FABIAN SOCIETY

EXPENSIVE AND UNEQUAL

THE CASE FOR REFORMING PENSION TAX RELIEF

Andrew Harrop

August 2024

Acknowledgements

This report develops and updates analysis and proposals originally published in the Fabian Society's 2022 report Good Pensions for All: The Left's Agenda for Private Pensions. That project was supported by the ABI and we repeat our thanks to them for making the research possible.

This is the last report I will author before I stand down as Fabian Society general secretary in the autumn. I would like to take this opportunity to thank all my incredible colleagues past and present for the support they have given me while researching and writing at the society – and also to my family, Katie, Anila and Karna.

About the author

Andrew Harrop has been general secretary of the Fabian Society since autumn 2011. He stands down in October 2024. While at the society he has authored more than 40 reports including in 2022 Good Pensions for All: The Left's Agenda for Private Pensions.

FABIAN SOCIETY

Like all publications of the Fabian Society, this report represents not the collective views of the society, but only the views of the individual writer. The responsibility of the society is limited to approving its publications as worthy of consideration within the labour movement.

CONTENTS

SUMMARY 1
1. IN NUMBERS 4
2. PRINCIPLES 8
3. PROPOSALS 12

SUMMARY

The chancellor of the exchequer is considering how to raise taxes in October's budget in ways that do not breach the 2024 Labour party manifesto. This report explains why the government should reduce and redistribute pension tax relief as part of this package. It also presents a menu of possible reforms.

Today pension contributions and investments are largely exempt from tax. This is called pension tax relief. Pensions in payment do incur some tax, however almost all workers receive far more in tax relief on their pension contributions and investments than they can expect to pay in tax on their pension income. This is especially true for high earners. For this reason, reform of pension tax relief should be a priority for a revenue-raising Budget.

In numbers

- Tax relief on pension contributions was worth £66bn in 2022/23, an increase of 55 per cent since 2016/17. Only one third of pension tax relief was offset by tax revenue from pensions in payment (£22bn in 2022/23).
- More than half of tax relief (an estimated 53 per cent or £35bn in 2022/23) went to upper and top rate taxpayers who make up just 19 per cent of employee taxpayers. Only an estimated 35 per cent of tax relief on pension contributions benefited women.
- £56bn of tax relief on contributions (84 per cent) was associated with employer pension contributions, so it is essential that these are included in any reforms.

Principles

We suggest the following principles for reforming pension tax relief:

- Overall, the tax system should reward pension saving but the value of tax relief should not hugely exceed likely future tax revenues, as it does today.

- To incentivise beneficial behaviours by individuals and employers the system should be simple to understand and communicate.

- Tax relief should be broadly proportionate to people's earnings, rather than benefiting high earners more than low and mid earners, and men more than women.

- Pension tax reform should encourage high-quality pensions - and at least 'do no harm' to existing defined benefit schemes.

Proposals

A selection of these reforms could raise at least £10bn per year for the exchequer.

a) Reform income tax relief on pension contributions

1. Create a single flat rate of tax relief for individual pension contributions, for workers in all tax bands (eg 25p or 30p per pound of gross income).
2. Apply the same flat rate of tax relief to employer contributions (but consider special arrangements for defined benefit schemes).
3. Present this help from government as a simple top-up credit on pension contributions (eg a £1 match for every £3 of contributions after tax).

b) Consider increasing taxes on pensions in retirement

4. Reform the taxation of pension lump sums - eg cut the maximum tax-free lump sum to the lower of £100,000 or 25 per cent of pension wealth.
5. Charge employee national insurance on private pension incomes (with an annual allowance that would exempt small pensions). This measure should be introduced instead of means-testing the winter fuel payment.
6. Fairly tax the inheritance of pensions by subjecting pension assets to inheritance tax and levying income tax on all inherited pensions.

c) Consult on reforms to national insurance on pension contributions

7. Consult on levying employee NICs on employer contributions, in exchange for a higher flat-rate pension tax credit on the first tranche of annual pension saving (eg £1 match for every £2 of contributions after tax).
8. Consult on reforming employer NICs on employer contributions so they raise more money for the Treasury while also incentivising voluntary pension contributions by employers.

d) Recycle some of the savings into improving support for under-pensioned groups

9. Increase minimum employer contributions under automatic enrolment from 3 to 7 per cent of earnings.

10. Develop a new opt-out pension for the self-employed with tax relief designed to match that received by employees.
11. Consider providing pension credits to people out of work because they are caring for young children or disabled people.

