when analysing the taxation of savings, since people save (and borrow) precisely in order to shift income across their lives, including via pensions. Indeed, people may put more into a pension at precisely those times when their income is unusually high, making pension savers look (in a snapshot) like higher-income people than they really are. For example, a self-employed individual who is a basic-rate income tax payer in the vast majority of years might in a particularly successful year be a higher-rate income tax payer and also choose to make a relatively large pension contribution in that same year. To attribute all of the up-front income tax relief that they receive as going to higher-rate taxpayers is to miss an important aspect of the story.

It is of course much harder to get data on people's lifetime incomes than on their current incomes, but at a minimum we should bear in mind the limitations of looking only at current income and consider carefully what we can learn from the available data.

## 4.5 Consider generational issues and transitional arrangements

It is important to consider how the impact of the system of pensions taxation, and any reforms to it, varies across characteristics other than income. One set is the nine protected characteristics laid out in the Equality Act of 2010: age, sex, race, religion, sexual orientation, disability, marital status, gender reassignment and pregnancy. As well as considering the effects of the pensions tax reforms through the lens of age, the impacts across different generations should be assessed. And when considering how a reform affects (for example) richer and poorer individuals, it will often be appropriate to examine how this varies within different generations as well as across a snapshot of the whole population.

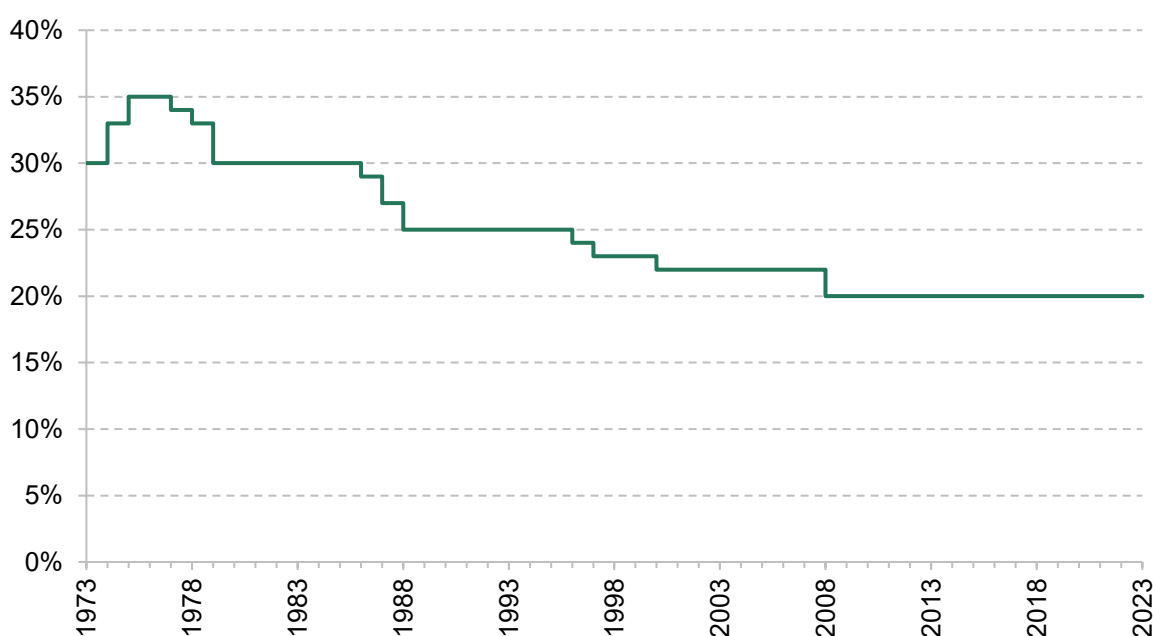
The distribution of tax payments across a cross-section of the population will partly reflect different people being at different stages of their lives: whether they are at their peak earning power, for example; whether they are at a stage when they are contributing a lot to a pension, or drawing from it. It can therefore be helpful to separate out the distributional effects of a system (or reforms) within generations from the distributional effects between generations.

Considering how different generations would fare under different tax treatments links closely to the need to think holistically about how the tax system treats both pension contributions and pension withdrawals, and also the design of any transitional period. Most obviously, while policymakers could set up a new system that works well ‘from scratch’, they would need to make a decision over how to treat those who have already accumulated funds in a pension, perhaps in the expectation of a certain tax treatment. Should any reform only apply to new saving made after the reform is introduced or should there be a ‘retrospective’ change to the treatment of funds that are already in a pension? For example, suppose it was decided that the amount that could be withdrawn from a pension free of income tax should be reduced from one-quarter to one-fifth. At one extreme, this could be introduced immediately, reducing the generosity of the tax treatment of all funds already accumulated in a pension. At the other extreme, it could apply only to those currently aged under 16 and therefore yet to consider pension saving. The choice of either of these extremes would have very different impacts by generation, with the latter approach only affecting those who have not yet started accumulating pensions, and the ‘big bang’ approach also affecting all those with accumulated pensions.

Designing transitional arrangements well is important. But it will usually be a matter of political value judgement as well as economic analysis. Because pension saving can be done many years before the funds are withdrawn, extremely long transitional periods would be required if the tax treatment of some saving is not to have an element of retrospection.

If a tax on existing wealth is increased, this will reduce its value, and therefore effectively impose a windfall tax on those holding that wealth (with tax reductions giving a windfall gain). A little-noticed example occurs when the main rate of VAT is increased: to the extent to which it increases the price level, it will in part be a windfall tax on those with wealth as it will reduce its real value. One can make an argument in favour of this: it can be economically efficient. The tax that applies to already-accumulated wealth will raise revenue – from wealthy people – in a way that does not weaken their incentives to work and save. Or at least it will not damage incentives unless the change leads individuals to change their behaviour in response to worries that such taxes might be used more in future.

**Figure 4.1. The basic rate of income tax over time**



Note: Horizontal axis refers to financial years, with 1973 corresponding to 1973–74 and so on.

Source: IFS Fiscal Facts ([https://ifs.org.uk/tools\\_and\\_resources/fiscal\\_facts](https://ifs.org.uk/tools_and_resources/fiscal_facts)).

The argument against increasing tax on existing wealth is that some people deem it unfair to tax people more than they had been led to expect when they earned and saved the money. This argument is not clear-cut: most tax rises involve some degree of retrospection – it is a spectrum, not binary – and it is debatable how far people can reasonably feel they have a right in future to the tax treatment that happens to be in place when they earn and save the money. And it is important to note that the converse – windfall gains – also sometimes occur. For example, whenever income taxes are cut, this will increase the value of existing pension wealth (which is subject to income tax when it is withdrawn). Figure 4.1 shows how the basic rate of income tax has changed since the early 1970s. While the rate has remained at 20% since April 2008, it was higher before that. The result is that, for example, a 30-year-old who saved in a pension in the early 1990s might have done so in the expectation that those funds would be taxed at the then

basic rate of 25% when they reached retirement. Now aged around 60 they might be withdrawing funds from their pension and paying basic-rate income tax at the now lower rate of 20%: a windfall gain. For 30-year-olds saving in a pension in the early 1980s, the basic rate was 30%, meaning that withdrawals they are now making around age 70 will be worth even more relative to what they might have expected when that saving was done.

When reforming the tax treatment of pensions, the potential need for transitional arrangements will depend on what is being changed. Reforming the tax treatment of pension contributions does not raise the problems described above to any great extent – although even then it is not entirely clear-cut: for example, if one were to propose a large reduction in the amount that can be contributed in a tax-advantaged way to a private pension, it could be argued that some might have saved more in their pension in earlier years had they known that their ability to make pension contributions in future would be more constrained. But the issue of retrospection is more acute where policies affect the tax treatment of existing pension wealth. This might be a reason why governments have seemed more open to changing the tax treatment of pension contributions (for example, reducing the annual allowance) than the treatment of withdrawals (for example, the ability to withdraw up to one-quarter of a pension free of income tax, or how pensions are taxed at death). But if so, a consequence is that earlier generations always end up getting some – potentially full – protection from reforms that make the system less generous, with the full burden only falling on later generations.

Essentially, if wanting to make a change to how the tax system will treat existing pension wealth, there are three options:

- Opt for a ‘big bang’ solution and implement the reform with no transitional protection, which is the administratively simplest solution. This would require either taking the view that it is fine – for example, it could be argued that a particular reform was a reasonable option for a government to take and that individuals should not have simply assumed that current practice would continue – or that it is unfortunate but still the best way to proceed. Such big-bang reforms have occurred: when Gordon Brown’s first Budget in 1997 abolished repayable dividend tax credits, this reduced the value of existing pension wealth.
- Make the change but only for new pension contributions. This ensures, as much as possible, that retrospection is avoided. But it is administratively extremely burdensome as it requires drawing a distinction between ‘old’ and ‘new’ parts of people’s pensions and then maintaining this distinction for decades. This type of approach can lead to a proliferation of arrangements over time as successive reforms occur – which is what had happened in the UK up until the April 2006 ‘A-Day’ pensions tax reforms, and has happened again since then with transitional protection each time the lifetime allowance has been reduced.
- Have a gradual phase-in. This entails trying to balance competing considerations as well as possible, but accepting that there will be both some complexity and some rough justice. This

would involve announcing that the reform will fully apply at some point in the not too distant future alongside a path for moving from the current system to the new one. This needs to be carefully done: in some cases, it might be deemed OK to phase in by the date at which some event occurs – for example, moving to a better system for taxing pensions at death could be phased in over a few years by the date of death (Adam et al., 2022) as future dates of death will be little influenced by the reform. But in other cases, using, for example, the future dates at which funds are withdrawn from a pension, it could create very strong and undesirable incentives for funds to be withdrawn earlier (or conceivably later) in response. In such cases, it might be better to phase the reform by the date of birth of the individual.

## 4.6 Summary

The starting point for the taxation of pensions, as with all taxation, should be neutrality: taxing similar activities similarly. Departures require a clear justification, and it must be possible to target any special tax incentives accurately, such that they achieve their desired objective better than other policies could, and without complexity and side effects outweighing the benefits. But there is a good case for incentivising pension saving: good reason to think that some would, if left to their own devices, save too little for their retirement, and that judicious use of tax incentives (alongside other policies such as automatic enrolment) can help to rectify that.

Would-be reformers should consider how pensions taxation fits into the tax system as a whole. In particular, we should not generally change the treatment of one particular form of income/spending/saving as a way to raise revenue or redistribute, when we have other tools – principally the overall personal tax and benefit rate schedule – which can achieve those goals in a way that treats different forms of income/spending/saving equally. The aim should be to target incentives where they are needed, and otherwise to avoid distorting behaviour, creating complexity and arbitrarily favouring some groups over others. While governments' desire for revenue and redistribution varies over time, the factors making for a simple and efficient tax base change much less, so this approach should also make for stability in the pensions tax system – itself an important contributor to simplicity and helping people to make long-term savings plans and respond to incentives with more confidence.

Although pensions tax reforms should not be pursued for distributional reasons when better-targeted policies are available, it is nonetheless important to analyse who would gain and lose from alternative systems, not least so that policymakers can adjust other policies to achieve their overall desired revenue and distributional patterns. When analysing those distributional effects, we should consider the whole pensions tax regime – the full savings cycle, from contribution to withdrawal; consider the effects by lifetime income, not just a snapshot; and consider how the policies redistribute both within and between generations, not just across a cross-section of the

whole population. The distributional effects of a reform between generations will depend heavily on transitional arrangements. There will often be a trade-off there: for example, if increasing taxes, doing so for existing savings as well as future savings will often be both simpler and more economically efficient (when the money is already there, earning and saving it can no longer be disincentivised) and mean that the older generation shares the burden of the tax rise with the younger generation, but might be considered unfair on those who had saved in the expectation of paying existing tax rates.

## 5. Method for quantifying the impacts of reforms

In addition to applying the economic principles set out in Chapter 4, we quantify empirically the fiscal and distributional effects of the current UK pensions tax system relative to two benchmark systems and of various reform options. Results are shown in Chapters 6 and 7; here we summarise our empirical methods. Appendix A provides full details.

Broadly, our approach is to construct a model that maps the pension contributions of people saving today (in 2022–23) to the income that is expected to result from those contributions during retirement. The model embeds a tax calculator, allowing us to analyse tax payments on pension savings both under the current tax system and under various counterfactual reforms.

This approach allows us to model the *lifetime impact* of tax by considering tax both at the point at which pension contributions are made and at the point at which the subsequent income (i.e. the contribution plus any returns) is withdrawn. This is more limited than the ideal of modelling pension contributions and tax implications in every year of life (which is not possible given available data).<sup>16</sup> But it is a significant advance on current practice in the UK, which considers contributions and/or withdrawals in isolation, thereby precluding analysis of the full effect of tax on distributional outcomes, long-run government revenue or saving incentives.

One consequence of this approach is that where we derive fiscal impacts of potential reforms these refer to the long-term revenue impacts on *current contributions*. That is, the question being answered is ‘How does the total amount of tax on contributions made this year change, accounting for both the tax paid up front at the point of contribution and (in present-value terms) the tax paid when the resulting income is withdrawn in later life?’. This approach yields valuable insights. However, it should be kept in mind that in many cases such figures will not provide a straightforward estimate of revenue impacts in any given year (particularly in the short term). We discuss this further alongside our results in the following chapter.

<sup>16</sup> Modelling the entire lifetime of pension contributions, income and associated tax would allow a richer analysis of tax policy, including by allowing assessment of how reform impacts vary by lifetime income rather than just by income in a single year. This is not feasible in practice. Among current pensioners there are insufficient data on their prior pension saving, while among current savers we would need to forecast income and pension saving in each future year which would be very difficult to do with reasonable accuracy.

The model is based on data from large household surveys, most notably the Wealth and Assets Survey (WAS).<sup>17</sup> WAS provides rich information on the pension saving and wealth of UK households. We create a dataset detailing the pension contributions (both by individuals and by employers) of all working-age households for the 2022–23 financial year, including tax-relevant information such as whether contributions are made on a salary sacrifice basis.<sup>18</sup>

Constructing a mapping between total pension savings today and income in a future period and calculating the effect of tax reforms require various assumptions. These are set out in detail in Appendix A. The key choices we make are as follows:

- 1 WAS documents employee but not employer contributions to defined benefit pension arrangements. Employers' contributions to funded defined benefit pension funds are determined by what is required to keep the fund as a whole solvent, and are not therefore readily attributable to individuals (see Chapter 2). Our approach is to calculate how much it would cost for an individual to buy a fairly priced annuity<sup>19</sup> offering the same benefits as those accrued in their pension in the past year. This quantity is then discounted to account for the fact that benefits cannot be realised until retirement. The resulting amount represents the total value of pension rights accrued this year. Once the employee contribution has been subtracted, what remains is the implied contribution of the employer.
- 2 For defined contribution pensions, withdrawals in retirement will consist of both money saved in the pension during working life and the investment returns earned on those savings while in the pension. We must consider both what rate of return the investments will yield and how to discount future pension income into today's terms. This is complicated by the fact that pension funds may be invested in risky assets, and a risky future stream of income is worth less than a central estimate of its likely value. Our analysis is undertaken assuming that the rate of return on pension investments equals the discount rate: it perfectly compensates individuals for the delay in consumption that their saving entails. In other words, we assume that returns are such that savers value £1 today exactly as much as they value the future income derived from investing £1 in a pension. In effect, this means that our estimates of the value of future pension income, and the tax paid on it, are adjusted for a risk premium. We think this is a sensible approach, and reflects how risky assets are actually valued in the market. But, particularly when looking at tax revenue implications of changing the taxation of future pension income, it is worth highlighting that the estimates we present

<sup>17</sup> WAS is a representative household panel survey, administered by the Office for National Statistics, that has been published biennially since 2008. We make use of round 6 of WAS, uprating all income and pension contributions to a 2022–23 basis in line with average earnings growth.

<sup>18</sup> One tax-relevant question that is not asked in WAS is whether an individual is making contributions on a relief-at-source or net-pay basis. We therefore impute whether individuals are relief-at-source contributors – details of this process can be found in Appendix A.

<sup>19</sup> Taken here to mean an annuity that would yield zero profit to the seller in expectation.



are – unusually – for risk-adjusted expected revenue, not just expected revenue. The expected yield or cost of such changes will be bigger than the numbers we present, but we implicitly adjust them downwards to account for their risky nature.

- 3 It is necessary to estimate the tax rates that individuals will face in the future when withdrawing the income that results from a contribution made today. This is a challenge because it depends on total pension saving (not only contributions made today) and on the amount of non-pension income received in the year of withdrawal. Broadly, we estimate future tax rates in two steps. First, we create a mapping between income in working life and tax rates in retirement. We use information (from household surveys) on a group of recent retirees for whom we observe individual earnings while in their 50s and tax paid on private pension withdrawals while in their 70s. This allows us to ascertain the age- and sex-specific probability of moving from a given earnings quintile in working life to a given average tax rate on private pension income in retirement. Second, we apply this mapping to individuals who are making pension contributions today. That is, we assume that (for example) a female in the top quintile of today’s earnings distribution for her age group will go on to face the same average tax rate on pension income in retirement as a top-quintile female who was working in their 50s and has now retired.

**Table 5.1. Transitions from marginal tax rate in year of pension contribution to average tax rate on pension income at withdrawal**

Marginal tax rate in year of contribution	Average tax rate on pension income in retirement					Total	Average tax rate on pension income
	Non-taxpayer	0% < x ≤ 10%	10% < x < 20%	20%	>20%		
Non-taxpayer	72%	5%	12%	9%	2%	100%	4.5%
Basic-rate taxpayer	39%	8%	33%	16%	4%	100%	9.7%
Higher-rate taxpayer	13%	7%	50%	15%	14%	100%	16.1%
Additional-rate taxpayer	12%	6%	50%	12%	20%	100%	17.2%
All	41%	8%	31%	14%	5%	100%	10.0%

Table 5.1 shows how tax rates faced by individuals in working life correspond to those paid on pension income in retirement (for individuals in our data and using the method summarised above). Unsurprisingly, most (72%) of those who are non-taxpayers in working life (because their incomes are too low to incur tax liability) tend also to be non-taxpayers in retirement. Similarly, those who are higher- or additional-rate taxpayers in working life are more likely than non-taxpayers or basic-rate taxpayers also to be higher- or additional-rate taxpayers in retirement. That said, because incomes in retirement for higher earners are generally lower than income in working life, the majority of those who were higher- or additional-rate taxpayers in

working life are basic-rate taxpayers in retirement (i.e. they pay income tax on their pension income in retirement, but at an average rate of less than 20%). It is also notable that a substantial proportion (39%) of those who pay basic-rate tax in working life become non-taxpayers in retirement.

