PENSION CORPORATION

Pension Corporation Research Briefing Note

Tax relief on employer and employee pension contributions: rationale, value and distribution

March 2010

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Introduction

This briefing note focuses on one particular aspect of the British pensions landscape, namely that of tax relief. Tax relief has been a controversial issue for a long time and returned fully to the limelight in early 2009 when the Government announced that it would reduce tax relief on pension contributions for those on incomes of £150,000 and over, arguing that high income earners benefited disproportionately from the relief offered and would have otherwise benefited even further from recent policy changes.[1]

This note provides some facts and figures on pension tax relief in the UK. Much of the information is based on 2006-07, the last year for which reliable outturn data are available. Before presenting these facts and figures though, the note discusses the rationale for providing tax relief – not only in the UK but more generally - and some recently expressed concerns regarding the efficiency of such policy.

The rationale for tax relief: encouraging pension savings

The main objective of offering tax relief on pension contributions is to encourage individuals to save for retirement, either in the form of contributing to occupational or private pensions. It does so by making saving relatively more attractive, with someone, say, facing a marginal income tax rate of 50 per cent in effect paying only 50 pence for every pound saved. In other words, tax relief is a subsidy by government to individuals to encourage a certain type of behaviour.

Saving for retirement is seen as key to ensuring that people will have adequate pension incomes in retirement. To quote the British Government:

"*Pensions tax relief is a longstanding feature of the pensions tax landscape. The generous tax relief provided by the Exchequer raises incentives to save in a pension relative to other products, encourages employer engagement and sits alongside Government's wider objectives to tackle pensioner poverty and to enable low and moderate earners to have access to low cost saving for their retirement. Part of the longstanding deal is that pensions tax relief is given in return for pensions saving being used to produce an income in retirement*."[2]

In many countries saving for retirement complements the more or less generous pay-as-you-go social security pension promises made by the state. Everything else equal, tax relief should play a greater role in a country's pension system the smaller society's reliance on unfunded statutory pay-as-you go social security pensions.

Most EU countries offer tax relief on contributions and investment returns; a slightly smaller number only on contributions. The latter is not as generous as the former approach but allows for better cost control. Income derived from pensions is then taxed in retirement. However, there are also other approaches. For example, the Czech Republic and Luxembourg

[1] *Building Britain's Future Budget 2009*, HM Treasury, 2009, page 107.

[2] *Regulatory Impact Assessment – Tax Relief for Pensions*, Budget 2007, March 2007.

operate a system called TET – tax exempt tax, which means that the individual is taxed twice, while Estonia or Bulgaria exempt contributions, investment returns and pensions themselves from income tax.[3]

The rationale for offering tax relief seems intuitive and convincing – especially in countries where pension saving is mainly on a voluntary rather than compulsory basis - and surveys conducted to establish whether tax relief actually makes a difference to savings behaviour have found that individuals feel incentivised by the existence of tax relief to save.[4] Whether this actually makes a significant – or indeed any - difference to actual behaviours is not clear though. Indeed, the European Commission has argued that there could be substantial deadweight costs from providing tax relief, in other words there could be substantial inefficiencies as the government provides financial incentives for savings which would have taken place even in the absence of these incentives anyway.[5] In more detail, the European Commission argues that:

"In rewarding private saving, tax relief aims to ensure a higher standard of living in retirement in two ways: by encouraging more private saving and by contributing to the final sum. The efficiency and cost of these tools clearly depend on whether additional savings are made, which can be hard to calculate…

Providing tax relief can be very expensive, costing between over 1.7 % GDP in Ireland and the United Kingdom to less than 0.2 % GDP in Slovak Republic. OECD projections suggest that, while demographic changes will mean an increase in revenues from taxed withdrawal from pension schemes, the costs of tax relief will continue to out weigh revenues collected…

There is a lack of clear evidence for the efficacy of using tax relief to improve overall retirement savings outcomes. For instance, it is not clear that tax relieves actually create additional saving rather than simply divert existing saving. If saving is merely diverted then tax relief will be both expensive and inefficient as it rewards saving that would have taken place without it. It can also be argued that savings are offset, as individuals will save less to get the same outcome as a result of tax relief…

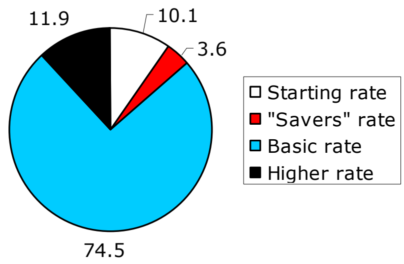
Another issue is who benefits from tax relief both in terms of greater incentives and greater savings… The design of certain tax relief systems seems…to favour higher earners, while the complicated nature of tax relief can result in confusion and it is often only higher earners who have access to independent financial advice to take full advantage. In assessing the effectiveness of tax relieves the costs borne by the State and the contributions these make to the final sums saved by individuals can be readily considered. But the other key part of the picture – what extra savings may have been made as a result of the tax relieves – remains hazy…"[6]

Fact and figures

Income tax and income tax distribution

In 2006-07 income tax revenue net of tax credits amounted to nearly £145 billion, which was around 10 per cent of GDP and close to a third of all government revenue.[7] Chart 1 shows that three quarters of the 32 million individuals paying income tax in 2006-07 were on the "basic" marginal rate, while those facing the higher marginal rate of 40 per cent represented a relatively small fraction of 12 per cent (or 3.8 million in absolute terms). Of those facing the top marginal income tax rate, close to 40 per cent earned less than £50,000, 44 per cent between £50,000 and £100,000. Only 15 per cent of those facing the top income tax rate (and hence less than two per cent of the total) had incomes in excess of £100,000 per year.