1. IN NUMBERS

Introducing pension tax relief

On Tuesday 30 July, chancellor of the exchequer Rachel Reeves MP confirmed she will raise taxes in October's budget. Reform of tax relief on pension contributions is said to be on her menu of options – and such changes have been proposed previously by the Fabian Society. This report sets out the case for measures to reduce and redistribute pension tax relief. It also sets out a menu of reform options.

As things stand, individual pension contributions are exempt from income tax. Employer pension contributions are exempt from income tax and national insurance. Pension investments are also untaxed. This is all called pension tax relief. The justification for this tax relief is that pensions in payment are subject to income tax (the same earnings would be taxed twice if pension contributions and pension payments were both taxable).

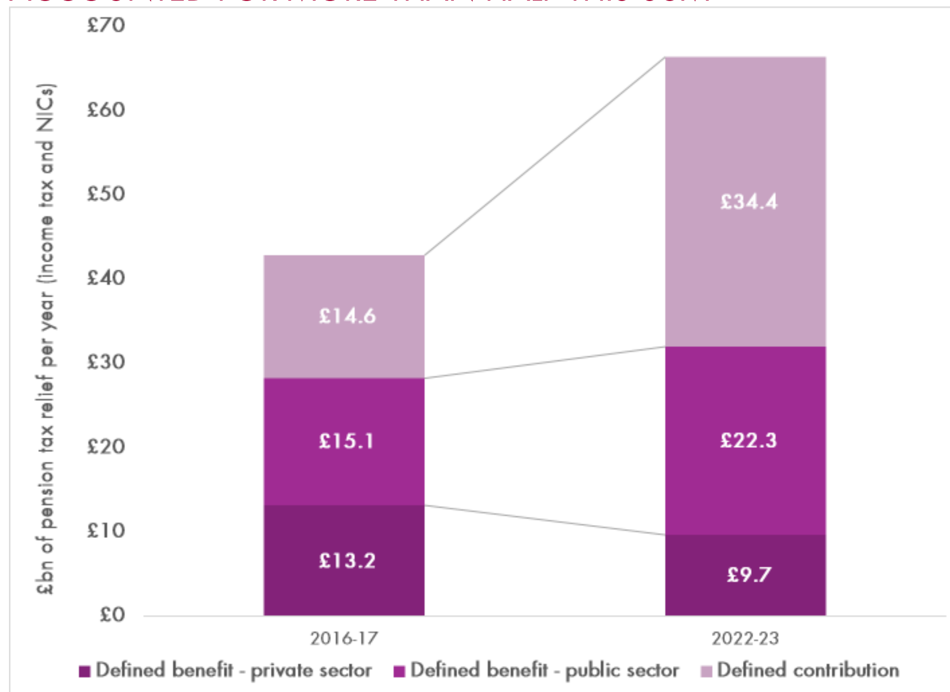
In practice however almost all workers receive far more in tax relief on their pension contributions and investments than they will eventually pay in tax on their pension income (setting aside the effect of inflation). This is especially true for high earners. The loopholes, exemptions and inconsistencies that give rise to this situation are described in chapter 2. First, in this chapter, we map the huge expense and inequality of pension tax relief today.

The scale of tax relief

HMRC statistics published in July show that in 2022/23 pension savers benefited from a staggering £66bn in tax relief on pension contributions (when looking at income tax and national insurance combined).[1] This is a 55 per cent increase since 2016/17 (see figure 1). Their pension funds also benefited from £4bn in tax relief from investment income and an undisclosed amount relating to capital gains.

In the same year less than one third of this tax relief was recouped through tax revenues from private and occupational pensions in payment: in 2022/23 taxes on non-state pensions raised £22bn. This tax revenue is also growing much slower than the cost of tax relief, rising by only 24 per cent since 2016/17. As a result, net pension tax relief in 2022/23 was £49bn, up 54 per cent since 2016/17.[2]

FIGURE 1: THE VALUE OF TAX RELIEF ON PENSION CONTRIBUTIONS INCREASED BY 55% BETWEEN 2016/17 AND 2022/23. FOR THE FIRST TIME DEFINED CONTRIBUTION PENSIONS ACCOUNTED FOR MORE THAN HALF THIS SUM



Source: HMRC

Unequal distribution

In 2022/23 an estimated 53 per cent of the foregone tax and national insurance revenue on pension contributions benefited higher and top rate taxpayers, who make up just 19 per cent of employees who pay income tax.[3] This amounted to £35bn. Figure 2 shows the cash value of the different elements of tax relief for basic and higher/top rate taxpayers. This total is a Fabian Society estimate rather than an official figure because HMRC does not publish distributional data for one component of pension tax relief (the exemption from employer NICs for employer pension contributions). [4]