All of our empirical analysis is done on the basis of ‘no behavioural response’. Specifically, we assume that the total amount of pension saving remains at currently observed levels irrespective of alterations to the tax system. One advantage of this approach is that our modelling applies changes in tax liability to a consistent base across all modelled reforms, allowing magnitudes to be readily compared. It would also be expected to be a good guide to the distributional and fiscal effects of reforms if behavioural responses to reforms were to be small. But it does imply that figures derived from the empirical modelling should be taken as an indicative starting point, rather than the final word, when considering the potential impacts of a reform. Even the direction of the effect that behavioural responses would have on costings is not always straightforward: for example, if an increase in tax on pensions led to individuals choosing to work less then the tax yield would be reduced, but if instead it led to them saving more in other (more heavily taxed) forms then the tax yield could be increased. (In analysing reforms in following chapters, we discuss the likely impact on saving incentives, drawing on evidence where it is available (such as that in Crawford, Disney and Emmerson (2012)), and how that may affect overall revenue.)

Throughout this report, we analyse taxes in isolation from the (important) role that means-tested benefits play. The reform proposals we analyse are all changes to tax policy, holding benefit policy fixed. We discuss how the current system and possible reforms would affect the work and saving incentives created by taxation, ignoring any interaction with means-testing. And our distributional analysis shows changes in tax liabilities, not any knock-ons to benefit entitlements. Incorporating means-tested benefits into our empirical modelling of people’s position in work and retirement would be extremely difficult, as it would require us to estimate/assume not only their income but also any partner’s income and a wide range of family circumstances in both work and retirement.

## 6. Benchmarking the current system

In this chapter, we quantify the generosity of the current system of pensions taxation. Assessing the generosity of the tax treatment of pensions requires the current system to be compared with an alternative system. We compare with two benchmarks:

- First, one where all pension contributions are made from after-tax income (that is, income after both income tax and NICs have been deducted), and no tax is paid on either any investment returns or the subsequent withdrawals from the pension. This is akin to how the tax system treats funds placed in an ISA. It is a pure taxed-exempt-exempt system (or TEE for short).
- Second, one where all pension contributions are made free of tax (both income tax and NICs), there is no tax on any investment returns, but both income tax and NICs are levied on pension income. This would be a pure exempt-exempt-taxed system of taxation (or EET for short).

Moving fully to either of these systems is not likely, and we would not advocate either move. But consideration of these two systems is helpful in putting into perspective the generosity of the UK's current system of pensions taxation and who 'gains' relative to these benchmarks.

### 6.1 Current system compared with TEE

We first compare the current treatment of pensions with the TEE benchmark. TEE treatment would remove up-front income tax and NICs relief from all pension contributions and, in return, abolish income tax on any withdrawals from pensions. There are four notable groups for whom this TEE system would be less generous than the current system:

- First, those who currently receive income tax relief on pension contributions and are able to withdraw at least some of their pension at a lower rate of income tax than the rate at which they received relief by 'smoothing' their taxable income. This will be a large group of income tax payers. Most obviously, it includes those who receive income tax relief at the higher or additional rate and then pay a lower rate of income tax (or no income tax) on at least some of their withdrawals. But it also includes those who receive basic-rate relief on their contributions and then pay no income tax on at least some of their pension withdrawals. Currently, pension contributions made by those groups act to smooth their taxable income

over time and so reduce their total tax paid. A system that collects income tax up front would prevent individuals from being able to do this and increase the tax they pay on a given amount of pension contributions.

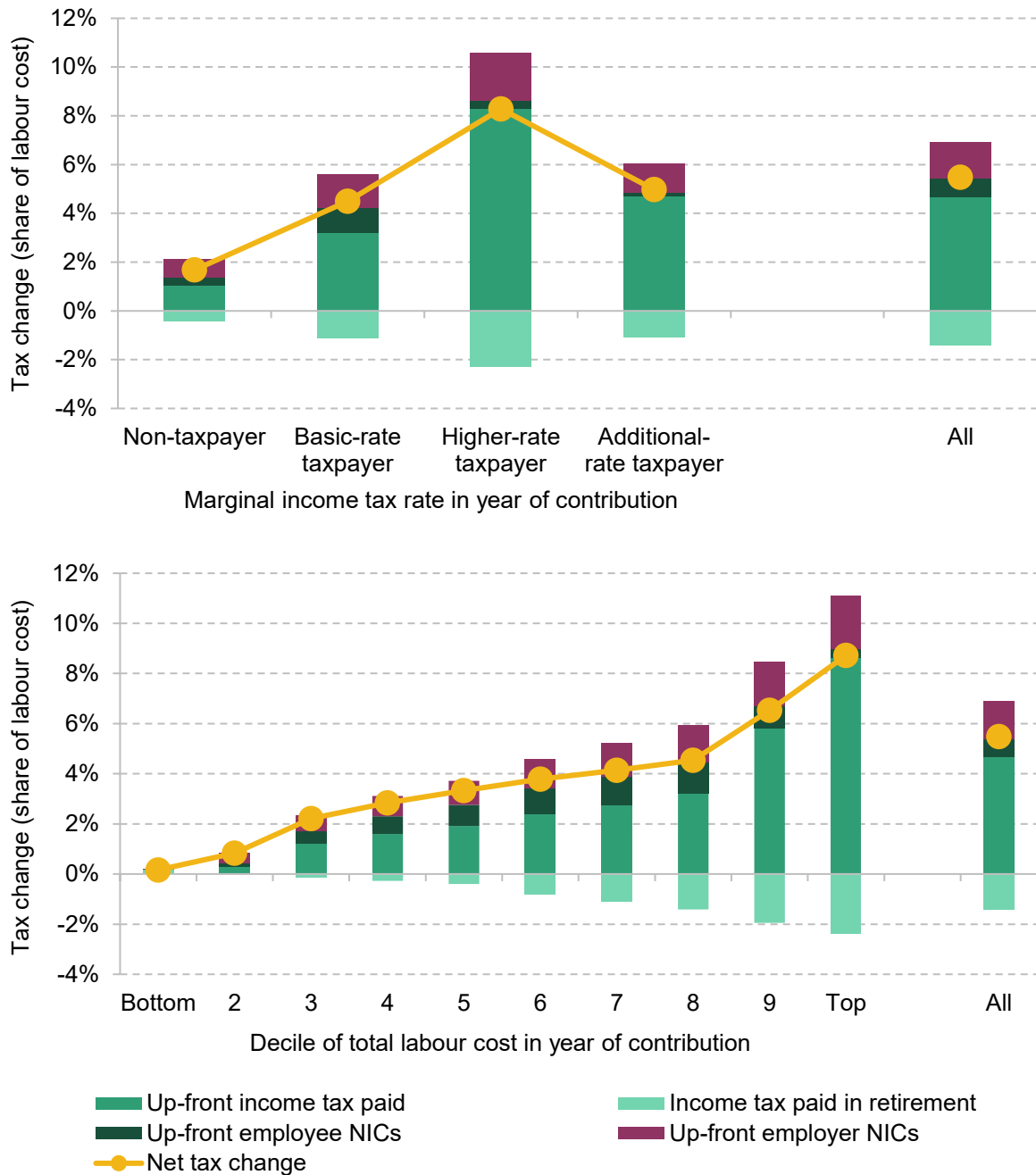
- Second, those who are not currently income tax payers and do not pay income tax on any of their pension income in retirement. This group can currently receive up-front relief on their contributions at the basic rate of income tax. Under TEE, they would continue not to pay any income tax on any of their pension withdrawals but they would lose all of the up-front relief. This group is different from the first group because, while under the current system they receive a higher rate of income tax relief on contributions than they pay on average on their withdrawals, this does not arise due to the smoothing of taxable income.
- Third, those who face a lower rate of income tax on their pension withdrawals than they receive in up-front tax relief because they take advantage of the ability to withdraw up to 25% of their pension pot free of income tax. This is another way in which people, under the current system, receive a higher rate of income tax relief on contributions than they pay on average on their withdrawals, that does not arise due to the smoothing of taxable income.
- Fourth, those receiving employer pension contributions. Under TEE, both employee and employer NICs would be applied to pension contributions made on individuals' behalf by their employers. This is in contrast to the current system where employer pension contributions escape employee and employer NICs entirely.

These are the groups who can be described as 'gaining' from pensions being taxed as per the existing system rather than a TEE system.

There are some individuals who would pay less tax under TEE than under the current system. One group will be those who are able to get particularly high returns on their savings: as described in Chapter 3, these high returns would be entirely untaxed under TEE. The other group is some of those who currently end up paying income tax at a higher rate in retirement than when making pension contributions. Some of these individuals might under the current system be better off saving for retirement through something other than a pension (for example, by using a lifetime ISA). This group is likely to be small.

Figure 6.1 quantifies the difference in average tax paid under an entirely up-front system of taxing pensions relative to under the current system. There is a substantial difference in the tax burden under these two systems, with a TEE system raising – according to our model – the equivalent of around £46 billion more a year in today's terms than the current system (a little over the total revenue raised in 2022–23 from council tax). TEE would raise additional up-front revenue from working-age contributors equivalent to around £58 billion a year (£39 billion from

Figure 6.1. Difference in tax paid by working-age earners under full up-front taxation of pensions, compared with the existing tax system



Note: Total labour cost refers to pre-tax earnings plus pension contributions (including employer pension contributions) and employer NICs. Our sample is all individuals aged between 20 and 64 with income from either employment or self-employment. For tax payments made in retirement, figures represent the total net present value, at the point of contribution, of all additional tax payments made across retirement (see Chapter 5 and Appendix A for details).

Source: Authors' calculations using the 2016–18 Wealth and Assets Survey, updated to 2022–23 terms as described in Appendix A.

additional income tax revenue and £19 billion from additional NICs<sup>20</sup>). This is partially offset by the reduced revenue from exempting pension withdrawals from income tax, a tax reduction equivalent to around £12 billion a year for current contributors in today's terms. (Though recall from Chapter 5 that this £12 billion is implicitly adjusted downwards to reflect its riskiness: if pension funds earn a high return, this figure would be higher, with consequences for the other figures in this paragraph.) In other words, our estimates suggest that the current tax treatment of pensions is equivalent to a £46 billion a year tax subsidy when measured relative to a counterfactual system where pension contributions are taxed up front.

HMRC's estimate for the overall amount of pensions tax relief on contributions in 2020–21, net of the income tax paid on pension income *in that same year*, is £45 billion (as set out in Chapter 3, HMRC quotes a total amount of relief, net of income tax paid on pension income, of £48 billion as it also includes income tax relief on investment returns of £3 billion). Our benchmarking exercise asks the, arguably more appropriate, question of what is the value of up-front tax relief on current contributions, net of income tax that will be paid *on those contributions when withdrawn*. Our modelling exercise suggests that, at least at present, these two different questions give quantitatively similar answers.

As shown in the top panel of Figure 6.1, higher-rate taxpayers see the largest 'subsidy' to their pension saving, as a share of total remuneration, with additional-rate taxpayers seeing a slightly higher 'subsidy' than basic-rate taxpayers. The reason that additional-rate taxpayers 'benefit' less than higher-rate taxpayers is that pension contributions are a smaller share of income for the former group. The bottom panel shows that overall, each decile is found to benefit from the current system, relative to one where pension contributions were taxed up front, with higher-earning groups benefiting more. Indeed, the top 10% of earners would contribute just under 50% of the additional revenue that would be raised by a TEE system, compared with the current system. This is because these individuals, on average, receive larger employer contributions and also, under the current system, tend to benefit most from smoothing their taxable income – that is, they are able to receive up-front income tax relief at a higher rate than they end up paying on part or all of their pension income.

The average additional tax payments under TEE, compared with the current system, split by region, sex and sector – or, equivalently, the benefits of the current tax system, relative to one where pension contributions are fully taxed up front – are broken down in Table B.1 of Appendix B. Those regions with a higher share of higher earners would see a greater additional tax burden under TEE than the current tax system. Earners in the South East and London would pay tax on their contributions worth £2,200 more in today's terms, equivalent to a rise of around

<sup>20</sup> These estimates are similar to HMRC's figures for 2020–21 of £41 billion up-front income tax relief on contributions and £23 billion from NICs relief on employer contributions.

6% of labour cost (i.e. earnings plus employer pension contributions). This compares with around £1,300–£1,500, or 5% of labour cost, for those in the North East, North West and South West. Against the TEE benchmark, those in the South East and London get a £900 greater annual subsidy from the current pensions tax system than those in the North West.

On average, we find that moving to a system where pension contributions are fully taxed up front would increase cash tax bills of men more than women (because the former tend to have higher earnings), but when measured as a share of earnings the impact would be almost identical. Women would lose, as a share of earnings, more from applying employer and employee NICs to employer pension contributions. This may be because they are more likely to work in the public sector and enjoy membership of a relatively generous defined benefit pension arrangement. As can be seen in Table B.1, the rise in tax bills would be higher for public sector employees than for those working in the private or not-for-profit sectors.

## 6.2 Current system compared with EET

We next compare the current system of pensions taxation with the EET benchmark. An EET system of taxing pensions differs from the current system in the following ways:

- It would remove the 25% income-tax-free component currently available for pension withdrawals.
- Full relief from employee and employer NICs would be applied to individual pension contributions as well as employer pension contributions. But both employee and employer NICs would be levied on pension withdrawals.

One interpretation of EET would be that the annual and lifetime allowances would be removed, but we do not model that here.

The following groups would be taxed more highly under EET than under the current system:

- Those who receive employer pension contributions and have sufficiently high retirement income that they would pay NICs when making pension withdrawals in retirement. The current system already gives up-front NICs relief to employer pension contributions so these contributions would be taxed in the same way at the point of contribution under both systems. But these people would have to pay NICs on the pension income that results from their employer contributions under EET, which is not the case under the current system.
- Those who take advantage of the 25% income-tax-free component of withdrawals. This means all those who pay income tax on their withdrawals in retirement.
- Those who make employee contributions above the National Insurance upper earnings limit (UEL) and withdraw at least part of the resulting pension income at a level that attracts a

higher rate of NICs. Under EET, contributions above the UEL would qualify for up-front NICs relief at a rate of 2%, whereas the main rate of employee NICs that would be faced on income drawn between the lower earnings limit and upper earnings limit in retirement would be 12%. It is therefore quite possible for someone with a high working-life income and who uses pension saving to smooth their income to face higher NICs under EET than under the current system.

There are some people who would be taxed no more highly – or perhaps less highly – under EET than under the current system:

- Those with retirement incomes that are low enough that they do not face any income tax on their pension withdrawals are not affected by whether or not 25% of pension withdrawals can be taken income-tax-free.
- Someone who makes individual contributions that benefit from up-front relief at the main NICs rate of 12% and whose resulting retirement income means that some of their pension income would fall below the point where NICs start to be paid so that their average rate of NICs in retirement would be lower than 12%.

The same person can be in more than one of the groups set out above. For example, someone who makes individual pension contributions that, under the current system, benefit from up-front relief at the main NICs rate and whose resulting retirement income means that some of their pension income would fall below the point where NICs start to be paid (meaning they would pay less NICs on those contributions under EET) is someone who also benefits from the 25% tax-free amount (meaning they would pay more income tax under EET).

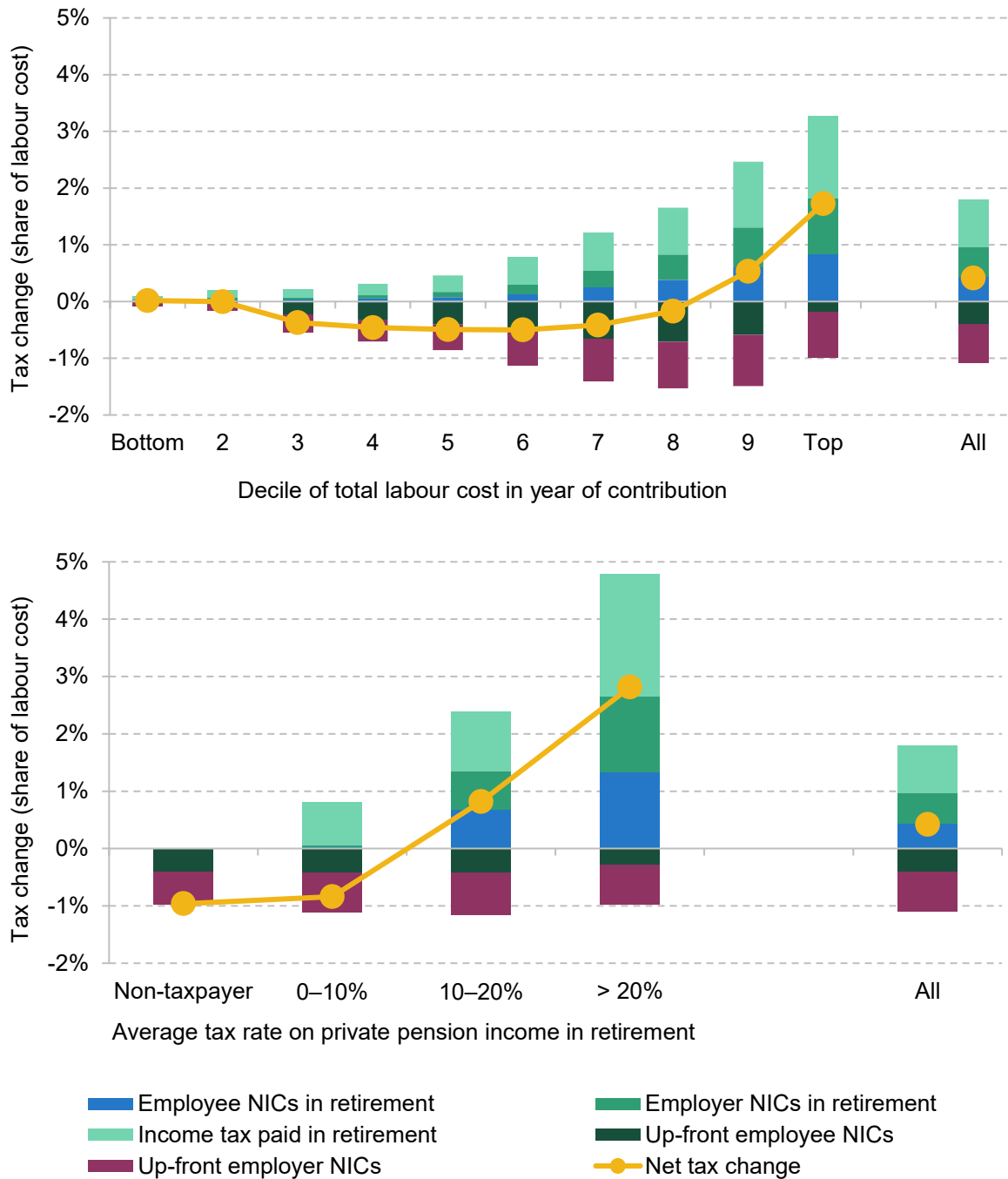
Figure 6.2 illustrates how the tax liability arising under EET would differ from the current system. The EET benchmark would, on average, represent a net tax rise of £4.4 billion (in today's terms) on current pension contributions. This is the net effect of a £5.5 billion increase in income tax arising from the abolition of the 25% tax-free component, a £9 billion cost of providing NICs relief on individuals' pension contributions and an £8 billion yield from levying NICs on all pension withdrawals.<sup>21</sup> Again, the revenue from the tax rises on future income (and therefore from EET as a whole) would be higher if we allowed for pension funds to earn high returns and ignored the associated risk.