Chart 1: Share of income taxpayers based on marginal income tax rates (2006-07)



Source: HMRC Income Tax Statistics.

[3] *Privately managed funded pension provision and their contribution to adequate and sustainable pensions*, The Social Protection Committee, European Commission, 2008, page 28.
[4] See *Incentives to save for retirement: understanding, perceptions and behaviour A literature review*, Roger Wicks and Sarah Horack, 2009.
[5] *Privately managed funded pension provision and their contribution to adequate and sustainable pensions*, The Social Protection Committee, European Commission, 2008.
[6] *ibid*, Page 27.
[7] The information is taken from HMRC Statistics and Budget 2008, HM Treasury.

Even though higher income earners only represent a small fraction of those paying income tax, they make a very substantial contribution to income tax revenue: according to HMRC, in 2006-07 the top ten per cent of income earners paid more than half of all income tax, with the top one per cent of income earners alone contributing nearly a quarter to all income tax revenue. Despite this disproportionate contribution to income tax revenue, the top one percent of income earners commanded a sizeable share of total income of 10.5 per cent even after tax. This compares with 12.9 per cent pre tax. For the top quarter of income earners the respective shares were 51.7 per cent and 55.8 per cent.

The value and distribution of pension tax relief

In 2006-07 the gross value of income tax relief to registered pension schemes amounted to around £28 billion. National Insurance relief on employer contributions added another £8.6bn.[8] This compares with £15.4 billion and £2.8 billion in 1998-99 respectively. This means that as a share of GDP, gross income tax relief to registered pension schemes increased from 1.7 per cent in 1998-99 to 2.1 per cent in 2006-07, while the share of relief on national insurance contributions rose from 0.3 per cent to 0.6 per cent.

Employer versus employee tax relief

According to HMRC, the majority of tax relief on contributions to occupational pension schemes was enjoyed by employers: of the £17.7 billion of tax relief on contributions to occupational pension schemes, £13.3 billion went to employers and only £4.4 billion to employees. This more or less tallies with the aggregate data on pension contributions themselves: in 2006 employers contributed £38.9 billion to funded pension schemes (which with the exception of the UK's local government pension funds are in the private sector).[9] With a "small companies" corporation tax rate of 19 per cent and a main rate of 30 per cent in 2006-07, this is in line with the tax relief figures given. Adding NI tax relief, employer tax relief amounted to around £21½ billion in 2006-07.

Tax relief and income distribution

HMRC data also show that tax relief and deductions are disproportionately geared towards those on higher incomes. In 2006-07 those on incomes above the tax allowance and up to £10,000 received less than 2 per cent of *all* tax relief or deductions even though they represented 20 per cent of individuals with taxable income. Those earning less than £20,000 made up around a third of all earning taxable income but their share in receiving tax relief or deductions was merely 12 per cent. Those on less than £30,000 made up close to two thirds of individuals paying income tax but their share was just over a quarter (27 per cent). Those on less than £50,000 made up nearly 90 per cent of all income tax payers; they received more than half of all tax relief and deductions.

The uneven distribution becomes even more pronounced towards the top end of the income distribution: those with taxable incomes in excess of £70,000 represented only 6 per cent of all individuals with taxable incomes in 2006-07 but received 39 per cent of all tax relief and deductions, while those with taxable incomes in excess of £1m – a tiny minority of 0.06 per cent of income tax payers – received close to 6 per cent of all tax relief and deductions.

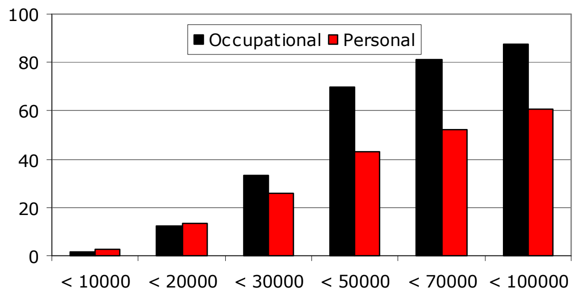
Tax relief on employee (and self employed) pension contributions accounts for more than 80 per cent of all tax relief and deductions. As such it is not surprising that a similar picture emerges for the share of pension tax relief along the income distribution. Starting with occupational pension schemes, those on taxable incomes up to £10,000 accounted for 6½ per cent of all individuals contributing to occupational pension schemes but their tax relief amounted to only 1½ per cent of the relevant tax relief. The respective shares for those earning up to £20,000 were 30½ per cent and 12½ per cent and for those earning up to £30,000 57½ per cent and 33½ per cent. Those contributing to occupational pensions and earning above £100,000 accounted for only 2.9 per cent of all individuals with occupational pensions but their share of tax relief was 12½ per cent of the total.