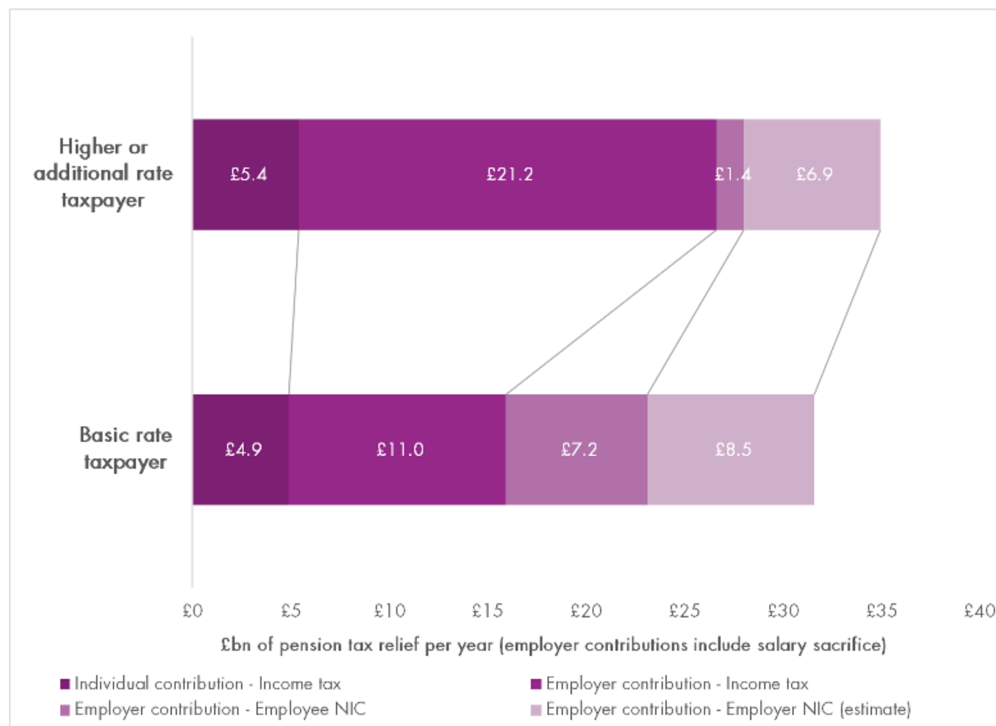
In 2022/23 higher and top rate taxpayers benefited from:

- 52 per cent of foregone income tax on employee contributions
- 66 per cent of foregone income tax on employer contributions (including salary sacrifice schemes)
- 16 per cent of foregone employee NICs on employer contributions (including salary sacrifice schemes)
- An estimated 45 per cent of foregone employer NICs on employer contributions (including salary sacrifice schemes)

All these percentages are a little higher than in 2019/20 – the year for which we last presented this analysis, in our 2022 report Good Pensions for All.[5]

The increase is explained both by there being more higher and top rate taxpayers and by their average pension contributions being greater.

FIGURE 2: IN 2022/23 AN ESTIMATED 53% OF PENSION TAX RELIEF FOR EMPLOYEES WENT TO HIGHER/TOP RATE TAXPAYERS (WHO MAKE UP 19% OF EMPLOYEE TAXPAYERS). TAX RELIEF FOR EMPLOYER CONTRIBUTIONS IS LARGER AND MORE UNEQUAL THAN FOR EMPLOYEE CONTRIBUTIONS.



Source: HMRC. Fabian Society estimate for 'employer contributions – employer NIC'

The targeting of tax relief towards high earners also means that men benefit far more from pension tax relief than women. From the publicly available data we estimate that men receive 65 per cent of tax relief on pension contributions and women 35 per cent (the calculation is based on HMRC statistics on taxable income, by income bracket and sex). [6]

Figure 2 also shows how employer contributions generate the lion's share of tax relief: in 2022/23 they accounted for £56bn or 84 per cent of tax relief on contributions. Employer contributions are more skewed in favour of upper and top rate taxpayers (and in the case of income tax attract much more generous tax relief). Tax reforms therefore need to target pension contributions made by employers not just individuals. Indeed, if they did not, employees in higher and top rate tax bands would make 'salary sacrifice' arrangements, whereby employers make pension contributions on their behalf. Already in 2022/23 salary sacrifice schemes which are designed solely to reduce tax liabilities generated over £7bn of tax relief.[7]

Protecting defined benefit pensions

In our 2022 report we pointed out that some of this tax relief cannot easily be reallocated. In 2022/23, £22bn (34 per cent of relief on contributions) was allocated to public sector pension schemes. If this money was withdrawn the exchequer would have to either compensate public employers in other ways or reduce the generosity of pensions.