This £4.4 billion higher tax paid under EET is far less than the estimated £46 billion additional tax that would be paid under TEE. In other words, the extent to which we think the tax system is

<sup>21</sup> The £9 billion in up-front relief breaks down as £3.3 billion and £5.7 billion reductions in employee/self-employed and employer NICs respectively; the £8 billion increase in NICs on pension income breaks down as £3.6 billion in employee/self-employed NICs and £4.4 billion in employer NICs.



Figure 6.2. Difference in tax paid by working-age earners under an EET system, compared with the existing tax system



Note: Total labour cost refers to pre-tax earnings plus pension contributions (including employer pension contributions) and employer NICs. Our sample is all individuals aged between 20 and 64 with income from either employment or self-employment. For tax payments made in retirement, figures represent the total net present value, at the point of contribution, of all additional tax payments made across retirement (see Chapter 5 and Appendix A for details).

Source: Authors' calculations using the 2016–18 Wealth and Assets Survey, updated to 2022–23 terms as described in Appendix A.

giving a ‘subsidy’ to pension saving depends on what our benchmark is. The reason that the current system is much more generous when compared with the TEE benchmark than the EET benchmark is that far more people face higher income tax rates in work than in retirement than vice versa. This means that levying income tax on pensions in retirement will, all else equal, mean a lower lifetime tax burden than taxing them in working life. Similarly, many of those making individual pension contributions would gain from up-front NICs relief but pay little or no NICs on pension withdrawals (although, conversely, high earners would get only 2% employee NICs relief on contributions but might pay 12% employee NICs in retirement).

Figure 6.2 shows how the ‘subsidy’ to pension saving provided under the current system (compared with the EET benchmark) is distributed across the earnings distribution and across those facing different tax rates in working life. For the bottom 80% of earners, moving to a system where pension contributions were fully relieved and pension withdrawals fully taxed would represent a modest tax reduction on average. This is because, on average, the NICs relief in the year of contribution more than offsets the increased tax (from both NICs and the removal of the 25% tax-free component) on pension withdrawals. They often end up on lower retirement incomes – and therefore face the lower rates of tax shown in the lower panel.

Contributions made by the top 20% of earners would be meaningfully higher under EET than under the current system (lower panel of Figure 6.2). This is because these people typically end up on higher retirement incomes, which means that they would lose more from the abolition of the 25% tax-free component, and would also face a higher average rate of NICs on their pension income. In addition, their higher earnings while working make it more likely that they are only paying employee NICs at a rate of 2%, and therefore, if they are making individual pension contributions, they would gain relatively little from the extension of employee NICs relief to these contributions.

Estimates of how the additional tax payments under EET would differ by region, sex and sector can be found in Table B.2 of Appendix B. Equivalently, this shows the estimated benefits of the current tax system, relative to EET, for each group. On average, we find that the biggest tax rise would fall on those in London and the South East. This is because individuals from these regions are more likely to be higher earners when working (and therefore to benefit from just 2% up-front employee NICs relief under EET) and to face a higher marginal NICs rate in retirement than others (due to their relatively higher retirement income). The larger difference in tax for higher earners is also why, on average, moving to EET would be a tax increase for men and a tax cut for women. Perhaps surprisingly, the increase in tax would also fall more heavily on private sector workers than public sector workers (for whom it is on average a tax reduction). While the latter typically have bigger employer contributions (which would become more heavily taxed), they also typically have bigger employee contributions (which would become less heavily taxed).

## 7. Options for reform

This chapter discusses some options for reforms to the tax treatment of pensions. For each reform, we set out how it sits with the principles set out in Chapter 4, what the reform would do to different individuals' incentives and any practical issues around implementation including consideration of how a transition might work. We also set out the distributional impact of each reform, by income and by some other key characteristics, using the methodology set out in Chapter 5 and – where possible – produce a costing under an assumption that the amounts individuals save in a pension would not be changed by the reform.

The chapter starts, in Section 7.1, by considering two commonly advocated reforms to the tax treatment of pension contributions: first, restricting up-front income tax relief to the basic rate, and second, moving to a flat rate of up-front income tax relief for all. As neither reform aligns with the principles we set out in Chapter 4, and both would face substantial practical issues around how to assign employer pension contributions made to defined benefit pension arrangements to individual employees as they accrue, we do not recommend either is implemented. But we hope that our analysis makes a positive contribution to the debate around these often-proposed policies.

We then turn to reforms that we do advocate as they would improve the efficiency and fairness of the tax treatment of pensions. In Section 7.2, we set out improvements to how NICs treat pension contributions and pension income. In Section 7.3, we set out how the effective subsidy provided by the ability to withdraw up to 25% of a pension free of income tax could be better targeted at those who are at risk of undersaving for retirement. In Section 7.4, we consider how the limits on how much can be saved in a pension – both each year and in total – could be reformed to work better. The estimated impact of implementing all of these changes as a package is set out in Section 7.5.

One area we do not consider in this report is how the tax system treats pension pots that remain at death. We addressed that in a separate recent report (Adam et al., 2022), which noted that it is bizarre that the tax system treats pensions more generously as a vehicle for bequests than it does as a vehicle for providing a retirement income. As that report set out, there are solutions that would not in principle be difficult to implement: income tax should be levied on withdrawals from an inherited pension, regardless of the age at which the individual dies, and remaining pension pots should be counted as part of an individual's estate for inheritance tax purposes.

## 7.1 Reforms to ‘up-front’ income tax relief

We now turn to discuss the potential impact of two commonly proposed reforms: first, restricting up-front relief to the basic rate of income tax, and second, moving to a flat rate of up-front relief (where we choose to model a 30% rate). We are not advocating either reform, for two reasons, the first of which is a principled one and the second a practical one:

- First, while it is often claimed that it is ‘unfair’ that some people (particularly better-off people) get a higher rate of tax relief on their pension contributions than others do, it is not clear that limiting the ability of higher earners to smooth their taxable income through their lifetimes would actually be an improvement.
  - Pension contributions are tax-deductible only because the future pension income will be taxed instead; if there is a case for relieving all pension contributions at the same rate, there would equally be a case for taxing all pension income at the same rate too.
  - A more reasonable argument is that it is ‘unfair’ for people to get higher-rate relief on their pension income but pay only basic-rate tax on their pension income. But allowing individuals to smooth their taxable income across years moves us closer to taxing people based on their average income, which might be considered fair: not allowing this would penalise those who have higher incomes in some years and lower incomes in other years relative to those with the same average income but received evenly.
  - There is a counterargument that the existence of pensions does not mean everybody’s taxable income is smoothed across their lifetimes: some people do not know enough about how their income is likely to change in future; some might not want to save in a pension; some might have higher spending needs in some parts of life than others,<sup>22</sup> others do not have the financial sophistication. This means that allowing smoothing reduces the inequity between those with stable incomes and those with variable incomes, but creates inequity between those who smooth their variable incomes and those who do not. Reasonable people can take different views on that.
  - It should also be remembered that it is not just higher- and additional-rate taxpayers who benefit from getting a higher rate of tax relief on their pension contributions than they end up paying in retirement: our model estimates that 41% of individuals will not pay income tax in retirement (see Table 5.1) and all of these individuals could receive up-front income tax relief on their pension contributions at least at the basic rate of income tax. The same logic that says it is ‘unfair’ for people to get higher-rate relief on contributions and pay only basic-rate tax on withdrawals would presumably imply that it

<sup>22</sup> If this higher spending need could be met with borrowed money (allowing pension saving to continue when both costs and income were high) then this need not result in taxable income that is not smooth. In practice, access to borrowing is often constrained and can be costly.

is equally ‘unfair’ for people to get basic-rate relief on contributions and pay no tax on withdrawals.

- If the aim of such a reform is merely to increase taxes on those with higher incomes then this could be achieved by changing rates and thresholds in the income tax system.
- Second, both the reforms would require assigning employers’ contributions to defined benefit pensions accurately to individuals and it is at best questionable whether this could be done with sufficient precision to avoid arbitrary unfairness and distortions. To give an example: suppose an employer made pension contributions equivalent to 25% of the total wage bill of pension members. This could imply that all active members benefited from an employer’s pension contribution in that year worth 25% of their salary. But perhaps part of the contribution was to fill a pension deficit created by retired members living longer than expected: not taxing this contribution would create a bizarre incentive to try to underfund pensions, but which individuals should pay the tax? And the pension contribution made in respect of new accrual among active members might be more valuable to some than others – for example, because they are closer to drawing their pension, or because they expect to live for longer or, in a final salary arrangement, because they now expect to be promoted in the future. Adjusting accurately for all these factors would be difficult to say the least. With (as shown in Chapter 3) half of up-front income tax relief being in respect of contributions to defined benefit pensions, this is far from a minor issue.

Although we do not recommend these reforms, our model allows us to shed light on what their impacts might be, and so we are publishing this analysis in order to contribute to the debate around these types of options.

### Restricting up-front relief to the basic rate

Restricting relief to the basic rate refers to the capping of up-front income tax relief available to pension contributions (both employee and employer) at 20%. In effect, those who would have paid higher- or additional-rate income tax on all or some portion of their pension contributions were pension contributions made from after-tax income would instead pay the difference between the basic rate and their marginal income tax rate (so 20% for a higher-rate taxpayer and 25% for an additional-rate taxpayer) on that portion of their pension contributions. There would be additional impacts: for example, more parents would lose some or all of their child benefit due to their taxable income being pushed above £50,000, while those who saw their taxable income pushed above £100,000 would lose some or all of their personal allowance and some would also lose entitlement to free childcare.

This would greatly limit opportunities for individuals to smooth their taxable income over time, effectively ending the ability for higher- and additional-rate taxpayers to reduce their tax bill by shifting income into years where they expect to be basic-rate taxpayers. It is important to note that it is not just current higher- and additional-rate income tax payers who would lose from this

change: the restriction of up-front relief would also hit those whose income plus their pension contributions pushed them into higher-rate income tax. The reform might be seen as being particularly harsh on (the admittedly relatively small group of) higher-rate income tax payers who end up paying higher-rate income tax in retirement: if the tax relief they receive on pension contributions is to be limited to the basic rate of income tax, one might think the income tax rate on pension income should also be limited to the basic rate.

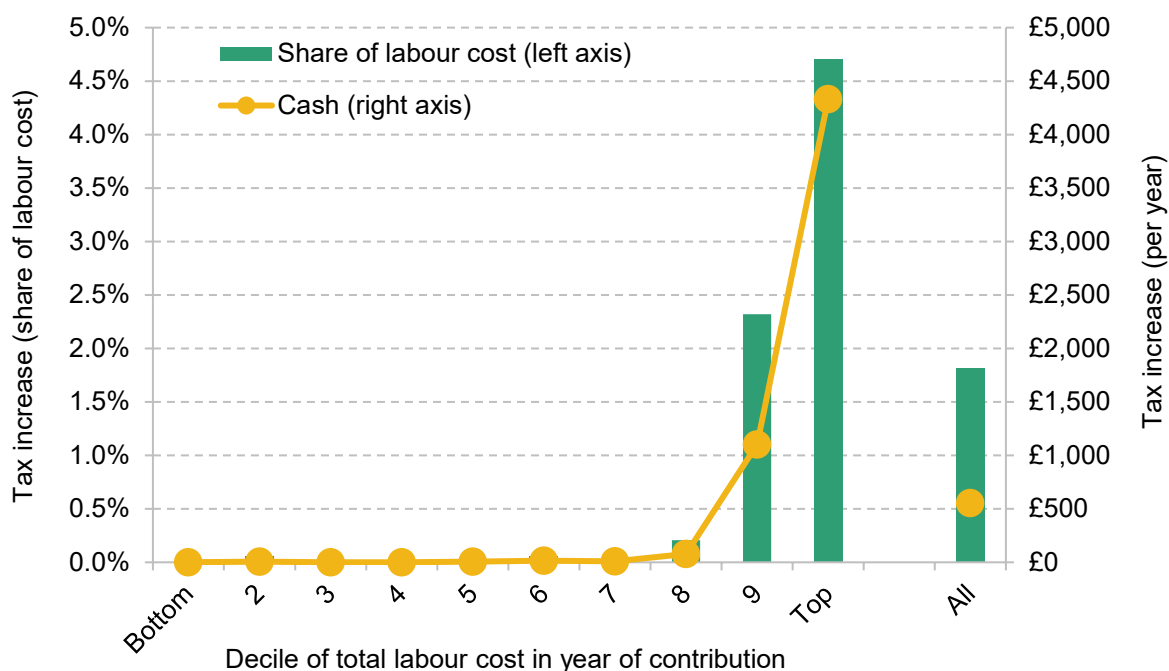
We estimate that limiting income tax relief to the basic rate would represent a £15.1 billion increase in taxation – slightly less than the revenue that would be raised from a 3 percentage point increase in the basic rate of income tax.<sup>23</sup> Higher- and additional-rate taxpayers would have a much reduced incentive to save in a pension, and also weaker work incentives.

As with moving to a system where pensions were fully taxed up front, it would also raise the issue of how to attribute accurately employers' defined benefit pension contributions to individuals.

For those individuals benefiting from particularly large employer contributions – who perhaps are brought into higher-rate income tax as a result of the reform – the resulting income tax increase could be sizeable relative to their current income. For example, if an individual whose earnings put them just below the higher-rate threshold has a pension contribution of 30% (high but by no means implausible), restricting tax relief to the basic rate would see them face an increase in their income tax bill of 6% of their earnings (or just over £3,000 a year). In addition, they would lose entitlement to any child benefit: for two children in 2022–23, this would be a further loss of £1,890, bringing the total bill up to nearly 10% of their earnings. For someone with an income of £100,000 making a 30% pension contribution, the increase in income tax bill would be £11,028, or just over 11% of their earnings, since as well as losing 20% relief on their £30,000 pension contribution their taxable income would rise to £130,000 meaning that they would also lose their income tax personal allowance.

As can be seen from Figure 7.1, the substantial increase in tax from this reform would fall almost exclusively on the top 20% of earners, with the bottom 80% (who already tend to receive income tax relief on pension contributions at only the basic rate) experiencing little to no change. For the top 10% of earners, such a reform would represent an average annual tax increase of £4,300 a year – around half of what they would see under a wholesale move to taxing pension contributions fully up front (see Section 6.1). For breakdowns of the impact of such a reform by region, sex and sector, see Table B.3 of Appendix B.

<sup>23</sup> <https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes/direct-effects-of-illustrative-tax-changes-bulletin-june-2022>.

**Figure 7.1. Impact of limiting up-front income tax relief on pension contributions to the basic rate**

Note: Total labour cost refers to pre-tax earnings plus pension contributions (including employer pension contributions) and employer NICs. Our sample is all individuals aged between 20 and 64 with income from either employment or self-employment.

Source: Authors' calculations using the 2016–18 Wealth and Assets Survey, updated to 2022–23 terms as described in Appendix A.

### Flat rate of up-front relief

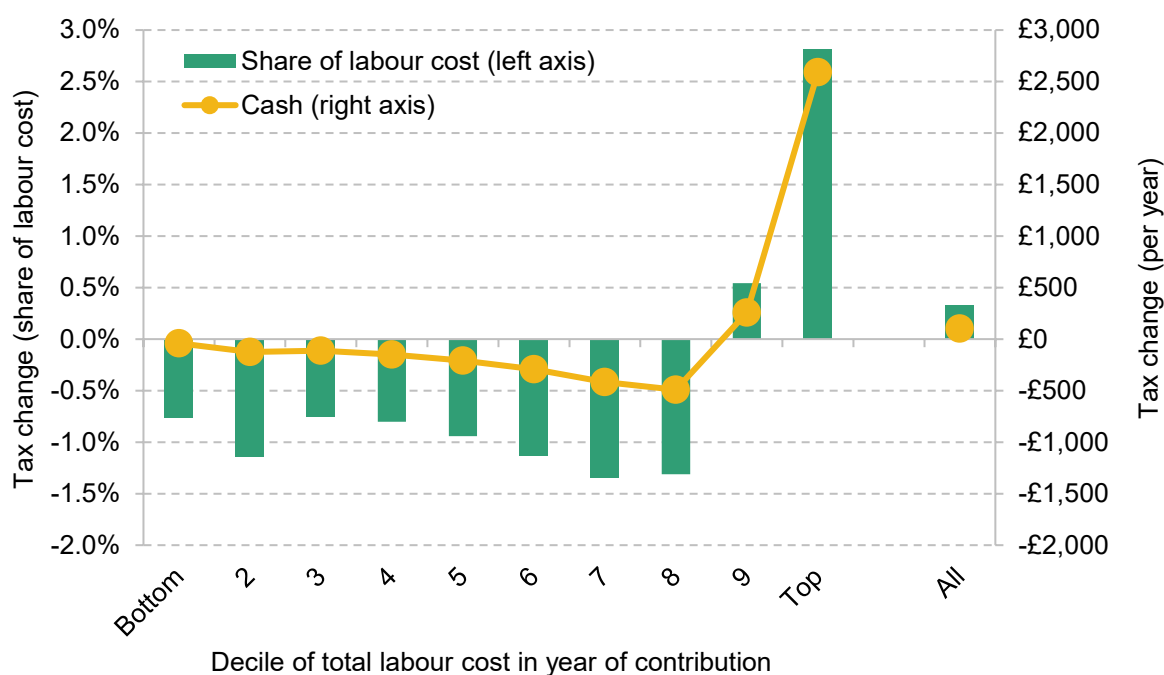
Rather than simply capping the up-front income tax relief available on pension contributions, one could instead impose a flat rate of relief. One way to operationalise this would be for pension contributions to be made after income tax has been deducted (so pensions would be subject to income tax up front) and then for these contributions to be subsequently topped up. This could be done at a rate of, for example, 30%. This would be equivalent to basic-rate taxpayers receiving an additional 10% top-up on their pension saving and higher-rate taxpayers being taxed at a rate of 10% on their contributions. Subsequent pension withdrawals would then be subject to income tax as is currently the case (so, for example, up to 25% could be taken free of income tax while the remainder would count as taxable income in the year it was withdrawn).

As with limiting up-front income tax relief to the basic rate, pension savers who were higher- or additional-rate taxpayers would lose and would face a reduced incentive to save in a pension and also a reduced incentive to work. For higher-rate taxpayers, with a 30% top-up, the increase in their tax bill – and the reduction in their incentive to save in a pension – would be half what it would be were relief restricted to the basic rate of income tax. Those currently getting relief at the basic rate of income tax would gain and face an increased incentive to save in a pension and an increased incentive to work. Again, there would be the substantial complexity of how to

attribute employers' pension contributions to individuals: to reiterate, it is far from clear this reform could be implemented without creating unfairness and oddly distorted outcomes for some.

Like limiting up-front income tax relief to the basic rate, the reform might be seen as particularly harsh on higher-rate income tax payers who end up paying higher-rate income tax in retirement: if it were considered fair to limit the effective tax relief on pension contributions to, say, 30%, it might be considered fair also to limit the tax rate on pension income to 30%.

**Figure 7.2. Impact of moving to a flat 30% rate of up-front income tax relief on pension contributions**



Note: Total labour cost refers to pre-tax earnings plus pension contributions (including employer pension contributions) and employer NICs. Our sample is all individuals aged between 20 and 64 with income from either employment or self-employment.

Source: Authors' calculations using the 2016–18 Wealth and Assets Survey, updated to 2022–23 terms as described in Appendix A.

Figure 7.2 shows the distributional consequences of imposing a 30% flat rate of income tax relief on all pension contributions. Our estimates suggest that this would lead to a £2.7 billion increase in tax – and that a revenue-neutral reform could be achieved with a 32% top-up (although, as discussed in Chapter 4, achieving the right system of pensions taxation is unlikely to coincide with a reform being revenue neutral). On average it would represent a tax increase for the top 20% of earners, with the top decile seeing an average tax increase of just under £2,600 a year. The bottom 80% of earners, meanwhile, would on average see a tax reduction of around £230 a year as a result of the top-up provided to pension saving undertaken by basic-rate taxpayers. Within the bottom 80% of earners, the policy is mildly regressive, which is driven by



the fact that, within this group, pension contributions are relatively higher among higher earners, which means they would benefit more from the new top-up.

This redistributive aspect of the policy would also extend in a geographic dimension. London, the South East and the East of England would all experience substantial average tax increases, while Northern England, the Midlands and Wales would all see their average tax burden reduced. This aspect of the reform's impact can be seen in greater detail (along with a breakdown of impacts by sex and sector) in Table B.4 of Appendix B.

## 7.2 Improving the National Insurance treatment of pensions

We now turn to the first of the areas where we are advocating reform. NICs on employee earnings have both an employer and an employee component (obviously NICs for the self-employed do not, making self-employment generally tax-favoured). Both of these components can be levied – at the point of contribution, accumulation withdrawal, or not at all – on both employer and employee pension contributions. Currently, employee contributions to private pensions are subject to both employer and employee NICs up front, and no NICs are levied on either returns or when pensions are withdrawn. So, in this case, NICs are levied once and only once. But contributions to a pension made by an employer on an individual's behalf escape both employee and employer NICs entirely: they are levied neither on the contributions nor when the pension is subsequently withdrawn.

This provides a very generous subsidy to employer pension contributions. Employer pension contributions to finance new pension accruals escape a total of £18.6 billion<sup>24</sup> a year in NICs (£12.5 billion in employer NICs and £6.1 billion in employee NICs) relative to levying both employer and employee NICs up front on all such pension contributions. But it is a rather opaque form of subsidy, and it is not well designed. For example:

- It changes in generosity when the rates of NICs change.
- It is not available to those without an employer, most obviously the self-employed.
- Among employees, it encourages pensions to be arranged in such a way that any contributions are notionally made by the employer – most explicitly via salary sacrifice arrangements – and particularly benefits those who have an employer that facilitates this.

<sup>24</sup> This figure is somewhat lower than that published in HMRC's cost of pensions tax relief tables (<https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics/private-pension-statistics-commentary-september-2022#the-estimated-cost-of-pension-relief>), because we exclude contributions made to defined benefit arrangements by employers to finance deficits resulting from the underfunding of previously accrued entitlements.

It is hard to see why these features should be desirable. Both employee and employer NICs treatments of employer pension contributions need to be reformed. But they should be reformed in different ways. In short, for employee NICs, it makes sense to align with income tax – i.e. to move to an EET tax treatment. This avoids the need to assign employers’ defined benefit pension contributions to specific individuals. But for employer NICs, EET treatment is not practical. This is because once someone has retired it would not be practical to bill their previous employers for the employer NICs on their pension income (not least because those employers may no longer exist), and it would be a difficult sell – to say the least – to bill the retiree for employer NICs not paid. It would, however, be practical to apply TEE employer NICs treatment to employer pension contributions: because employer NICs is broadly flat-rate, it could be levied on all employer pension contributions without the need to attempt to assign employers’ defined benefit pension contributions to specific employees. While moving in this way to EET employee NICs treatment and TEE employer NICs treatment of employer pension contributions would move closer to neutrality, there may be good reasons for keeping a subsidy for employer pension contributions – but the subsidy should be decoupled from the NICs rate that a particular individual or employer happens to face at a particular point in time. Below we take each element of these reforms in turn.

### **Extending up-front employee NICs relief to individuals’ pension contributions, and phasing in employer NICs on pension withdrawals**

As described in Chapter 6, TEE (taxing pension contributions) and EET (taxing pension income) would be two reasonable, coherent benchmark approaches to taxing pensions. In practice, however, it would not be straightforward to apply employee NICs to employer pension contributions on a TEE basis. This is because employee NICs have a banded structure: they are levied at a main rate of 12%, but this then falls to 2% at the upper earnings limit (£50,270 a year in 2023–24). Given also the difficulty of assigning employers’ defined benefit pension contributions accurately to individuals, this points to instead adopting EET treatment: aligning how employee NICs treat pension saving with how income tax does.

As a result, we propose making two changes: first, extending employee NICs relief to all individual pension contributions; and second, levying employee NICs on pension withdrawals.<sup>25</sup>

<sup>25</sup> We assume that employee NICs would be levied on an individual’s total private pension income, rather than having a separate employee NICs threshold for each pension (like people with more than one job have a separate NICs threshold for each job); otherwise the system would strongly favour having a number of separate pensions rather than a single consolidated one. This would add somewhat to the administrative burden of the tax, though it might be possible to use the income tax apparatus to alleviate that.

As well as practicality in the treatment of defined benefit pensions, adopting EET treatment would have a number of other advantages over TEE. It would align the timing of NICs revenue more closely with additional public spending pressures from having more pensioners. It would reduce any inappropriate incentives the retired might have to vote for increases in the rate of employee NICs (having perhaps opposed them while working). It would also mean that unusually high returns on pensions were taxed more similarly to earned income – which is appropriate regardless of whether those returns arise from luck, skill or effort. Individuals and generations that did relatively well from investments would share those spoils, via higher tax payments, with those that fared less well.

The clear group of losers would be those who receive sizeable employer pension contributions. Currently, these escape employee NICs entirely. Under our reformed system, they would continue to attract up-front relief, but the pension withdrawals that they facilitate would become liable to NICs. Employees would have less reason to want their employer to remunerate them in the form of pension contributions – something we address later in this section.

There would also be a clear group of winners: employees who currently make individual contributions during working life while facing the main rate of NICs. They would now receive employee NICs relief up front, at a rate of 12%. When they withdraw their pension, only those withdrawals above the primary threshold (£12,570 a year in 2023–24) would be subject to employee NICs at this rate: so typically some, and potentially all, of their pension withdrawals would be free of employee NICs.<sup>26</sup> So this group would face an increased incentive to provide retirement income for themselves through a pension.

Our proposed reform would also have a subtle impact on the extent to which individuals could reduce their lifetime tax bill by smoothing their taxable income. In the case of income tax, those who are higher-rate taxpayers when working and basic-rate taxpayers when retired can reduce their overall tax bill by saving more in a pension. They will get income tax relief at 40% (the higher rate of income tax) and end up paying income tax at 20% (the basic rate of income tax).

The rate structure of employee NICs is different. The main rate is 12%, but at the upper earnings limit – which for someone with only (stable) earned income is the same point as the income tax higher-rate threshold – it falls to 2%. This means that someone who has some earnings above the UEL and contributes them to a pension and then has pension income that does not exceed the UEL pays less tax relative to a system with EET employee NICs. In other words, because of the fact that the employee NICs rate *falls* at the upper earnings limit, whereas the income tax rate

<sup>26</sup> We envisage that the NICs earnings period for pension income would be set at one year, and that all pension withdrawals would be treated as coming from a single source – and thus benefit from a single primary threshold – in order to avoid creating a tax incentive to split pension wealth across multiple pots.

*rises* at the higher-rate threshold, those who earn above the UEL / higher-rate threshold and use pension contributions to smooth their post-contribution income do better under EET income tax (relative to TEE) but do better under TEE NICs (relative to EET).

Our proposed system would therefore provide less advantage from tax-base smoothing to a higher-rate taxpayer who ends up retiring as a basic-rate taxpayer. The logic is as follows. Suppose they make an additional individual pension contribution of £1. They would currently pay 2% employee NICs on this contribution, receive 40% up-front income tax relief on it and then pay income tax at a rate of 20% on the subsequent pension withdrawal. So they would get up-front relief of 38% and pay tax on withdrawals of 20%, roughly speaking a gap of 18 percentage points. In our reformed system, they would qualify for bigger up-front relief of 42% (40% income tax and 2% employee NICs) but would now pay tax on pension withdrawals at a rate of 32% (20% income tax and 12% employee NICs). This is a gap of 10 percentage points, i.e. almost halving the advantage they currently get from tax-base smoothing. For individuals in this situation who benefit from employer contributions, the gap would also be roughly halved: from 20% (40% income tax relief up front, 20% income tax on withdrawals with NICs escaped entirely) to roughly 10% (42% up-front relief, 32% tax on withdrawals).

So while these individuals would still be provided with an incentive to save for retirement, and would still be able to reduce (relative to the TEE benchmark) their tax bill by smoothing their taxable income, the extent of this reduction in tax liability would be significantly curtailed. This would seem to be a reasonable and fair change: if someone happens to have particularly high earnings in some years that exceed the UEL but saves these particularly high earnings, while another person has the same lifetime earnings but receives them more evenly across years such that their earnings never exceed the UEL, it seems fair that they would both face the main rate of NICs on those earnings rather than the person with more uneven earnings paying less tax.

There would be an issue about how to treat the pension contributions of those who are not employees. Most obviously this includes the self-employed, but also non-workers who make pension contributions. Since their pension income would have to be taxed at employee NICs rates (it would be impractical to charge lower rates on withdrawals funded by contributions made when an individual had been self-employed and zero for those funded by contributions made when an individual was not working), the fairest approach would probably be to provide NICs relief on their pension contributions at employee rates as well (with the self-employed having first paid self-employed NICs on their earnings). This would raise some administrative complexities, but they should not be insurmountable.

Implementing such a reform would be very slightly tax-raising in steady state, increasing taxes by £0.3 billion a year in today's terms. (Recall that we implicitly adjust revenue from taxing future pension income downwards because of its riskiness: if pension funds earn high returns as

they have in the past, the actual yield would be higher, perhaps substantially so.) The up-front cost would be £3.3 billion a year, less any revenue raised from imposing NICs on the pension income of those currently drawing pensions (which would raise around £¼ billion for every 1 percentage point of NICs charged).

As shown in Figure 7.3, this tax increase falls primarily on those with high levels of remuneration at the point when they (or their employer) make pension contributions. There are two reasons for this:

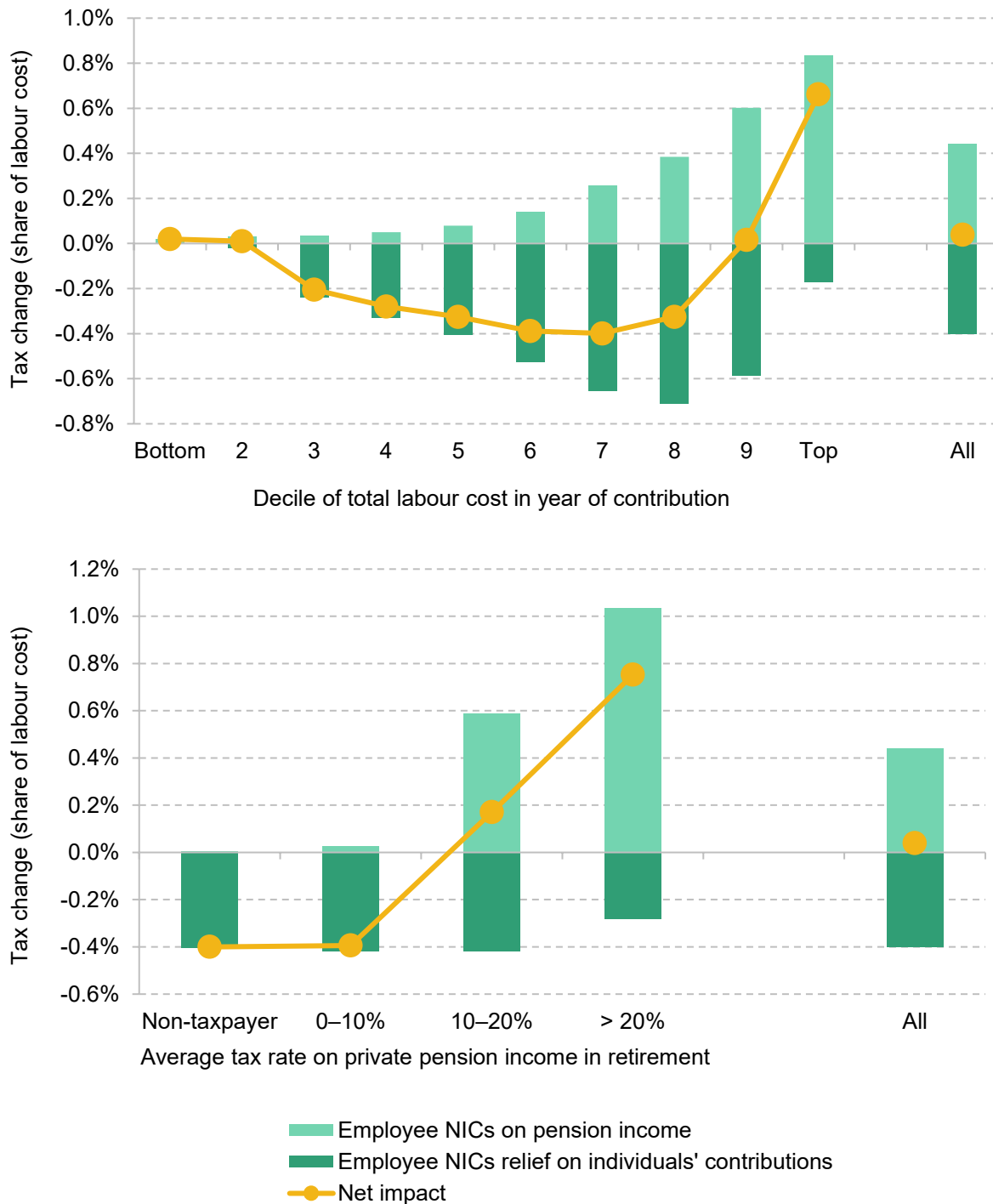
- First, employee NICs would be extended to pensions coming from employer contributions, which are disproportionately received by higher earners.
- Second, since people's earnings while in work tend to be higher than their pension income in retirement, high earners who currently pay only 2% NICs on their individual pension contributions are likely to pay 12% NICs on much of their pension income, while lower earners who currently pay 12% NICs on their pension contributions are more likely to see much of their pension income fall below the NICs threshold. Thus high earners lose, while lower earners gain, from levying employee NICs on pension withdrawals rather than on individuals' pension contributions.

That said, the magnitude of this effect is rather small, with the tax rise (even for top earners) considerably less than would occur under major reforms to income tax treatment (such as restricting income tax relief to the basic rate). (For further breakdowns of the impact of this reform to employee NICs by region, sex and sector, see Table B.5 of Appendix B.)

If this reform were to be implemented, careful consideration would need to be given to how to transition from the current system to the new one. At one extreme, the government could decide to provide up-front employee NICs relief on the pension contributions for those currently aged 16 and younger, and that these individuals should be the only ones that had to pay employee NICs on their resulting pension income. This would be fair in the sense that the new tax charge on pension income would only apply to income that was generated where up-front relief had been provided. But it would also allow employer pension contributions to continue to escape employee NICs entirely for many decades.

A faster reform would be desirable. Up-front employee NICs relief could be provided immediately on all individual pension contributions. The question then would be how quickly to move to making pension income fully subject to employee NICs. Increasing tax on those who have saved in a pension in the expectation of not paying employee NICs on pension withdrawals could be argued to amount to unfair retrospective taxation, although – as was shown in Figure 4.1 – it is worth noting that many will have saved in a pension in the expectation that they would pay basic-rate income tax on the pension withdrawals at a rate higher than the current 20%.

**Figure 7.3. Impact of extending up-front employee NICs relief to individuals' pension contributions and imposing employee NICs on pension withdrawals**



Note: Total labour cost refers to pre-tax earnings plus pension contributions (including employer pension contributions) and employer NICs. Our sample is all individuals aged between 20 and 64 with income from either employment or self-employment. For tax payments made in retirement, figures represent the total net present value, at the point of contribution, of all additional tax payments made across retirement (see Chapter 5 and Appendix A for details).

Source: Authors' calculations using the 2016–18 Wealth and Assets Survey, updated to 2022–23 terms as described in Appendix A.

One possibility would be to make pension withdrawals made now subject to employee NICs but initially at only a fraction of the standard NICs rates, with this fraction increasing over time until it eventually reaches 100%. This would make some sense. But it would inappropriately encourage individuals with defined contribution pensions to withdraw their pensions earlier, as it would lead to them being liable for less tax.

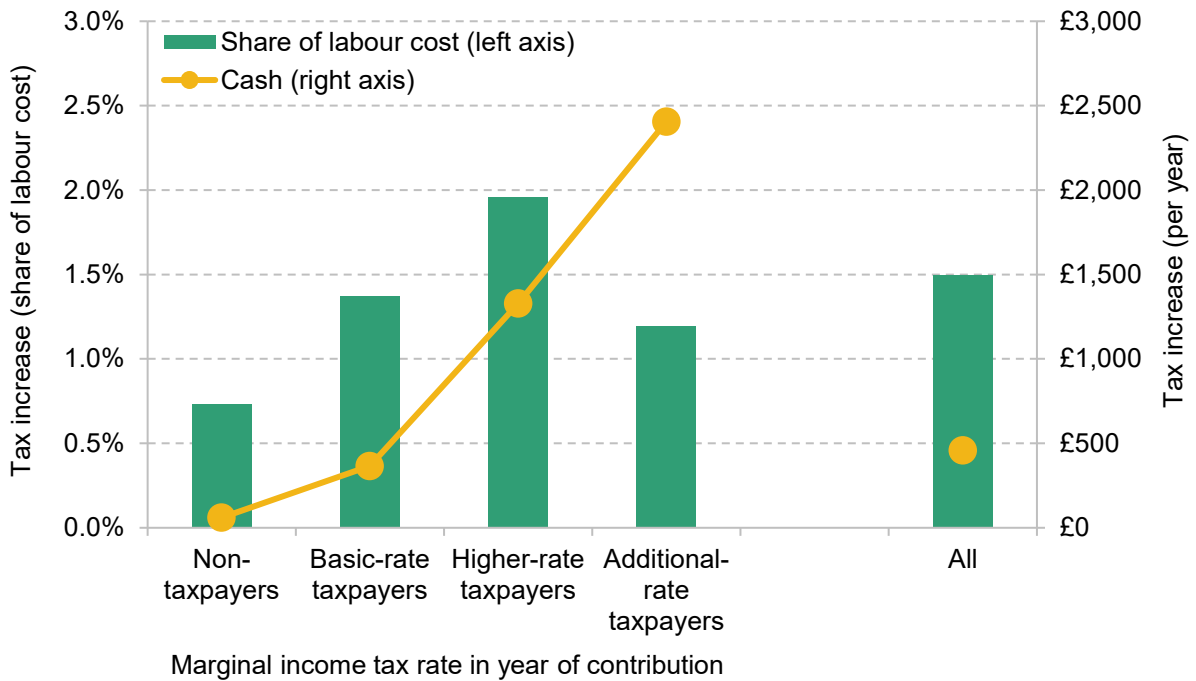
A more sensible alternative is therefore to phase in the reform by date of birth. For example, those born before 1950 might pay employee NICs at a fraction – say 10% – of standard NICs rates, with this fraction increasing by date of birth, with, for example, those born after 1990 paying employee NICs at the full rates on their pension withdrawals. What percentages should apply to individuals of each year of birth would be a political decision. There would still be some unfairness: within each birth cohort, those who had done more of their pension saving via individual (rather than employer) pension contributions prior to the reform would be more harshly treated as they would have received less up-front employee NICs relief. But a transition along these lines might seem a sensible compromise between wanting to move to a more rational treatment of employee NICs to pension saving and wanting to provide some protection to those who will not have expected the system to change in this way.