A further £10bn of tax relief went to private sector defined benefit (DB) schemes in 2022/23 (of which almost £3bn was still being used to fund pension scheme deficits). Major changes to the tax treatment of DB schemes might trigger the few remaining private sector schemes to close. There would also be significant administrative complexities in changing the tax treatment of employer DB contributions.

Debate about better design of tax reliefs should therefore look separately at DB and defined contribution (DC) pensions. Tax relief on DC contributions is shooting up. Figure 1 shows how in 2022/23 the DC sector for the first time accounted for more than half (52 per cent) of relief on pension contributions (rising from 34 per cent in 2016/17). Over that time total tax relief for DC contributions more than doubled from £16bn to £34bn (while the value of tax relief for private DB pension contributions declined by 27 per cent).

In examining reforms, the first instinct should be to seek to apply the same rules to all pension schemes to retain consistency. However, carve-outs or separate but parallel reforms should be considered for DB pensions if the impact of any general changes were to risk the financial sustainability of schemes or creates very high administrative burdens. Any such exemptions should only apply to pension schemes that are available on the same terms to all employees to prevent senior executives creating DB pensions only for themselves for tax-related reasons.

2. PRINCIPLES

Objectives and inconsistencies

Before setting out proposals for pension tax reform, it is important to review the rationale for tax relief on pensions. The original purpose for pension tax relief was to prevent 'double taxation' – ie paying tax both when you originally earn an income and again when you take it as a pension. To avoid this problem the UK system has traditionally worked on the basis that pension contributions are not taxed when they are made, because they will be when they are taken as a pension.

Other reasons for tax relief have since accumulated. First, it can help to ensure pensions adequacy: there are lots of people who will struggle to achieve an acceptable income in retirement, and government contributions are an important way of plugging the gap. Second, tax relief creates the right incentives. It rewards delayed gratification over immediate consumption, and it ensures that saving pays.

Balanced against these considerations, there is the case against tax reliefs: (1) an effective tax system should be as simple as possible with minimal exemptions and loopholes; (2) the tax system should maximise public revenue, bearing in mind that every pound foregone translates into a pound less of public spending; and (3) in practice almost all tax reliefs tend to favour high income groups the most. This is definitely true in the case of pensions, even though one might expect higher earners to need less in subsidy or incentive to secure an adequate pension.

When it comes to pension tax relief, defenders of the status quo often start by raising the spectre of 'double taxation'. But today's tax system is already highly flawed from this standpoint of tax neutrality, and in almost all cases it provides more in tax relief on pension contributions and investments than people can expect to be taxed on pensions in payment (once inflation is taken into account):

- **National insurance on employer contributions** – individual pension contributions are subject to national insurance. But employer contributions are exempt from both employer and employee NICs, even though national insurance is not charged on pensions in payment. This means that national insurance on employer contributions is never paid. Figure 2 shows that in 2022/23 the government passed up £24bn in NICs on employer contributions (this amount may have declined somewhat

since then, following cuts to the main rate of employee NICs). The same chart shows how much national insurance relief on employer contributions benefits upper and top rate taxpayers, even though they experience a lower marginal rate for employee NICs than basic rate taxpayers. This is because high earners typically receive larger employer contributions than low earners (as a percentage of earnings as well as in terms of cash).

- **Lower income tax rates in retirement** – high earners receive income tax relief at their marginal rate of tax for both employee and employer contributions. For example, people who pay upper rate income tax (currently charged on incomes over £50,270) receive tax relief worth 40 per cent of the value of gross contributions. However, most or all of their private pension income will go on to be taxed at the basic rate of 20 per cent. There are two reasons for this. First, a large proportion of high earners end up having incomes in retirement below the upper rate threshold. Second, the minority who reach the upper rate in retirement still pay basic rate tax on all their income up to this threshold (which will often be most of it). Since almost all pension income will be taxed at the basic rate, there is a strong case for applying the same rate of income tax relief to all pension contributions when they are made.

- **Tax-free lump sums** – people can take a quarter of their pension tax-free in one or more lump sum, up to a limit of £268,275. This is a popular policy and may help incentivise saving, but it undermines the case for exempting pension contributions from upfront tax. It also creates a disincentive to convert pension pots into long-term incomes and favours high income groups far more than those with less. HMRC last estimated the cost of the policy in the early 2010s at £2.5bn per year.[8] The Institute for Fiscal Studies (IFS) estimates that in the long term scrapping the policy will increase the tax associated with a year of pension contributions by £5.5bn.[9]

- **Low earners can receive income tax relief without paying income tax** – some elements of tax relief policy benefit people with low lifetime incomes (though overall, high earners benefit much more). First, workers earning less than the income tax personal allowance in a particular year can still receive money from the government towards their pension, even though they do not earn enough to pay income tax. Second, retirees with modest pensions in payment often pay no income tax, even though they received tax relief on their contributions (this will change in the next few years, as typical state pension payments catch up with the income tax personal allowance).