### Levying employer NICs on employer pension contributions

The proposal above for employee NICs – taxing pension withdrawals, having given up-front relief on pension contributions – would not work for employer NICs. As discussed above, it would not be possible to track down former employers and levy employer NICs on them when an individual retires and withdraws their pension, and the alternative of deducting an equivalent amount of tax directly from the individual's pension in retirement might well not be politically viable.

This points instead to levying employer NICs on employer pension contributions. As pointed out earlier in the report, assigning employers' defined benefit pension contributions to specific individuals would be hard to do accurately. This is a problem where each individual must be taxed on the right amount of pension contributions and the marginal rate of tax varies – as it does with income tax or employee NICs – since the contribution must be assigned to the individual in order to levy the correct amount of tax. But employer NICs are paid by the employer, and largely levied at a flat rate above the secondary threshold. For defined benefit pensions, it would therefore be straightforward to levy employer NICs on each employer's aggregate pension contributions, without needing to assign them to individual employees (as would be required for income tax or employee NICs). The only inaccuracy in this approach would be that employers' defined benefit pension contributions would be taxed even where they related to employees whose earnings would not normally attract employer NICs, such as those earning below the NICs secondary threshold, those aged under 21 and apprentices aged under 25. But these account for only a tiny minority of employer pension contributions.

Figure 7.4. Impact of imposing employer National Insurance contributions on employer pension contributions



Note: Total labour cost refers to pre-tax earnings plus pension contributions (including employer pension contributions) and employer NICs. Our sample is all individuals aged between 20 and 64 with income from either employment or self-employment.

Source: Authors' calculations using the 2016–18 Wealth and Assets Survey, updated to 2022–23 terms as described in Appendix A.



We therefore propose that employer NICs be extended to employer pension contributions. This would represent a tax rise of £12.5 billion for contributions towards new accrual. Done in isolation, this would reduce the incentive for employers to contribute to a pension on their employees' behalf. However, our proposal is that this could be replaced, at least initially and/or partially, with a new subsidy which we describe below.

The distributional impact of imposing employer NICs on employer pension contributions is shown in Figure 7.4. This tax increase would be formally paid by employers, though we would expect that a large part of this would ultimately be passed on as a reduction in employees' remuneration and we analyse the reform assuming all of it would be. For the average worker, the change would represent an annual £460 increase in tax, although for high earners (whose employers typically make larger pension contributions) the tax increase would be substantially larger. Of the £12.5 billion overall tax increase, £5.3 billion would come from the top 10% of earners, who would see an average annual tax increase of just under £2,000. That said, as a share of total remuneration, the tax increase experienced by additional-rate taxpayers would (on average) actually be below that of basic-rate taxpayers. This result can be seen clearly in the lower panel of Figure 7.4 and reflects the fact that pension contributions tend to comprise a smaller share of total remuneration for those with the highest incomes. (For further breakdowns of the impact of this reform to employer NICs by region, sex and sector, see Table B.6 of Appendix B.)

### **A new subsidy for employer pension contributions?**

The EEE NICs treatment of employer pension contributions represents a big subsidy for employer but not employee contributions. Moving to EET employee NICs treatment and TEE employer NICs treatment would remove that.

This could be seen as removing an anomaly: treating employer and employee pension contributions in the same way would be a welcome move towards neutrality. It would remove the rationale for the bizarre, complex and opaque practice of salary sacrifice, and the inequity between people whose employers do and do not facilitate such arrangements. Aside from explicit salary sacrifice arrangements, it is surely no coincidence that the majority of pension contributions are made by employers, the tax-favoured route: a tax-induced distortion to behaviour. The current system also seems unfair on those who do not have an employer, notably the self-employed.

While there is a good case for subsidising pension saving, it is harder to see a principled case for subsidising employer contributions more than employee contributions. It is common to say that we must incentivise employers to make pension contributions, but that is not obviously true: why not make it equally worthwhile to pay higher wages instead, and allow employees to choose for themselves how much they save in a pension – or to agree with their employer how much of

their remuneration will come in the form of pension contributions, without that decision being distorted by tax considerations? We do not provide tax relief for employers' contributions to ISAs or other savings products, or incentives for employers to contribute directly to employees' housing, food or other needs. Why should pensions be different?

Note that we could still have automatic enrolment and subsidies for pension saving to address concerns about undersaving, even if the subsidy were no bigger for employer than employee contributions. Other incentives such as the 25% tax-free component subsidise employer and employee contributions equally (though it has other flaws, as we discuss in Section 7.3). If desired, subsidies that applied equally to employer and employee contributions could be increased to offset the removal of the subsidy specific to employer contributions.

All that said, in reality, if the NICs subsidy for employer pension contributions were simply removed overnight, there clearly must be a risk that employers would respond by reducing the pension contributions they provide while (a) the employer does not increase their employees' cash salary by an equivalent amount and/or (b) employees do not increase their own pension contributions by as much as employers reduce theirs. Removing the NICs subsidy might be justified in principle, but it would be a big gamble in practice.

There might therefore be a case for keeping some subsidy specifically for employer pension contributions to mitigate that risk. It would be relatively straightforward to introduce a new flat-rate subsidy on all employer pension contributions which would be better designed than the existing NICs relief.

It is hard to know what the level of subsidy should be. One option would be to start with a level of subsidy similar to that implied by the existing NICs relief and then try gradually reducing this rate, evaluating the effects on take-home pay and employer and employee pension contributions. A subsidy of 13.8%, for example, would mirror the employer NICs rate and therefore, in most cases, perfectly offset the impact of imposing employer NICs on employer pension contributions. To also offset the impact of imposing employee NICs on pensions financed by employers, the subsidy rate would need to be significantly higher than that (though note that adding the 12% main rate of employee NICs to the subsidy is more than would be needed to

compensate on average for levying employee NICs in retirement, since much pension income would fall below the employee NICs threshold).<sup>27</sup>

Whatever the level chosen, decoupling the subsidy for employer pension contributions from NICs rates would have two favourable features:

- The new subsidy on employer pension contributions would, at least by default, apply to those groups whose earnings are exempt from employer NICs, such as most employees aged under 21, apprentices aged under 25 and new employees earning less than £25,000 in Freeports. It would also extend to the large number of employers that currently pay no NICs because their total payroll is within the employment allowance. It seems unlikely that, when employer NICs were reduced for these groups of workers and employers, it was considered desirable that this would reduce the encouragement the tax system was providing to employers to make pension contributions.
- The rate of subsidy would no longer automatically change when the rate of employer NICs was changed. For example, when the Health and Social Care Levy was legislated to come in from April 2023 (since abandoned), it seems unlikely that it was considered desirable that it would increase the incentive that employers have to make pension contributions by almost 10% (a 1.25 percentage point rise from a base of 13.8%) and increase the value to employees of being remunerated in that form by a similar amount (1.25 percentage points from a base of 12%).

In short, moving to EET employee NICs and imposing employer NICs on employer pension contributions while replacing the NICs exemption with a subsidy on employer pension contributions would allow employer pension contributions to be subsidised to whatever degree was deemed appropriate. Beginning with a subsidy of comparable generosity to the existing NICs exemption would leave the overall system little changed, but without the current arbitrary variation according to the NICs rates that the particular employer and employee happen to face. Over time, policymakers could decide to target the subsidy in different ways: for example, maybe the subsidy should be more generous for small employers than larger employers (whereas at the moment the smallest employers do not pay employer NICs and therefore do not receive this tax subsidy on any employer pension contributions they make). And maybe the right rate of the subsidy will be different – higher or lower – than the NICs rate happens to be. For example,

<sup>27</sup> The subsidy could either be paid to taxpayers (employers and/or employees to mirror employer and/or employee NICs relief respectively) or paid into the pension fund (allowing employers and/or employees to reduce their pension contributions in order to pay the new NICs liability, if they wished). For defined benefit pensions, however, it would be difficult to replicate the existing employee NICs subsidy for employer pension contributions: once again, that would require estimating the implicit pension contribution in respect of each individual. The nearest equivalent would be to pay an additional subsidy to the employer (or – equivalently – into the fund, if it is a funded scheme, allowing the employer to reduce its contributions by the same amount), which would deliver a similar outcome if employers passed on the subsidy to employees in higher wages.

the government could decide that a cheaper subsidy of, say, 10% might be enough, which would cost around £3½ billion a year less than a 13.8% subsidy (which is what is provided to many employers through the current exemption of employer NICs).

## 7.3 Better targeting the 25% tax-free component

Relative to a pure EET system (see Section 6.2) alongside the favourable NICs treatment of employer pension contributions, the ability to withdraw 25% free of income tax is the main current subsidy for pension saving. But the current design of the 25% tax-free component of pension withdrawals suffers from three undesirable features:

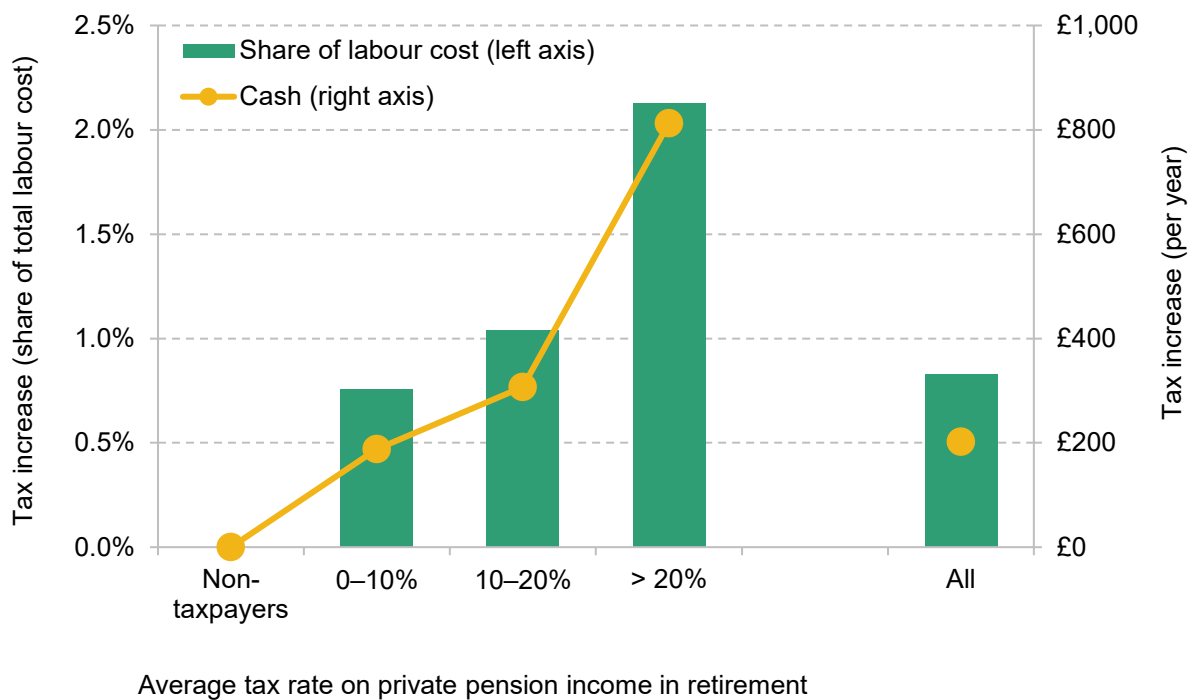
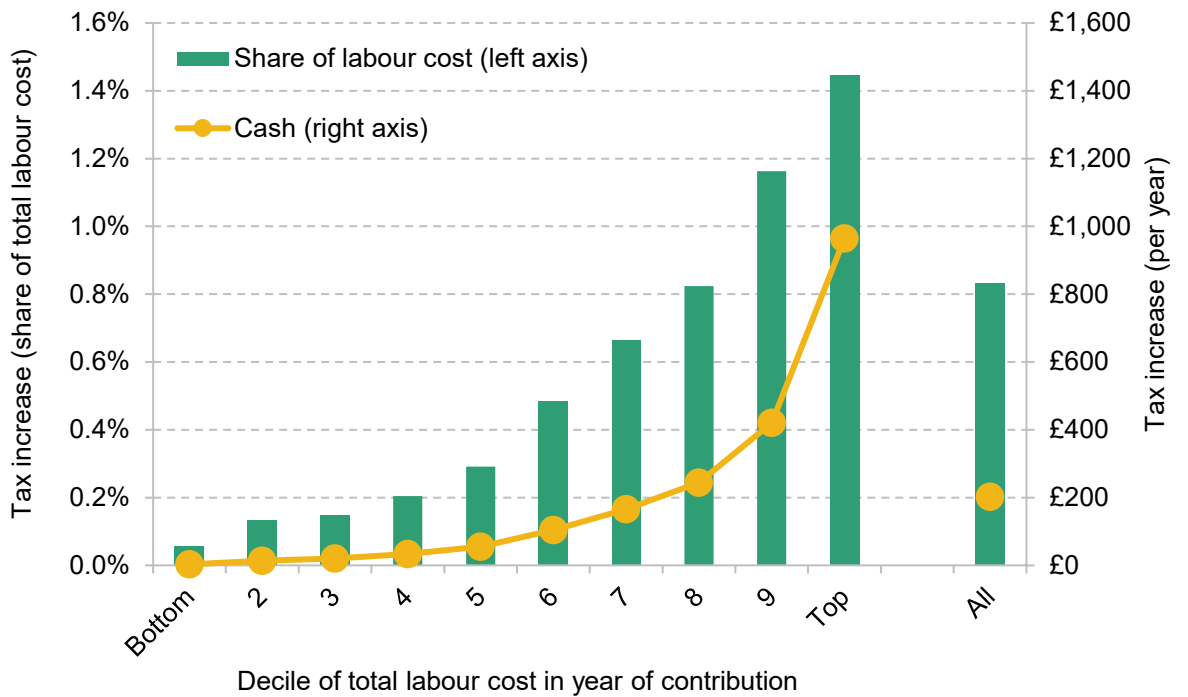
- It applies to the entirety of an individual's pension wealth, limited only by the lifetime allowance for pension savings. This means that it continues to offer a tax incentive for the individual to engage in additional pension saving even if they have already accumulated substantial pension savings. It is hard to see why the government should be using the tax system to subsidise additional pension contributions for an individual with, say, a £900,000 pension pot. Indeed, the ability to withdraw 25% of the entirety of an accumulated pot free of income tax is a justification for the lifetime allowance.
- The tax-free component is most generous towards those who are higher- or additional-rate taxpayers in retirement (because they escape income tax at a higher rate). Conversely, the 25% tax-free component is of no value whatsoever to the relatively large number of individuals whose incomes in retirement are too low for them to pay income tax. Again, it is hard to understand why it would be desirable to provide the largest incentive to save in a pension for those who expect to be richest in retirement, while offering no incentive at all for those who expect to be poorest.
- It favours taking at least 25% of the pension in the form of a lump sum, or a series of lump sums, rather than buying an annuity or entering formal drawdown without taking a 25% lump sum first.

In this section, we consider and assess a number of available avenues for reforming the tax-free component.

### Abolishing the 25% tax-free component

Perhaps an obvious way to do away with the inequities of the 25% tax-free component would be to abolish it entirely. Modelling its complete abolition is also a useful benchmark for understanding the generosity and distributional implications of current policy.

Figure 7.5. Impact of abolishing the 25% tax-free component



Note: Total labour cost refers to pre-tax earnings plus pension contributions (including employer pension contributions) and employer NICs. Our sample is all individuals aged between 20 and 64 with income from either employment or self-employment. Figures represent the net present value at the point of contribution of additional tax payments made across retirement (see Chapter 5 and Appendix A for details).

Source: Authors' calculations using the 2016–18 Wealth and Assets Survey, updated to 2022–23 terms as described in Appendix A.

The results of this modelling are shown in Figure 7.5, which shows the estimated total lifetime tax increase on pension contributions made in the current year.<sup>28</sup> In today's terms (adjusting for investment risk), individuals making contributions to their pensions in 2022–23 could expect in the long run to face an additional tax burden of £5.5 billion on their pension withdrawals as a result of abolishing the 25% tax-free component. Both because those with higher earnings tend to also have higher incomes in retirement (and therefore benefit more from the 25% tax-free component) and because pension contributions tend to comprise a higher share of total remuneration for higher earners, this tax increase would fall most heavily on those with the highest levels of total remuneration at the point of contribution. Indeed, just under 70% of the total £5.5 billion tax increase would fall on the top 20% of earners. Those individuals who do not pay income tax in retirement would in general not see any loss from the removal of the 25% tax-free component.<sup>29</sup> (For further breakdowns of the impact of abolishing the tax-free component by region, sex and sector, see Table B.7 of Appendix B.)

### Capping the tax-free component

Given its popularity, a more realistic and sensible approach to reforming the 25% tax-free component would be to restrict it. This could be done by reducing the 25% figure: for example, reducing it to 20% would reduce the generosity, and therefore the cost, of the tax-free component by one-fifth. While this would be straightforward to do, limiting it in this way would still mean that the system was providing individuals who have substantial pension pots with an incentive to save more in a pension. And while it would be true that their incentive to do this would be reduced, the incentive for other individuals with much smaller pension pots would also be reduced.

Another way to limit the tax-free component would be to put a cap on the amount that it can apply to. Effectively such a cap implicitly already exists as, for those with defined contribution pensions at least, there is a lifetime allowance on pensions that is currently set at £1,073,100. But this still means that an individual could withdraw an astonishing £268,275 from a pension entirely free of income tax.

An attractive option could therefore be to reduce the limit on the amount of pension withdrawal that could be made free of income tax. For example, it could be set so that only 25% of the first £400,000 of withdrawals from pension could be made free of income tax (with the £400,000

<sup>28</sup> Note that our modelling assumes that the 25% tax-free component is smoothed evenly across all years of pension withdrawal.