It is very hard to project the cumulative impacts of all these loopholes at the level of individuals. But their overall effect is clear: (1) almost everyone can

expect to pay less in tax on their pension income during retirement than the amount of tax relief they receive during working life (after the effects of inflation); and (2) high earners usually benefit far more than low and middle earners, both in cash terms and as a percentage of the value of their pension.

Previous governments have attempted to cap the extent to which very high earners can exploit the system by applying annual and (until recently) lifetime limits on tax-advantaged pension saving. But this is a sticking plaster applied to a system that is very expensive and stacked in favour of high earners.

Tests for reform

There is a strong case for fundamental reform of pension tax reliefs. In progressing this agenda, politicians should consider a series of tests:

- Do proposals for reform move the system closer to tax neutrality (ie neither double taxation nor zero taxation for each pound of income)?
- What level of financial top-up is needed to help secure acceptable retirement incomes for people in different circumstances?
- Which financial incentives are needed to secure desirable behaviours by individuals and employers – and how can these be clearly communicated?
- What distributional allocation of tax relief between low, middle and high earners is appropriate – thinking about the value of tax relief in terms of cash and as a percentage of people's earnings?
- Do reforms come with administrative complexity and the risk of unintended consequences?

The answers to these questions come down to judgement, but a centre left politician might come to the following conclusions:

1. Overall, the system should reward pension saving, rather than being neutral between spending and saving. Tax relief should be greater than the tax people will pay on their private pensions, both to top up retirement incomes and to create positive incentives. But the value of tax relief should not hugely exceed likely real-terms future revenues, as it does today: taxes on pensions in payment should rise and/or the total level of tax relief should fall.
2. Tax relief should be designed to incentivise and reward beneficial behaviours. This requires clear communication and a system that is simple to understand. The design of incentives should encourage individuals to (1) make pension contributions during working life and

(2) convert their pension pot into an income for life. It should also encourage employers to provide more than the legal minimum in employer pension contributions.

3. Taxpayer support should be broadly proportionate to people's earnings (taking account of both employer and employee contributions) since the aim of pensions is to replace lifetime income. High earners should not benefit proportionately more than mid earners as they will not pay a significantly higher average tax rate on private pensions once they retire. Likewise, men should not benefit proportionately more than women. This implies a fundamental shift away from today's system of tax relief linked to people's marginal rate of income tax.

4. Pension tax reform should encourage high quality pensions - and at least 'do no harm' to existing provision. If reforms risk seriously undermining existing pensions – especially defined benefit schemes – they should not proceed, or exemptions should be created.

3. PROPOSALS

Over the last decade the main way politicians have sought to contain pension tax relief has been by freezing the lifetime and annual allowance on pension funds. This was effective in containing the cost of tax relief (reforms since 2010 have saved the Treasury £8bn) but it only did a little to address the targeting of tax relief towards high earners.[10]

The lifetime allowance was scrapped in April and replaced by a new cash limit on the amount people can take as a tax-free lump sum. This was couched as a response to a specific problem affecting senior doctors but is in fact benefiting a far larger group of high earners. The Office for Budget Responsibility estimates the reform will cost £1.6bn per year by 2027/28 and in 2023 Labour committed to reverse the policy. [11]

The new government should instead carry out a wholesale review of tax reliefs and make more fundamental changes, by selecting from some of the options proposed in this chapter. By selecting some of the options from this list ministers can save at least £10bn and ensure that the tax relief remaining is more equitably distributed and effective in meeting policy aims.

a) Reform income tax relief for pension contributions

- Give all workers the same flat rate of tax relief on individual contributions irrespective of their marginal rate of income tax (eg 25p or 30p per pound of pre-tax earnings)
- Present this support as a tax credit or match payment to increase transparency and understanding (ie a government top-up to contributions made from net earnings).
- Make employer pension contributions taxable, and eligible for the same flat-rate tax relief as individual contributions (this measure is essential to prevent distortion and exploitation).

First, **the rate of income tax relief should be equalised** for people on all tax bands – for example at 30 per cent of gross earnings, midway between the 20p and 40p rates of tax. This rate would save a limited amount – so a lower rate could be set to generate rather than recycle revenue, for example 25 per cent (see table at end of chapter).[12] Such a flat rate would target tax relief more efficiently towards basic rate taxpayers.