<sup>29</sup> It is possible that those who, before such a reform, were not paying income tax on their private pension income could, as a result of the reform, become taxpayers because the addition of the lump-sum component to their taxable income would take them above the basic-rate threshold. Because the observations of individuals' income in Understanding Society do not generally include lump sums taken from pensions, we cannot take this into account. However, any such effect is likely to be small.

figure appropriately uprated over time; under the current system, it would probably make sense to set it to be a fixed proportion of the lifetime allowance). A £400,000 limit, equivalent to just under 40% of the lifetime allowance, would still allow £100,000 to be withdrawn income-tax-free, and provide those with pension pots of under £400,000 with as strong an incentive to save in a pension as under the current system. The minority of individuals with pensions worth more than this would lose out and face a reduced incentive to save in a pension. For example, someone with a £1,000,000 pension pot would pay income tax on an additional £150,000 of pension withdrawals (25% of the difference between £1 million and the lower £400,000 cap). If this was withdrawn at the basic rate of income tax, it would see them pay an additional £30,000 in tax (and more if some of it was subject to income tax at a higher rate).

This £400,000 example is only illustrative: one could make the case for a lower or a higher limit. Having a limit would deal with the issue of providing a subsidy to those with pension pots that were already sizeable although it would still mean a larger subsidy for those with higher incomes in retirement and no subsidy at all for non-taxpayers.

Based on the distribution of pension wealth for those currently approaching retirement,<sup>30</sup> limiting the 25% tax-free component to the first £400,000 of pension wealth would affect only about one-in-five retirees (although it would affect almost half of those who had been employed in the public sector). Of the total stock of pension *wealth* meanwhile, just over 40% would lose the benefit of the tax-free component. This means that the reform would raise at least 40% as much revenue as abolishing the tax-free component entirely.

Geographically, those affected are disproportionately found in the South East of England (although not London), where the concentration of individuals with pension pots exceeding £400,000 is disproportionately high.

Two obvious issues would arise with the implementation of such a cap:

- **Transitional arrangements.** Rather than immediate implementation, there would be a case for phasing the introduction of any limit. This is to balance the ongoing unfairness from continuing to provide a tax subsidy to those who already have substantial pension pots against the unfairness from taxing individuals more harshly than they had anticipated when they did their pension saving. A gradual phase-in of any limit by date of birth would seem natural. This could range from 100% of the current lifetime allowance for older individuals and apply on a sliding scale down to the chosen reduced limit (just under 40% in the case of the £400,000 example given above) for those born more recently. How quickly to have this fully in place would be a political choice.

<sup>30</sup> Figures are based on those aged between 55 and 59 in round 6 of the Wealth and Assets Survey.

- **Operational arrangements.** If this reform were implemented, whether an individual is able to qualify for a tax-free withdrawal will depend on how much they have withdrawn already. Where individuals have more than one pension pot, it will therefore require sharing of information (unlike under the present system where 25% of each pension can be taken free of income tax). Broadly speaking, there would be two ways of making this work. First, pension funds could share information whenever a pension withdrawal is made – as is done for assessment against the lifetime allowance. Second, all pension withdrawals could be made subject to income tax and individuals could then claim rebates against any unused tax-free component from HMRC (which would then keep records of how much had been claimed to date).

### Making the tax subsidy flat-rate

A cap on the amount of withdrawals from a pension that could benefit from the 25% tax-free component would still mean that it was only of benefit to those who pay income tax in retirement and was worth more to higher- and additional-rate taxpayers than basic-rate taxpayers. An option to deal with this would be to provide support equivalent to the current 25% tax-free component for basic-rate taxpayers, but in such a way that it increased the after-tax value of everyone's pension income by the same proportion – basic-rate, higher-rate and non-taxpayers alike. This could be achieved by – and might most easily be legislated as – topping up all withdrawals by a taxable payment of 6¼%.<sup>31</sup>

Under this system, £1,000 taken out of a pension would be topped up to £1,062.50 and then treated as taxable income. For a basic-rate income tax payer, this would be of equal generosity to the current system.<sup>32</sup> In summary:

- In the absence of any tax-free component or top-up, someone withdrawing £1,000 from a pension would end up with £800 after tax if they were a basic-rate taxpayer, £600 if they were a higher-rate taxpayer and £1,000 if they were a non-taxpayer.
- At present, the 25% tax-free component means that the basic-rate taxpayer ends up with £850, the higher-rate taxpayer £700 and the non-taxpayer £1,000: the tax-free component

<sup>31</sup> A similar, but less progressive, alternative would be to top up withdrawals by a tax-free payment of 5%. This would be equivalent to making the 25% component free of basic-rate tax for everyone, including providing relief at the basic rate to non-taxpayers. It would mean that two people withdrawing the same amount from their pension before tax would see their after-tax withdrawal topped up by the same cash amount regardless of their tax rate (£50 for each £1,000 of pre-tax withdrawal), rather than seeing their after-tax withdrawal topped up by the same *proportion* (6¼%) regardless of their tax rate.

<sup>32</sup> £1,000 withdrawn from a pension pot would, net of income tax, currently be worth £850 to a basic-rate taxpayer (£250 tax-free plus £750 taxed at a rate of 20%). This is equivalent to the £1,000 withdrawal being topped up to £1,062.50 and then this all being taxed at 20%. They would be of exactly equal generosity only if the individual's private pension income were all taxed at the basic rate both with and without the implementation of the reform.

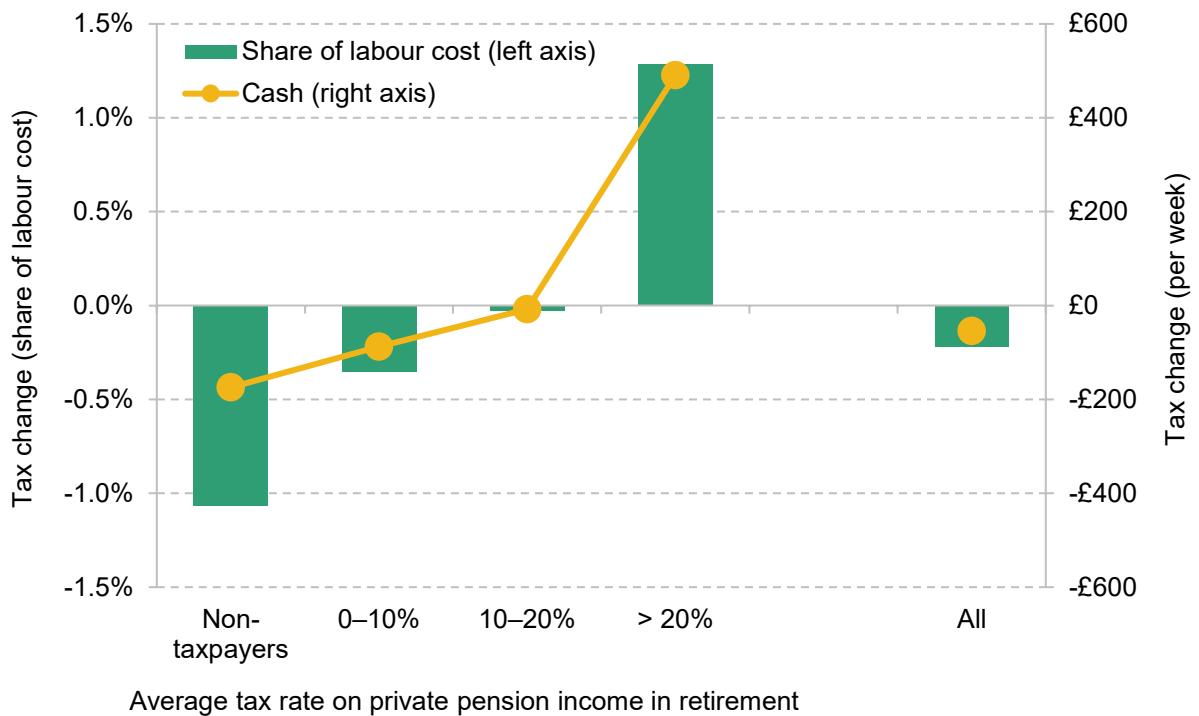


benefits higher-rate taxpayers most (in both cash and percentage terms) and is worth nothing to non-taxpayers.

- With the flat-rate tax subsidy we propose, the basic-rate taxpayer would end up with £850 – the same as now – but the higher-rate taxpayer would get £637.50 and the non-taxpayer £1,062.50. The top-up increases each of their after-tax pension incomes by the same proportion, 6¼%.

Relative to the current system, this policy would be more generous to those not paying tax in retirement, and therefore increase their incentive to save in a pension (and increase their incentive to work), while it would be less generous to those paying higher-rate income tax in retirement and therefore reduce their incentive to save in a pension (and reduce their incentive to work). Because of how it interacts with the tax system, it would further encourage individuals to draw their pensions smoothly: someone who took an unusually large amount from their pension in one year would be more likely to find that part of it – and the top-up – fell into a higher tax band. In contrast, for better or worse, the tax-free component provides individuals with the flexibility to withdraw a large chunk of their pension whenever they like without it affecting their overall tax liability.

**Figure 7.6. Impact of replacing the 25% tax-free component with a 6¼% taxable top-up**



Note: Total labour cost refers to pre-tax earnings plus pension contributions (including employer pension contributions) and employer NICs. Our sample is all individuals aged between 20 and 64 with income from either employment or self-employment. Figures represent the net present value at the point of contribution of additional tax payments made across retirement (see Chapter 5 and Appendix A for details).

Source: Authors' calculations using the 2016–18 Wealth and Assets Survey, updated to 2022–23 terms as described in Appendix A.

Operationally, our proposed flat-rate tax subsidy should be relatively straightforward to implement as all pension withdrawals would be topped up by the same amount, and all would then be subject to income tax as presently.

Figure 7.6 breaks down the change in tax liability that such a reform would entail for current pension contributors, broken down by the tax rates they can expect to pay on their pension income in retirement. Overall, the measure would be modestly tax-reducing (by around £1.5 billion), with the benefits flowing exclusively to those who, on average, pay income tax at below 20% on their pension income. (For further breakdowns of the impact of this policy by region, sex and sector, see Table B.8 of Appendix B.)

One drawback of providing a top-up to pension pots would be the continued subsidisation of saving for those with high levels of pension wealth. It would therefore be desirable to combine any move from a tax-free component to a top-up equivalent to the tax-free component for a basic-rate taxpayer with a cash limit of the kind described above (i.e. a top-up on just the first £400,000, say, of pension income).

Were it deemed desirable, this reform could be introduced for all future withdrawals. If this were seen as the best way to proceed, the top-up on future withdrawals would need to be scaled by how much of the tax-free component had already been used before the reform. Those who had used all of their tax-free component would receive no top-up on subsequent withdrawals, those who had used none of it would receive the top-up in full, and there would be a sliding scale for those who had made some use of their tax-free component. For example, a top-up on future withdrawals could be provided at 90% of 6¼% for someone who had already used a tenth of their 25% tax-free component before the reform, and at 50% of 6¼% for someone who had used half of it.

But as with all reforms that affect how pension withdrawals are treated, there would also be a case for some phasing in. The trade-off would be between preserving the inefficiency and unfairness created by the 25% tax-free component for longer, and the unfairness of treating pension withdrawals differently from what individuals had expected when they saved in a pension. Reasonable people will disagree over how best to balance these two. Whatever speed of phasing was deemed appropriate, the natural approach would be to do it by the date of birth of the individual, so that older individuals would be unaffected by the reform (or affected only slightly) while those born more recently would benefit less from some of the 25% component being taken free of income tax before the reform and benefit more from some of the 25% component being given a top-up after the reform. Unlike with capping the tax-free lump sum, or with imposing employee NICs on pension withdrawals, it should also be remembered that transitional protection in this case would not just limit the extent to which some older individuals

lost from the reform – in this case it would also limit the extent to which other older individuals benefited from it.

One could go further in how the policy was targeted. For example, if the intention for pensions tax relief is to encourage individuals to secure a regular income throughout their retirement then that might suggest that individuals should be steered towards arrangements that provide a guaranteed income for life as is the case with defined benefit arrangements and where defined contribution pension pots are used to purchase an annuity. This might be deemed appropriate if, for example, individuals might otherwise run down their pension wealth too quickly or too slowly. Encouraging a secure retirement income could be done by providing a more generous top-up (say, 8%) where the withdrawal was via an annuity (including defined benefit pensions) and a less generous top-up (say, 5%) where it was not.

More generally, decoupling the tax subsidy from individuals' marginal income tax rate would allow the government to increase or reduce it according to whether it thought there should be more or less reward for saving in a pension. However, unlike changing the rate at which contributions are subsidised (discussed at the end of Section 7.2), changing the rate at which withdrawals are subsidised would mean that any change to the incentive to make pension contributions in future would inevitably be accompanied by 'undeserved' windfall gains or losses on existing pension savings. This is, of course, already the case whenever income tax rates change, as these affect how generously any pension saving already done will be treated.

## 7.4 Pension limits

Since 2010 there have been substantial reductions to the annual and lifetime limits on tax-privileged pension saving. The annual allowance now stands, for most individuals, at £40,000 whereas in 2010–11 it was £255,000: a nominal cut of over 80%. There is a reduced annual allowance (as low as £4,000) for some very high earners, and for those who have already withdrawn part of their pension. The lifetime allowance is £1,073,100 whereas in 2010–11 it was £1,800,000: a nominal cut of over 40%. These cuts have substantially reduced the overall cost of pensions tax reliefs, and in particular reduced the extent to which those on very high incomes and those wanting to save relatively large amounts in a pension can benefit from tax reliefs.

Placing a limit on the amount that can be saved in a tax-privileged pension over a lifetime is one way of ensuring that pension saving is only subsidised up to a point. However, there are drawbacks to the lifetime allowance. The lifetime allowance applies to the value of the fund accumulated, including investment returns as well as pension contributions. Individuals can therefore inadvertently exceed the lifetime allowance even if they stop actively contributing

while still some way below it. This is opaque and arguably unfair. Where people do understand the risk of breaching the allowance, it can distort their behaviour – for example, leading them to invest their pension savings in lower-risk, lower-return assets or even to start withdrawing money from their pension earlier, in order to avoid accidentally exceeding the limit.

The lifetime allowance is also much more generous to those with defined benefit arrangements than to those with defined contribution pensions. This difference is hard to justify. It is a consequence of the crude and inaccurate way that wealth held in defined benefit pensions is estimated from an individual's rights to future pension income. For example, the lifetime allowance of £1,073,100 would enable a 65-year-old, at current annuity rates, to take a tax-free lump sum of £268,275 and receive an inflation-linked annual pension of about £33,800 from their defined contribution pension.<sup>33</sup> In contrast, for someone in a defined benefit pension arrangement, a £268,275 lump sum and an annual inflation-linked pension of £40,200 – nearly 20% higher than the maximum defined contribution pension – is deemed to be equivalent to a pension pot of £1.07 million (since defined benefit pension arrangements are deemed to have a pot size 20 times the annual pension). Adding in survivor benefits, or using annuity rates prior to the increase seen in the last year, would make the difference even bigger.

Reducing the annual allowance makes even less sense than reducing the lifetime allowance. For a given level of lifetime contributions, it is not clear why the government would want to penalise making occasional large contributions rather than frequent smaller ones. Indeed, from an individual's perspective, it may be preferable to contribute considerably more when earnings are high than to contribute a steady amount each year of working life. The annual allowance is therefore harsher on individuals who have particularly uncertain or volatile incomes – such as the self-employed – than on others.

In recent years, the government has reduced the annual allowance especially sharply for very high earners. As described in Section 3.1, it is now gradually reduced for those whose income including pension contributions is above £240,000, falling from £40,000 to £4,000 for those whose income is at least £312,000. This tapering of the annual allowance raises revenue from this well-off group. However, this is a complicated way of achieving this objective, with many unintended consequences. For example, it is very inflexible for people in defined benefit arrangements, who typically have less control over the amount deemed to have been contributed to their pension each year and can find themselves facing large unexpected tax bills and/or ridiculously strong disincentives to work more. More fundamentally, it is not clear why very

<sup>33</sup> Estimate taken from <https://comparison.moneyhelper.org.uk/en/tools/annuities> on 6 January 2023. Estimates for a single man born on 1 February 1958 drawing a pension from his 65<sup>th</sup> birthday on 1 February 2023. LPI indexation – that is, to the RPI capped at 5% – applied to aid comparability with a defined benefit pension. Individual assumed to live in Ipswich in good health and to want no guarantee period or any survivor benefit; including these would reduce the annual income further.

high earners should not be allowed to contribute as much to a pension (and get as much tax subsidy) as merely high earners – at least in cash terms, if not as a percentage of income.

The system that is currently in place laudably attempts to have a single system for defined contribution and defined benefit arrangements. But in practice this has not delivered a system that is equally generous to each type of arrangement. In addition, the annual allowance and lifetime allowance create specific issues for how defined contribution and defined benefit arrangements operate. Therefore, we propose that separate systems of lifetime allowances are adopted for defined benefit and defined contribution arrangements.

In addition, the reforms set out in earlier sections – in particular to the NICs treatment of pensions and to the 25% tax-free component – would make the tax treatment of pensions less generous for high earners. Their employer pension contributions would no longer escape NICs entirely, and they would no longer disproportionately benefit from the 25% tax-free component. Given this, we envisage that the pension limits could be made much more generous – perhaps going as far as a much more generous lifetime limit and no annual limit. Absent reform of how NICs treat employer contributions and of the 25% tax-free component, the argument for increasing the lifetime allowance in particular would be weaker.

### Reforming the lifetime allowance

Instead of attempting to have a single lifetime allowance, we propose that for defined benefit arrangements there is a cap on the maximum annual pension that could be accumulated. For defined contribution arrangements, we propose that the lifetime allowance is replaced with a new limit on lifetime contributions. Doing both would substantially ease measurement issues: in defined *benefit* arrangements, we would cap *benefits* and it is the benefits that are defined; and in defined *contribution* arrangements, we would cap (lifetime) *contributions* and it is the contributions that are defined. The precise level of these limits would be up for debate but, given the limits placed on the system's excesses by our other reforms, the government could consider increasing their generosity.

Moving to a cap on lifetime contributions in defined contribution arrangements would have the advantage of not distorting the investment choices of those with big pension pots. Extremely big pots could be accumulated through successful investment. But of course on withdrawal these would, under our proposals in earlier sections, be subject to employee NICs and full income tax (as the tax-free component would be capped at a lower level). And under the proposals in our earlier report (Adam et al., 2022), they would also not escape income tax if the pension saver died before age 75, and they would form part of the estate for inheritance tax purposes at death. So while there would be more scope for individuals to end up with very large pension pots, those spoils would be taxed and the rest of society would benefit. To paraphrase Lord Mandelson, the

pensions tax system would become intensely relaxed about sizeable pots accumulating through successful investment as long as tax is paid in full when the funds are withdrawn.