Second, for the sake of transparency **tax relief should be rebadged** as a pension 'tax credit', 'match payment' or 'government top-up'. Workers could be promised, say, £1 of government money for every £3 of pension contribution from taxed earnings. This is the approach followed with Lifetime ISAs, Help to Save and Tax-Free Childcare.

Third, the same policies should be applied to **income tax relief on employer pension contributions**. Proposals to reform pension tax relief frequently focus on employee pension contributions, which as we have seen are associated with a small proportion of the value of pension tax relief. If tax changes are made to employee contributions only, most higher earners would make 'salary sacrifice' arrangements and receive their pension payments as employer contributions instead. To avoid this, identical changes to income tax relief need be applied to employee and employer contributions. Employer pension contributions would become taxable income, and then the new single rate of income tax relief would apply to both employer and employee contributions.

This proposal would be administratively straightforward for DC schemes but would be potentially complex for DB schemes, where the value of the employer contribution may not be individually apportioned. If there were serious difficulties, employer contributions to DB schemes could be exempted, given a long transition period, or subject to alternative reforms.

b) Consider increasing taxes on pensions in retirement

- Reform taxation of pension lump sums, by reducing the maximum value of the lump sum that is free from income tax.
- Charge national insurance on private pension incomes in payment (with an annual allowance that would exempt people with small pensions). This could be in exchange for retaining the winter fuel payment.
- Fairly tax the inheritance of pensions by subjecting pension assets to inheritance tax and to income tax when the deceased is below 75

The **tax-free lump sum** is a popular feature of the pension system but it is expensive and runs counter to the purpose of pension saving – ie to build a secure, ongoing retirement income. Except for small amounts, the tax-free lump sum limit is currently the lower of 25 per cent of total pension funds or £268,275. To reduce the benefit the policy brings to high earners, ministers could reduce the cash limit to £100,000. The IFS estimates that this might eventually save over £2bn per year, which would be targeted entirely at people with high lifetime earnings or assets.[13]

This measure would create an incentive for people to take a higher share of their pension wealth as a regular income. It would be straightforward to

administer within a single pension scheme, but there would be (resolvable) complexities in tax reporting when people had more than one pension.

Employee national insurance could be levied on private and occupational pensions in payment (with a generous allowance to exempt modest pensions). With employee NICs currently at 8 per cent and the same annual allowance as for earnings (£12,570 per year) we estimate this policy would raise at least £2.5bn immediately and would then rise in value over time (the calculation is based on published HMRC data on taxable pension income).[14]

This measure would make up for NICs not having been paid on employer pension contributions in the past (as discussed earlier, employer contributions are exempt from national insurance both at the point of payment and when the associated pension benefit is drawn). The reform would therefore address the historic under-taxation of the pensions of today's pensioners. It would lead to today's affluent pensioners making a higher contribution to public services they rely on.

This policy would affect the richest 3 to 4 million retired people. In isolation it would be very controversial and might be seen to breach Labour's manifesto commitment on national insurance rates. However, it could be presented as a quid pro quo for **retaining the winter fuel payment for all pensioners** (which will no longer be universal from winter 2024/25). Levying employee national insurance on private pensions is more progressive than means-testing winter fuel payment. It would also side-step the financial harm associated with removing winter fuel payment from low-income pensioners who are not in receipt of pension credit.

Finally, reform is urgently required to the taxation of pensions **when people die**. The inheritance of pension assets used to be an insignificant issue when most people had DB pensions or annuities (ie guaranteed lifetime incomes bought using a DC pension fund). With these products, the pension either died with the pensioner, or there was a clearly specified survivor's income for a partner. This has changed following the gradual shift to DC pensions, the post-2014 'pension freedoms' which triggered the collapse of annuity sales, and the recent demise of the lifetime allowance. The result is that we can expect much larger amounts of wealth to be retained in pension pots until death. Indeed, financial advisers now tell rich retirees to turn to their pension last, after all other assets, as part of inheritance tax planning.

Pensions should be designed for use during a person's lifetime, not as a vehicle for low-tax bequests. There are therefore two important loopholes to close. First, pension pots should be liable to inheritance tax in the same way as other assets. This would only affect a small minority of bereaved families as most people die without sufficient wealth to incur inheritance tax (with or without a pension fund being taken into account). Second, income tax

should be levied on funds withdrawn from all inherited pensions. At the moment, income tax is not charged when the person inheriting draws on the pension, if the original pension saver died before the age of 75. There is no good reason for this, given that the original contributions were tax-free.

c) Consult on reforms to national insurance for pension contributions:

- Consult on levying employee NICs on employer pension contributions, and then compensating employees by increasing the proposed flat-rate pension tax credit. The total credit for the first tranche of earnings could be a £1 match for every £2 of contributions from post-tax earnings (whether contributed by individual or employer).
- Consult on reforming employer national insurance on employer contributions. For example, the exemption for employer contributions from NICs could be replaced by a clearer cashback scheme that rewards employers only for making voluntary contributions beyond the auto-enrolment minimum.

The distribution of tax relief is less skewed towards high earners for NICs than for income tax (because national insurance is not a progressive tax in the first place). From the perspective of progressivity, national insurance is therefore a lower priority for reform. However, from the perspective of 'lost' tax revenue, national insurance relief is important. It accounts for over one third of tax relief on pension contributions, and unlike with income tax, none of it is recouped through taxation on pensions in receipt. But any reform must ensure that employers still have good incentives to support pension saving.

Levying employee NICs on employer contributions would equalise the treatment of employer and employee contributions from the perspective of the individual. The total value of this relief in 2022/23 was £9bn. Some of this money could go to the Treasury but since basic rate taxpayers would lose from the measure, a high share of the proceeds should be returned to people by raising the rate of our proposed flat rate tax relief (to account for national insurance as well as income tax). This could again be presented as a transparent pension top-up rather than traditional tax relief. For example, relief from income tax and employee NICs could be converted into a £1 credit for each £2 of net earnings contributed by either individual or employer, on the first tranche of annual pension saving (eg £7,500 per year - a pension contribution of 15 per cent on £50,000 of gross earnings).

Tax relief should continue to be available with respect to **employer NICs for employer contributions** to encourage employers to pay more than minimum pension contributions. But politicians could consider introducing

reforms to make the system cheaper and simpler and to reward only voluntary action. One option would be to levy employer NICs on all pension contributions but to create a cashback scheme for employers that would return a fixed percentage of their voluntary employer contributions (ie the extra they pay in addition to minimum automatic enrolment requirements or the equivalent percentage contribution for high earners). Such a measure would create a clear signal to reward good pension provision. This option would sit well with proposals from the former Office of Tax Simplification to replace employer NICs with a simple payroll levy.[15]

d) Recycle some of the savings into improving support for under-pensioned groups

- Increase minimum employer contributions under automatic enrolment from 3 to 7 per cent
- Develop a new opt-out pension for the self-employed with tax relief designed to match what employees receive
- Consider providing pension credits to people out of work because they are caring for young children or disabled people

There is an urgent need to generate extra tax revenue. So the government's main focus must be on reducing the huge cost of pension tax relief. But ministers should also recycle some of the savings into providing more taxpayer support for people who are under-saving for a pension, especially those with low incomes. We have already examined one way to do this - by introducing a flat rate of tax relief that is higher than the current basic rate of tax. This would transfer resources from higher to lower earners.

The government should also expand the financial support available in three other ways. The first is to **increase minimum auto-enrolment contributions** by raising employer contributions from 3 to 7 per cent of earnings. There is almost complete support among pension policy experts for pension contributions to rise to 12 per cent of earnings because most people are not currently saving enough for an adequate retirement income. The Fabian Society has proposed a split of 7 per cent paid by employers and 5 per cent paid by individuals (others have suggested it should be 6 and 6).

The main obstacle is Treasury resistance to the extra tax relief associated with raising minimum contributions from 8 to 12 per cent. This is despite higher earners typically receiving much more in tax relief, both in cash terms and as a percentage of their earnings. In 2022 the Fabian Society estimated the upfront cost of increasing minimum contributions to be £4bn per year in extra tax relief. This could easily be absorbed as part of a comprehensive reform package that reduced the overall cost of pension tax relief, largely targeting high earners.

Second, the government should improve financial support for people who are **self-employed** (in tax law). Pension saving among this group has plummeted in recent decades and those who do make pension contributions receive much less in tax relief than employees (or self-employed people working through a company). In 2022 the Fabian Society proposed that people paying self-employed NICs should receive pension tax relief equivalent to the amount employees get from both their individual and employer contributions. We estimated this might cost £1bn per year, both as a result of more self-employed people saving and more generous tax relief.

Third, the government could pay tax relief to people who are not working because they are **caring** for young children or disabled people. This group are missing out on the taxpayer subsidy for pension saving that workers receive and our 2022 report suggested they should be offered an annual carer pension credit. Its value could match the annual pension tax relief provided to someone working full-time on the minimum wage. This proposal would reward an essential social contribution and help to reduce pension inequalities between men and women. The cost to government would depend on the eligibility and generosity of the scheme.