Arrangements would need to be put in place for those with both defined benefit and defined contribution pensions. The obvious way to do this would be for someone who had used up a certain percentage of the cap on benefits from a defined benefit pension to have their cap on lifetime contributions reduced by this amount. So, for example, if someone had a defined benefit pension worth 60% of the cap on pension benefits then their cap on lifetime contributions to defined contribution pensions would be set at 40% of the full limit.

The lack of records on historical contributions for those with defined contribution pensions would also raise the issue of how the new limit on lifetime contributions should apply to those with existing wealth in this form. A rough – but practical – solution would be to work out what share of the existing lifetime allowance individuals had used and then to subtract this from the new cap. So, for example, if someone had a defined contribution pension worth 40% of the existing lifetime allowance then going forwards they would be given a lifetime contribution allowance worth 60% of the full lifetime contribution allowance. Relative to having and using historical records on contributions, this would be generous to those who had made substantial contributions but achieved relatively poor investment returns and harsh on those who had made lower contributions but seen more substantial returns. This might not be particularly problematic – in part it would be redistributing from the lucky to the unlucky – and, even if full historical data were available, might be a reasonable way of dealing with a transition.

## Reforming the annual allowance

There is good reason to doubt the usefulness of a limit on the amount an individual can contribute to a private pension in a single year. With a more rational tax treatment of pensions – and in particular one that limits the extent to which those who are not at risk of undersaving for retirement are able to receive an effective tax subsidy on additional pension saving – then the case for a constraining annual limit would be reduced further. We therefore recommend that it is made much more generous so that fewer people are affected.

The annual allowance certainly should not be reduced for higher earners.

## 7.5 A package of improvements

Above we set out a range of options for reforming the tax treatment of pensions given the context set out in Chapter 2 and the principles for tax design set out in Chapter 4. What set of reforms is preferred will depend on various factors, including the transition arrangements that are deemed appropriate: we cannot hope to implement a new system as if doing so from scratch.

Below we summarise the broad parts of the system that require reform and propose specific measures (drawn from those laid out above) that we judge would be administratively feasible and entail manageable transitions. There would be scope for politicians to make judgements about, for example, the acceptable degree of retrospection entailed in moving to a new system. Taken as a package, the seven specific measures we propose would resolve (or at least vastly reduce) the problems we have identified with the current system. They would leave the tax treatment of pensions fairer and less arbitrary, handing policymakers the levers necessary to steer the future course of pensions taxation explicitly and deliberately. For the vast majority of pension savers, these reforms would, taken together, represent a tax reduction and a strengthening of incentives to save, all at very little overall cost to the Treasury. While those on high incomes would see their pension saving treated less generously by the tax system, the relaxation of annual limits that this would allow would remove some of the complexities created by the current system for some in this group.

- 1 **The 25% tax-free component needs reform.** It currently provides an additional tax subsidy to those who have already accumulated big pensions, provides a more generous rate of subsidy to those who are higher-rate taxpayers in retirement than to those who are basic-rate taxpayers and is of no value at all to those who have the lowest incomes in retirement: non-taxpayers. This is hard to justify. At the very least it should be capped so that it only applies to 25% of, say, the first £400,000 of accumulated pension wealth. Going further, **we propose providing the equivalent of a capped 25% tax-free component for basic-rate taxpayers, but designed in a way that increases the after-tax value of everyone's pension (up to the cap) by the same proportion – basic-rate, higher-rate and non-taxpayers alike.** A 6¼% taxable top-up on all pension withdrawals would achieve this. There would be a case for providing a bigger top-up on withdrawals made via an annuity (which provides a secure retirement income) and a smaller one for other withdrawals.
- 2 The EEE employee NICs treatment of employer pension contributions should be ended. **We propose that all individual pension contributions should receive up-front relief equivalent to the rate of employee NICs and, in return, we should gradually move to a system where pension withdrawals are subject to employee NICs.** This EET approach would align the employee NICs treatment of pension saving with that of income tax. For employee pension contributions the change would be one of timing, moving from a TEE to an EET approach – though deferring employee NICs liability until retirement would be a significant net tax reduction since much of people's pension income would be below the NICs threshold. For *employer* pension contributions, meanwhile, it would represent a clear reduction in the generosity of tax treatment, moving from full exemption (EEE) to taxation at withdrawal (EET).

One consequence would be closer alignment between the tax treatments of pension contributions made by the self-employed – who by definition cannot benefit from the EEE treatment currently afforded to employer pension contributions – and pension contributions made by employees. More generally, because the employee NICs rate falls from 12% to 2% at the upper earnings limit, EET treatment would also benefit low and middle earners who make individual contributions (who would get up-front relief at 12% and would typically have only part of their pension income above the NICs threshold in retirement) relative to higher earners who make individual contributions (who would get up-front relief at just 2% but often pay an average rate of NICs well above that in retirement).

- 3** The EEE employer NICs treatment of employer pension contributions should also be ended. **We recommend applying employer NICs to all employer pension contributions alongside introducing a new subsidy on all employer pension contributions.** Employer NICs would be levied on pension contributions on a TEE basis, with the largely flat-rate structure of employer NICs meaning this is practical for defined benefit and defined contribution arrangements alike. This change would end the current state of affairs whereby the effective subsidy on pension contributions depends on the NICs rates an individual and their employer face and is arbitrarily altered whenever NICs rates change, and ensure a uniform incentive for all employers (including those exempt from employer NICs). Policymakers would be forced to determine actively the right rate of subsidy and, once it was in place, would be free to adjust it independently of NICs rates. Below we model a subsidy set at 13.8% – the current main rate of employer NICs – which would mean no employer would immediately lose out from the reform.

We estimate the revenue effects of these reforms. For policies that apply to future pension income (where it is necessary to make an assumption about the value of risky future pension incomes in today's terms), we estimate the risk-adjusted present value of tax payments. Our modelling suggests that implementing these reforms would be close to revenue-neutral in the long run, although there is a lot of uncertainty around this estimate. If pension returns turn out to be strong (as they have been in the past), more (and possibly substantially more) revenue would be raised from policies that increase taxes on those future returns.

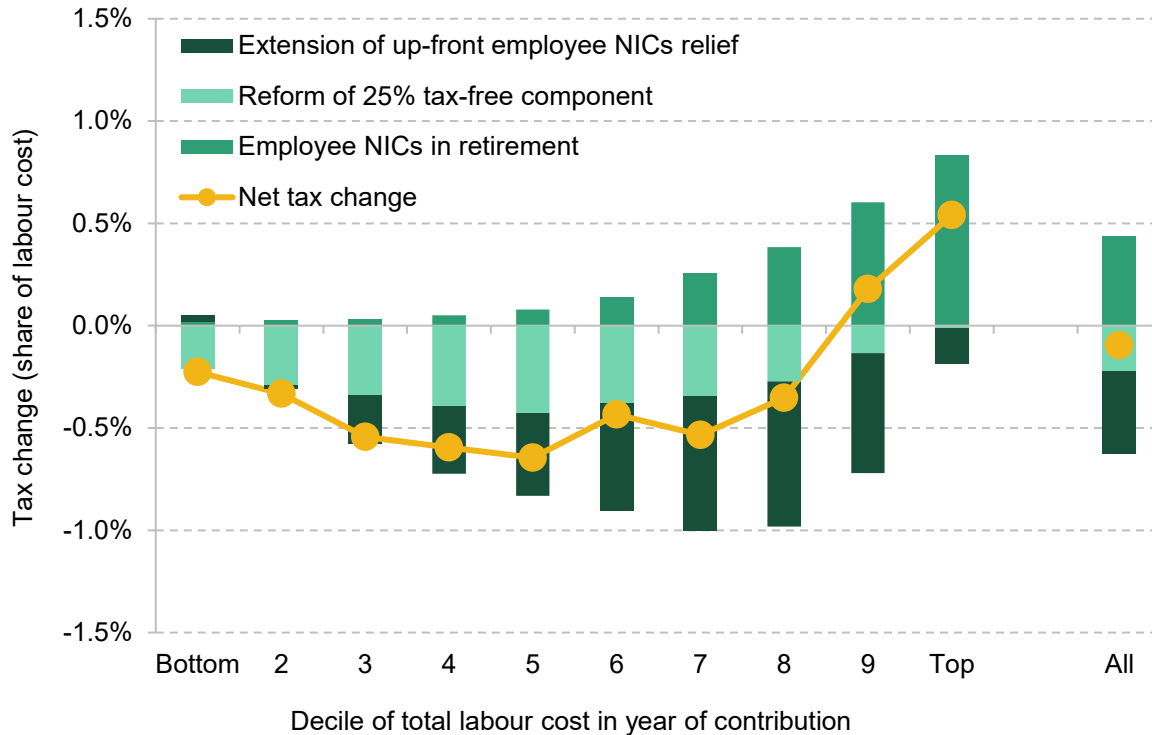
Providing any transitional protection from the application of employee NICs to pension withdrawals would reduce revenue in the near term. The up-front cost of the package would be £3.3 billion, less any revenue raised from imposing NICs on the pension income of those currently drawing pensions (which would raise around £¾ billion for every 1 percentage point of NICs charged).

The government could easily adjust how much revenue was raised overall by adjusting the proposed new subsidy on all employer pension contributions (for example, a rate of 10% rather than the 13.8% we assume in our modelling would save around £3½ billion a year immediately)



or the size of (or cap on) the income tax top-up on withdrawals, and there are two other tax measures that we set out below that could raise revenue.

**Figure 7.7. Impact on working-age earners of implementing the key income tax and NICs changes from our proposed pensions tax reform package**



Note: Total labour cost refers to pre-tax earnings plus pension contributions (including employer pension contributions) and employer NICs. Our sample is all individuals aged between 20 and 64 with income from either employment or self-employment. For tax payments made in retirement, figures represent the total net present value, at the point of contribution, of all additional tax payments made across retirement (see Chapter 5 and Appendix A for details).

Source: Authors' calculations using the 2016–18 Wealth and Assets Survey, updated to 2022–23 terms as described in Appendix A.

The estimated long-run distributional impact among current workers of the three reforms above is shown in Figure 7.7. This includes reforming the tax-free component so that it increases the after-tax value of everyone's pension by the same proportion, levying employer NICs on employer pension contributions and implementing a subsidy on all employer contributions of equal generosity, extending up-front employee NICs relief to all individual pension contributions and levying employee NICs on the resulting pension income. Excluded from the modelling is any cap on the reformed tax-free element which, as well as reducing the overall cost of the package, would also slightly increase the losses at the top of the distribution. Overall, the bottom eight deciles of earners would (in the long run) gain from these reforms and the top two deciles would lose. If the government did not want to redistribute from high to low earners

in this way, it could of course adjust the rates and thresholds of income tax and NICs to offset these distributional effects on average.

Incentives to save in a pension would be strengthened, on average, among the bottom 80% of earners and weakened among the top 20%. Low and middle earners, who fare worst under the current system relative to an EET benchmark, would gain because up-front employee NICs relief on individuals' pension contributions is worth more to them than the cost of having to pay employee NICs on pension withdrawals (even though employee NICs would apply to pensions generated by employer contributions – which are currently fully exempt – as well as employee contributions) and because our reforms extend the support currently provided by the 25% tax-free component to those who do not pay income tax in retirement. The losses among higher earners – who currently fare best relative to an EET benchmark – are driven primarily by the change to employee NICs: many of them would get up-front NICs relief at only 2% and would pay an average NICs rate in retirement in excess of this.

If the government were to judge that a flat 13.8% subsidy on all employer pension contributions (that is, a subsidy emulating the current exemption of employer pension contributions from employer NICs, though not employee NICs) were too generous, the impact of reductions in this subsidy would on average fall most heavily on higher earners and their employers. This primarily results from the fact that employer pension contributions tend to make up a much larger share of total remuneration for higher earners.

There would need to be a careful transition towards this long-run position. Specifically, where reforms would affect how already-accumulated pension wealth would be treated on withdrawal, there would be a trade-off between implementing a better system more swiftly and taxing some more heavily than they would have anticipated when they made the decision to save in a pension.

Where reforms are phased in, it would make sense for this to occur by date of birth so as not to distort the timing of pension withdrawals. And while retrospective taxation is never ideal, it is impossible to avoid completely without extremely long transitions, and it applies across all sorts of tax changes, not just taxes directly levied on savings and wealth. Retrospection is not binary; it comes in different types and degrees, and there are choices to be made as to what is acceptable in different circumstances. The strongest case for a phased introduction is with levying employee NICs on pension withdrawals. But even with this it is worth remembering that much of the pension saving of today's retirees will have not been subject to NICs and will have been done in the expectation that the basic rate of income tax on pension withdrawals would be above the current 20%. But some protection can be justified, not least because individuals' (though not employers') pension contributions will already have had NICs levied on them.

The exact shape of the transition would affect the revenue and distributional consequences of the policies in the short to medium run. But broadly, phasing in employee NICs on pension income gradually would make the reform package more expensive in the near term as it would be more generous to better-off members of older generations. Given the context set out in Chapter 2 – where policy has successfully reduced pensioner poverty so that it is no higher than poverty among other groups and where, remarkably, pensioners' average income is in line with that of the working-age population – there is a case for the reforms at least partially applying to all generations.

Further reforms should be introduced alongside the three measures set out above. As we pointed out in Adam et al. (2022), the tax system is currently more generous for the use of pensions as a vehicle for bequests than as a vehicle for providing a retirement income. When an individual dies before age 75, funds that remain in a pension escape income tax entirely. And in all cases pension pots at death are typically not counted as part of the deceased's estate for inheritance tax purposes. This is bizarre. Therefore, and as set out in that report, we propose the following two measures:

- 4 Income tax should apply on withdrawals from inherited pensions** regardless of the age of death.
- 5** If we are to have an **inheritance tax, it should apply to all forms of wealth and therefore pension pots should be included in estates.**

Together, these two measures would raise additional revenue, with the inheritance tax change in particular falling predominantly on wealthier individuals and their heirs. If the government did not want to increase inheritance tax overall, it could use the revenue raised from that measure to reduce the inheritance tax rate or increase the threshold.

Implementing these reforms (and therefore limiting the tax subsidy for pensions for higher earners) would allow policymakers to be more relaxed about the amounts that wealthy individuals can accumulate in pensions. We therefore recommend two further reforms:

- 6 Pension lifetime limits should be redesigned**, with distinct approaches for defined benefit and defined contribution arrangements (although with an eye to making them of roughly equivalent generosity). For defined benefit arrangements, it would make sense to use regulation to place a cap on the pension *benefits*. For defined contribution arrangements, we propose replacing the current lifetime allowance with a lifetime *contribution* cap. This would have the advantage of not distorting the investment decisions of those with large pension pots. This restructuring of lifetime limits could be coupled with an increase in their generosity.

- 7 The annual allowance should be made much more generous and, in particular, the policy of tapering the annual allowance for very high earners should be ended.** This would have the benefit of equalising incentives to save across extremely high and merely very high earners.

Taken together, this package of changes would, once fully in place, boost the retirement incomes of low and middle earners – and provide greater encouragement for them to save more in a pension. It would especially incentivise greater pension provision for those who expect to have the lowest incomes in retirement. It would also reduce some of the overly generous tax subsidies provided to those groups who are not in danger of undersaving for retirement (such as those who already have large pension pots and high earners receiving large employer pension contributions), while allowing them to save more in pensions that were not so heavily subsidised. Crucially, the new parameters in our proposed system – in particular, the rate of subsidy on employer contributions and the rate of top-up on pension withdrawals – would be decoupled from rates of income tax and NICs. This would leave policymakers with a free hand to make explicit and transparent decisions about how generous they wish the system of pensions taxation to be – a marked improvement on the current opaque and unwieldy arrangement whereby this generosity is a function of current income tax and NICs rates.

## 8. Conclusions

The amounts contributed to pensions are big: a total of £115 billion was placed in workplace pensions in 2021. The Office for National Statistics estimates that private pensions are now the largest component of household wealth, making up 42% of its total. It is therefore extremely important to get the taxation of pensions right. There are good reasons for the government to encourage those who would otherwise be at risk of undersaving for retirement to save more, not least because of the adverse consequences for individuals from having a drop in their living standards at retirement. But the scale of contributions also means that if tax treatment is made too generous – or if tax subsidies are given to those who do not need them – it will be costly.

As the modelling set out in this report has made clear, the current system of pensions taxation is a generous one – at least when compared with either full taxation of contributions or full taxation of withdrawals. What is more, that generosity is greatest for those pension contributors whose incomes are the highest. That fact cannot be ignored, but nor should it be decisive in dictating the future course of policy. Good tax design flows from adherence to sound principles: ensuring that incentives are coherent and well targeted, that policy is stable and predictable, and that similar incomes are taxed in similar ways. Where these principles conflict with achieving distributional goals, policymakers should not allow themselves to be blinkered. The tax system offers plenty of tools capable of effecting redistribution far more directly than can be achieved by altering the tax treatment of pensions. Policymakers should use them.

It is with that approach in mind that we do not recommend the curtailment of income tax relief provided on pension contributions. Limiting relief for higher-income individuals would diminish the ability of individuals to engage in tax-base smoothing. In terms of sound principles, such smoothing has much to recommend it, preventing individuals with similar lifetime incomes but differing degrees of income volatility from being treated differently by the tax system. The issue is not entirely clear-cut due to the fact that the availability of tax-base smoothing is not universal. But it is hard to see a principled rationale for moving to flat-rate relief on contributions without also moving to flat-rate taxation of withdrawals. For those who believe that limiting up-front relief would be an improvement on the current system, there is also a crucial practical issue of how employer contributions to defined benefit pensions could be accurately attributed to specific individuals in order to be taxed; with half of up-front income tax relief going to those in defined benefit arrangements, getting this right would be extremely important, and far from easy, to do well.

Instead, the package of reforms that we recommend seeks to address two ways in which current arrangements most clearly violate the principles of good tax design. The first is that some of the most important features of the current tax treatment of pensions rely on providing savers with reduced income tax and NICs liabilities (for example, the fact that up to 25% of pension withdrawals can be taken free of income tax, or the exemption of employer pension contributions from NICs). The result is that the generosity of pension subsidies is at the mercy of the broader tax system. If income tax rates fall, for example, the value of the 25% tax-free component reduces too, while if NICs rates rise, employers benefiting from NICs exemptions see their incentive to contribute to their employees' pensions increase. Such an arrangement breeds unintended consequences. We need a pensions tax system that has been designed, not one that has been shaped by accident.

The second violation of the principles of good tax design is that certain features of the current system create tax incentives that are poorly targeted at preventing undersaving. It is hard to see a good reason, for example, why government resources should be used to incentivise an individual with a £900,000 pension pot to save even more in their pension; yet this is precisely what the design of the 25% tax-free component does. The package of reforms proposed in this report would reform the 25% tax-free component so that it gives the equivalent of a capped 25% tax-free component for basic-rate taxpayers, but designed in a way that increases the after-tax value of everyone's pension (up to the cap) by the same proportion – basic-rate, higher-rate and non-taxpayers alike. This would end the current situation whereby those who expect the highest pension incomes face the biggest incentives to save. It would apply employee NICs to pension income while removing them from all pension contributions, ensuring a more even set of incentives for employees and employers making pension contributions. And it would replace the current exemption of employer pension contributions from employer NICs with a subsidy of (perhaps) equivalent value, breaking the link between NICs rates and the level of subsidy and freeing policymakers to make explicit decisions about the incentives they wish to create.