Revenue implications

Looking across all these measures, even if only a sub-set were progressed there would be ample scope to generate £10bn per year in extra tax revenues. The table below presents estimated costings for some of the main proposals in this chapter.

Policy	Possible revenue
Create a single flat rate of tax relief for individual and employer pension contributions – 30p for every £1 contribution from gross income	In 2020 the Pension Policy Institute estimated this would reduce the costs of income tax relief for DC pensions by 6 per cent.[16] In 2022/23 this would have equated to £1.4bn. Any reforms to DB pensions would raise more in addition.
Create a single flat-rate of tax relief for individual and employer pension contributions – 25p for every £1 contribution from gross income	In 2020 the Pension Policy Institute estimated this would reduce the costs of income tax relief for DC pensions by 22 per cent.[17] In 2022/23 this would have equated to £5bn. Any reforms to DB pensions would raise more in addition.
Reform the taxation of pension lump sums - eg cut the maximum tax-free lump sum to the lower of £100,000 or 25 per cent of pension wealth	In 2023 the IFS estimated that under this reform contributions made each year would be subject to around £2.2bn extra tax over a lifespan (this is not an estimate for the extra revenue raised in the first year of the policy).[18]

Charge employee national insurance on private pension incomes (with an annual allowance that would exempt small pensions). This measure should be introduced instead of means-testing the Winter Fuel Payment.	The Fabian Society estimates this reform would have generated around £2.5bn in 2021/22 assuming a tax allowance of £12,570. By contract the estimated saving from means-testing winter fuel payment will be £1.5bn in 2025/26.[19]
Fairly tax the inheritance of pensions by subjecting pension assets to inheritance tax and levying income tax on all inherited pensions.	Immediately the savings are modest but this measure prevents future problems. In 2022 the IFS estimated that tax exemptions on the transfer of pensions at death would in the long run cost £1.9bn per year (as wealthier people using today's DC pension rules die).[20]
Consult on levying employee NICs on employer contributions, in exchange for a higher flat rate pension tax credit on the first tranche of annual pension saving (eg £1 match for every £2 of contributions after tax).	No costings available
Consult on reforming employer NICs on employer contributions so they raise more money for the Treasury while also incentivise voluntary pension contributions by employers.	Scrapping relief on employer NICs entirely would raise more than £15bn.[21] Ministers could determine what percentage of this revenue should be ploughed into a new scheme for incentivising employers to provide good pensions.

Endnotes

[1] Estimated cost of pension Income Tax and National Insurance contribution relief, HMRC, 2024

[2] Ibid. Excludes tax relief on capital gains tax which is not included in HMRC data

[3] ibid; Profit, employment and pension income, tax year 2021 to 2022, HMRC, 2024

[4] We've estimated the value of foregone employer NICs based on the distribution of taxable income between people on the basic rate and other tax rates in 2021/22 (HMRC table 3.6: Profit, employment and pension income). This may underestimate how much goes to higher rate taxpayers who often receive more generous employer pension contributions.

[5] Harrop, A, Good Pensions for All: The Left's Agenda for Private Pensions, Fabian Society, 2022

[6] Distribution of total income before and after tax by sex, 2021 to 2022, HMRC, 2024; Profit, employment and pension income, tax year 2021 to 2022, HMRC, 2024

[7] Estimated cost of pension Income Tax and National Insurance contribution relief, HMRC, 2024

[8] Emmerson, C, et al, The IFS green budget: February 2014, Institute for Fiscal Studies, 2014

[9] Adam, S, et al, A blueprint for a better tax treatment of pensions, IFS, 2023

[10] ibid

[11] Economic and fiscal outlook, November 2023, OBR, 2023

[12] Pike, T, Tax relief on defined contribution pension contributions, PPI briefing note 122, Pensions Policy Institute, 2020

[13] Adam, S, et al, A blueprint for a better tax treatment of pensions, IFS, 2023

[14] Profit, employment and pension income, tax year 2021 to 2022, HMRC, 2024

[15] Closer alignment of income tax and national insurance: a further review, Office of Tax Simplification, 2016

[16] Pike, T, Tax relief on defined contribution pension contributions, PPI briefing note 122, Pensions Policy Institute, 2020

[17] ibid

[18] Adam, S, et al, A blueprint for a better tax treatment of pensions, IFS, 2023

[19] Calculation based on Distribution of total income before and after tax by sex, 2021 to 2022, HMRC, 2024; Profit, employment and pension income, tax year 2021 to 2022, HMRC, 2024;

[20] Adam, S et al, Death and taxes and pensions, IFS, 2022

[21] Estimated cost of pension Income Tax and National Insurance contribution relief, HMRC, 2024