Taken together with the recommendations set out in our recent report *Death and Taxes and Pensions* (in which we advocate ending the exemption of bequeathed pensions from inheritance tax – and in cases where individuals die before the age of 75, from income tax as well), these reforms would greatly enhance the coherence of pensions taxation and leave future governments in a far more flexible position. For most, the changes we propose would mean a reduction in tax, while for the Treasury the costs – at least in the longer term – would be modest. The current system of pensions taxation has too many features that are arbitrary, wasteful or unfair. It is long past time we retired them.

# Appendix A. Methodological details

This appendix provides a more complete and technical overview of the methodological approach described in Chapter 5 of the main report. Broadly speaking, our approach can be broken down into three components: creating a cross-section of current pension contributions, calculating the tax levied on contributions at the point of contribution (under the current system, two possible benchmark systems and various counterfactual reforms), and mapping current contributors to estimated tax rates in retirement. This appendix deals with each of these areas in turn.

## A.1 Creating a cross-section of current pension contributions

Our cross-section of current pension contributors is derived from round 6 of the Wealth and Assets Survey (WAS), a representative household survey conducted biennially by the Office for National Statistics (ONS). For each respondent, individual contributions to up to two active occupational pension arrangements and up to three active personal pensions are recorded. In the case of defined contribution (DC) pensions, respondents are also asked to provide information on any contributions made by their current employer to the arrangement. In the case of defined benefit (DB) arrangements, respondents provide some information on the scheme rules but are not asked explicitly about employer contributions to the arrangement.

This stems from the fact that employers' contributions to funded DB pension funds are determined by what is required to keep the fund as a whole solvent and are therefore not readily attributable to individuals. Furthermore, in the case of 'unfunded' DB pension arrangements which are widespread in the public sector, the contributions made by public sector employers are notional, in the sense that they need not correspond to the economic cost incurred by the public sector in making those pension promises.

In order to model the tax liabilities that would be incurred if (for example) tax were to be levied up front on all employer pension contributions, it is nevertheless necessary to quantify the annual value the employer is contributing to pensions of this kind. This requires us to take a stance on how to define the employer contributions made in respect of a particular individual and then how to measure these in the data. Conceptually, our approach is to estimate the net

present value of pension rights accrued by respondents over the past year and then to subtract the individual contribution, leaving the implied employer contribution to the pension as the residual.

Formally, total contributions to a DB pension in a given year are calculated as follows for final salary arrangements:

$$\Delta W_t^{DB} = \frac{(A_R \alpha_i^I + \alpha_i^L)(\Delta s_{it} n_{it} + s_{it-1})}{(1+r)^{R-a}}$$

or for career average arrangements:

$$\Delta W_t^{DB} = \frac{(A_R \alpha_i^I + \alpha_i^L) s_{it}}{(1+r)^{R-a}}$$

where:

- $\Delta W_t^{DB}$  is the change in DB pension wealth between the year of interview ( $t$ ) and the year prior to interview ( $t - 1$ );
- $A_R$  is a fair, inflation-linked annuity factor<sup>34</sup> (i.e. the expected cost of providing an income of £1 a year in real terms during retirement) from the respondent's state pension age ( $R$ );
- $\alpha_i^I$  is the pension income accrual fraction (which is recorded in WAS);
- $\alpha_i^L$  is the pension accrual fraction for lump-sum payments;<sup>35</sup>
- $s_{it}$  is the respondent's gross (of tax) salary in year  $t$ ;
- $\Delta s_{it}$  is salary growth over the previous year; because salary in previous years is not available for all respondents in WAS, we estimate one-year average earnings growth on an age-and-education-specific basis using the Understanding Society panel dataset and match these rates to WAS respondents;
- $n_{it}$  is the number of years of tenure in the arrangement (which is recorded in WAS);
- $r$  is a real discount rate, set equal to the Superannuation Contributions Adjusted for Past Experience rate ('SCAPE' rate) of 2.4%;
- $a$  is the age of the respondent at the time of interview.

In the case of both DB and DC pension arrangements, we then winsorise total annual contributions at the level of the annual allowance. Annual employee contributions are further winsorised at the lower of 100% of earnings and £3,600.

<sup>34</sup> Formally, annuity factors are calculated as  $A_R = \sum_{t=R}^{110} \left( \frac{p_t}{(1+r)^{t-R}} \right)$ , where  $R$  is the state pension age of the respondent,  $p_t$  is the probability of survival to year  $t$  (assuming the individual survives to the state pension age) and  $r$  is the discount rate described below.

<sup>35</sup>  $\alpha_i^L$  is not recorded in WAS. We therefore estimate it as  $\alpha_i^L = \frac{3}{80}$  if  $\alpha_i^I = \frac{1}{80}$  and zero otherwise.



Our final task is to uprate all contributions to 2022–23 terms (WAS round 6 was conducted between 2016 and 2018) using average weekly earnings growth.<sup>36</sup> One complication is that since the period when the WAS data were collected, an important change has occurred to UK pensions policy. Namely, the statutory minimum pension contribution under automatic enrolment increased from 2% of earnings before 6 April 2018 to 8% of earnings from 6 April 2019, with the minimum amount coming from the employer increasing from 1% to 3% of earnings. This quadrupling of default contribution rates is likely to have led to a substantial growth in contributions to DC pensions. Indeed, statistics published by HMRC<sup>37</sup> confirm that growth in DC pension contributions over this period was well above growth in earnings. To account for this, we make two further adjustments:

- 1 We impose that all survey respondents who report their employers making non-zero contributions to a DC pension must contribute at least the auto-enrolment minimum. That is, we impose an employee contribution of 5% and an employer contribution of 3% of all earnings between £6,240 and £50,270.
- 2 To account for any additional under-recording of pension wealth, we then scale all contributions so as to match HMRC's administrative statistics<sup>38</sup> for total individual contributions, total DC employer contributions and total DB employer contributions.

## A.2 Tax liability at the point of contribution

Having obtained a cross-sectional dataset of pension contributions in 2022–23 terms, our next task is to calculate the up-front tax liability incurred on these contributions (under the current system, under alternative benchmarks and under potential counterfactual reforms). This is undertaken with the use of a tax calculator, specially prepared for this project, which returns individual income tax and NICs liabilities for our cross-section of pension contributors. This calculator makes a number of simplifying assumptions:

- Reforms are assumed to have no implication for entitlement to means-tested benefits (with the exception of child benefit withdrawal, which is modelled).
- Dividend and savings income are treated as earnings for the purposes of income tax, with differential rates not accounted for.
- For the purposes of NICs calculations, earnings are assumed to be distributed evenly between all earnings periods throughout the year.

<sup>36</sup> As reported in ONS series KAB9: <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/averageweeklyearningsearn01>.

<sup>37</sup> <https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics>.

<sup>38</sup> <https://www.gov.uk/government/statistics/personal-and-stakeholder-pensions-statistics>.

- Differences in tax rates and bands faced by Scottish taxpayers are not accounted for.

In order for such a calculator to be accurate, it is necessary to know both which contributions are made on a salary sacrifice basis and which DC contributions are made on a relief-at-source (RAS) basis. The former is asked as part of WAS and so can be directly obtained. The latter is not and so must be estimated. To do this, we make use of HMRC's deductions and reliefs statistics,<sup>39</sup> which record the share of pension contributors making RAS contributions by taxable income band. We use these tabulations to derive income-band-specific probabilities of being a RAS contributor and we randomly impute on this basis.

The tax parameters applied in our tax calculations are those in place as of January 2023 or, when modelling a benchmark system or a potential reform, are those described in Chapters 6 and 7. In cases where we wish to model a reform (such as TEE treatment of pension contributions) that entails applying income tax to pension contributions up front, we treat pensions contributions as taxable income with the implications that this entails for relevant parts of the tax system (such as the tapering of the personal allowance).

## A.3 Tax liability at the point of withdrawal

Estimating the rate of taxation that is likely to be paid on pension contributions made in working life when they are subsequently withdrawn is inherently uncertain, depending as it does on the amount of pension saving undertaken in other years, the returns achieved, the amount of non-pension income received in the year of withdrawal and potential future changes to the tax system.

Our approach is to study the transition from working life to retirement for a group of recent retirees. This is undertaken using the British Household Panel Survey and Understanding Society datasets, which follow a representative sample of individuals from 1991 to the present. We use a sample of individuals who are observed at least once both between the ages of 50 and 59 and between the ages of 70 and 79 (with the latter appearance having to occur between 2016 and 2018).

First, we calculate the average tax rate paid by each individual in our sample on their private pension income.<sup>40</sup> Next, we assign our sample of retirees to sex-specific earnings quintiles on

<sup>39</sup> <https://www.gov.uk/government/statistics/deductions-and-reliefs-2010-to-2011>.

<sup>40</sup> We account for increased state pension generosity by scaling up observed state pension income in line with the level of the new state pension.

the basis of their earnings while aged between 50 and 59.<sup>41</sup> This leaves us with a sample of individuals for whom we are able to observe the correspondence between their position in the earnings distribution while in their 50s and the average tax rate paid on private pension withdrawals while in their 70s.

Finally, we use this correspondence to estimate the average tax rates on pension income that will be faced by individuals in our main WAS-based dataset of current pension contributors. Because many of these pension contributors are younger than 50, we would – ideally – use longer-run data to estimate separately the correspondence between tax rates in retirement and income levels for those in younger age groups. No such data currently exist in the UK. Instead, we make the simplifying assumption that an individual's position in the earnings distribution remains constant across the life cycle. That is, we assume that an individual whose earnings place them in the top 20% of female earners aged 30–39 will, 20 years later, also be in the top 20% of female earners aged 50–59.

Under this assumption, we sort each 10-year age group of the sample of pension contributors constructed in WAS into sex-specific earnings quintiles. We then randomly assign individuals to retirement tax rates using the probabilities observed from the corresponding quintile in the British Household Panel Survey / Understanding Society data.<sup>42</sup>

<sup>41</sup> Specifically, we create sex- and wave-specific earnings quintiles of all individuals with non-zero labour income aged between 50 and 59 at the point of interview. The quintile assigned to individuals in our sample is that of the earliest wave in which they are observed while between the ages of 50 and 59.

<sup>42</sup> Sampling is undertaken with replacement. We undertake a ten-fold duplication (making suitable adjustments to grossing factors) of the WAS data in order to reduce the degree of sampling variation.

## Appendix B. Further distributional analysis of reform options

Table B.1. Mean additional tax paid from moving to taxing pension contributions up front, by characteristic

	Mean net change in tax liability	
	Cash	Percentage of labour cost
<b>Region</b>		
North East	1,353	5.1%
North West	1,295	4.9%
Yorkshire and the Humber	1,557	5.6%
East Midlands	1,295	4.7%
West Midlands	1,327	5.0%
East of England	1,806	5.6%
London	2,155	5.7%
South East	2,222	6.4%
South West	1,496	4.8%
Wales	1,485	5.5%
Scotland	1,637	5.7%
<b>Sex</b>		
Male	1,997	5.5%
Female	1,335	5.5%
<b>Sector</b>		
Private & charity sectors	1,684	5.4%
Public sector	2,022	6.6%
<b>All</b>	1,681	5.5%

Note: The table shows the average impact of a reform to move from the current system of pensions taxation to a 'full TEE' system, expressed in both cash terms and as a share of total labour cost (i.e. gross earnings plus employer pension contributions). Effects include changes to taxation at the point of contribution and at the point of withdrawal (returns are untaxed at the point of accumulation in both cases).

**Table B.2. Mean additional tax paid from moving entirely to taxing pension withdrawals, by characteristic**

	Mean net change in tax liability	
	Cash	Percentage of labour cost
<b>Region</b>		
North East	83	0.4%
North West	71	0.4%
Yorkshire and the Humber	73	0.4%
East Midlands	103	0.5%
West Midlands	76	0.4%
East of England	151	0.6%
London	333	1.1%
South East	250	0.9%
South West	146	0.6%
Wales	66	0.4%
Scotland	135	0.7%
<b>Sex</b>		
Male	324	1.1%
Female	-28	0.0%
<b>Sector</b>		
Private & charity sectors	236	0.9%
Public sector	-59	0.0%
<b>All</b>	156	0.4%

Note: The table shows the average impact of a reform to move from the current system of pensions taxation to a full EET system, expressed in both cash terms and as a share of total labour cost (i.e. gross earnings plus employer pension contributions). Effects include changes to taxation at the point of contribution and at the point of withdrawal (returns are untaxed at the point of accumulation in both cases).

**Table B.3. Mean additional tax paid from limiting up-front income tax relief on pension contributions to the basic rate, by characteristic**

	Mean net change in tax liability	
	Cash	Percentage of labour cost
<b>Region</b>		
North East	329	1.2%
North West	316	1.2%
Yorkshire and the Humber	425	1.5%
East Midlands	365	1.3%
West Midlands	356	1.3%
East of England	625	1.9%
London	899	2.4%
South East	852	2.4%
South West	465	1.5%
Wales	372	1.4%
Scotland	517	1.8%
<b>Sex</b>		
Male	779	2.1%
Female	308	1.3%
<b>Sector</b>		
Private & charity sectors	611	1.9%
Public sector	497	1.6%
<b>All</b>	<b>555</b>	<b>1.8%</b>

Note: The table shows the average impact of a reform to move from the current system of pensions taxation to one in which up-front income tax relief is limited to the basic rate, expressed in both cash terms and as a share of total labour cost (i.e. gross earnings plus employer pension contributions).

**Table B.4. Mean additional tax paid from moving to a flat 30% rate of up-front income tax relief on pension contributions, by characteristic**

	Mean net change in tax liability	
	Cash	Percentage of labour cost
<b>Region</b>		
North East	-70	-0.3%
North West	-59	-0.2%
Yorkshire and the Humber	-13	0.0%
East Midlands	-12	0.0%
West Midlands	-28	-0.1%
East of England	160	0.5%
London	378	1.0%
South East	278	0.8%
South West	43	0.1%
Wales	-41	-0.2%
Scotland	45	0.2%
<b>Sex</b>		
Male	260	0.7%
Female	-74	-0.3%
<b>Sector</b>		
Private & charity sectors	181	0.6%
Public sector	-122	-0.4%
<b>All</b>	<b>101</b>	<b>0.3%</b>

Note: The table shows the average impact of a reform to move from the current system of pensions taxation to one in which up-front income tax relief at a flat 30% rate, expressed in both cash terms and as a share of total labour cost (i.e. gross earnings plus employer pension contributions).

**Table B.5. Mean additional tax paid from moving to providing full up-front employee NICs relief and charging employee NICs on all pension withdrawals, by characteristic**

	Mean net change in tax liability	
	Cash	Percentage of labour cost
<b>Region</b>		
North East	-36	-0.1%
North West	-27	-0.1%
Yorkshire and the Humber	-1	0.0%
East Midlands	-5	0.0%
West Midlands	-16	-0.1%
East of England	10	0.0%
London	82	0.2%
South East	47	0.1%
South West	-3	0.0%
Wales	-30	-0.1%
Scotland	-3	0.0%
<b>Sex</b>		
Male	73	0.2%
Female	-57	-0.2%
<b>Sector</b>		
Private & charity sectors	46	0.1%
Public sector	-91	-0.3%
<b>All</b>	11	0.0%

Note: The table shows the average impact of a reform to move from the current system of pensions taxation to an EET treatment of pensions for the purposes of employee NICs, expressed in both cash terms and as a share of total labour cost (i.e. gross earnings plus employer pension contributions). Effects include changes to taxation at the point of contribution and at the point of withdrawal (returns are untaxed at the point of accumulation in both cases).



**Table B.6. Mean additional tax paid from imposing up-front employer NICs on all employer pension contributions, by characteristic**

	Mean net change in tax liability	
	Cash	Percentage of labour cost
<b>Region</b>		
North East	375	1.4%
North West	372	1.4%
Yorkshire and the Humber	429	1.5%
East Midlands	366	1.3%
West Midlands	382	1.4%
East of England	481	1.5%
London	561	1.5%
South East	580	1.7%
South West	415	1.3%
Wales	434	1.6%
Scotland	462	1.6%
<b>Sex</b>		
Male	543	1.5%
Female	366	1.5%
<b>Sector</b>		
Private & charity sectors	459	1.5%
Public sector	554	1.8%
<b>All</b>	<b>458</b>	<b>1.5%</b>

Note: The table shows the average impact of a reform that imposes employer NICs on all employer pension contributions, expressed in both cash terms and as a share of total labour cost (i.e. gross earnings plus employer pension contributions).

**Table B.7. Mean additional tax paid on contributions made in the current year from abolishing the 25% tax-free component, by characteristic**

	Mean net change in tax liability	
	Cash	Percentage of labour cost
<b>Region</b>		
North East	179	0.8%
North West	152	0.7%
Yorkshire and the Humber	184	0.8%
East Midlands	158	0.7%
West Midlands	156	0.7%
East of England	207	0.8%
London	261	0.9%
South East	254	0.9%
South West	182	0.7%
Wales	176	0.8%
Scotland	193	0.9%
<b>Sex</b>		
Male	260	0.9%
Female	132	0.7%
<b>Sector</b>		
Private & charity sectors	201	0.8%
Public sector	232	1.0%
<b>All</b>	202	0.8%

Note: The table shows the average impact of a reform abolishing the 25% tax-free component, expressed in both cash terms and as a share of total labour cost (i.e. gross earnings plus employer pension contributions). Figures relate to the net present value of additional tax paid (at the point of withdrawal) on contributions made in 2022–23.

**Table B.8. Mean additional tax paid on contributions made in the current year from replacing the 25% tax-free component with a 6¼% taxable top-up, by characteristic**

	Mean net change in tax liability	
	Cash	Percentage of labour cost
<b>Region</b>		
North East	-37	-0.2%
North West	-62	-0.3%
Yorkshire and the Humber	-64	-0.3%
East Midlands	-56	-0.3%
West Midlands	-58	-0.3%
East of England	-56	-0.2%
London	-40	-0.1%
South East	-74	-0.3%
South West	-60	-0.2%
Wales	-52	-0.2%
Scotland	-69	-0.3%
<b>Sex</b>		
Male	-35	-0.1%
Female	-84	-0.4%
<b>Sector</b>		
Private & charity sectors	3	0.0%
Public sector	-37	-0.2%
<b>All</b>	<b>-54</b>	<b>-0.2%</b>

Note: The table shows the average impact of a reform abolishing the 25% tax-free component and replacing it with a 6¼% taxable top-up, expressed in both cash terms and as a share of total labour cost (i.e. gross earnings plus employer pension contributions). Figures relate to the net present value of additional tax paid (at the point of withdrawal) on contributions made in 2022–23.

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