The distribution was even more skewed for tax relief on pension contributions to personal pensions. Those earning £100,000 and more represented 2.9 per cent of all individuals with personal pensions but received 39 per cent of all relevant tax relief. At the other end of the income scale, slightly more than a third of all individuals contributing to personal pensions had incomes of less than £20,000; their share of tax relief was 13½ per cent. Chart 2 summarises the above discussion.

[8] See HMRC statistics and in particular Table Personal Incomes T3.8 "Deductions and Reliefs" and Table Pensions 7.9 "Registered pension schemes". See www.hmrc.gov.uk/stats/income_distribution/3-8tabledec08.pdf and www.hmrc.gov.uk/stats/pensions/table7-9.pdf

[9] *Pension Trends Chapter 8 Pension contributions*, Office for National Statistics, 2009.

Chart 2: Share of tax relief on pension contributions in total relevant tax relief based on incomes (£, 2006-07)



Source: Based on HMRC Statistics, Table 3.8.

Net tax relief: upfront tax relief versus tax on pension incomes

A key consideration of giving tax relief to encourage retirement saving is that the government will eventually claw back some of that relief in the form of income tax on pensionable incomes. HMRC has estimated that the government received £10.5 billion in the form of income tax on pension payments in 2006-07, the equivalent of 0.8 per cent of GDP.[10] This compares with a share of 0.7 per cent in 1998-99. Net tax relief to registered pension schemes therefore amounted to £18 billion in 2006-07 (1.3 per cent of GDP) and £9.3 billion in 1998-99 (1 per cent of GDP).

To put this into perspective, amounting to 1.3 per cent of GDP, in 2006-07 net tax relief on pension contributions was of a similar magnitude to government spending on long-term care and around a quarter of spending on state pensions or spending on education.[11]

The tax base is substantial: according to ONS there were 9.7 million individuals aged 65 years and over in the UK in 2006. Of these around 5.6 million lived as couples, the remainder as singles. According to HMRC, slightly less than half – 4½ million - of the individuals in this age group paid income tax in 2006-07.[12] Note that "pensioner couples" are defined as those couples where at least one person is over the State Pension Age. In 2006-07 this could, for example, have been a couple where the female and male were both 61 years old: the female would have been over her State Pension Age of 60 years whereas the male would have still been below his State Pension Age of 65 years.

The distribution of incomes for single pensioners[13] is as follows: single pensioners under the age of 75 years had a mean gross income of £13,800 in 2007-08, with the lower quintile on average on £6,000, the second lowest quintile on £9,000, the middle quintile on £11,000, the next fifth on £14,000 and the top quintile on £28,700. The distribution is not substantially different for those aged 75 years and above with the exception for the top group.[14] See Table 1.

Table 1: Gross income distribution for those in retirement across quintiles (2005-06 to 2007-08 means, annual incomes in £ 2007-08 prices)

	1st	2nd	3rd	4th	5th	Mean
Under 75						
Couples	11024	15808	20540	27924	61412	27352
Singles	5980	9048	11128	14092	28704	13780
75+						
Couples	11336	15496	19968	27196	56056	26000
Singles	6136	8944	11076	13832	23816	12740

Source: Based on Pensioners' Income Series, Department for Work and Pensions.

The relatively high average incomes for pensioner couples in the top income quintile can partly be explained by the fact that in many instances – especially for those under 75 years of age – one spouse will still be working. This is because pensioner couples are defined as those couples where at least one person is over the State Pension Age (see above). The UK's high degree of income dispersion will also play an important role.

Of the 1½ million single pensioners under the age of 75 years, 17 per cent paid no income tax at all. For the 2½ million single pensioners aged 75 years and over that proportion stood at 21 per cent. Roughly speaking, the lowest quintile of single pensioners did not pay any income tax as their incomes were below the tax allowances, which were around £7,000 in 2005-06 and £7,500 in 2007-08. This is consistent with the information above.

One point to note is that many individuals facing the 40 per cent tax rate during working lives will be in a lower tax band in retirement. This will particularly be the case for those earning, say, £40,000 to £75,000. Even someone on a final salary defined benefit pension

[10] *Table 7.9 Registered pension schemes*, HMRC Statistics at www.hmrc.gov.uk/stats/pensions/table7-9.pdf. To derive this figure HMRC has assumed that pension payments represent the top slice of taxable income.
[11] *2008 Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, 2008.
[12] *Table 2.1 Survey of personal incomes*, HMRC Statistics.
[13] Pensioner couples are much more difficult to analyse and would require more information.
[14] This is probably due to the fact that these are no longer receiving any earnings from work (other DWP statistics suggest that this remains an important income source for higher income pensioners inn their "earlier" years of retirement).

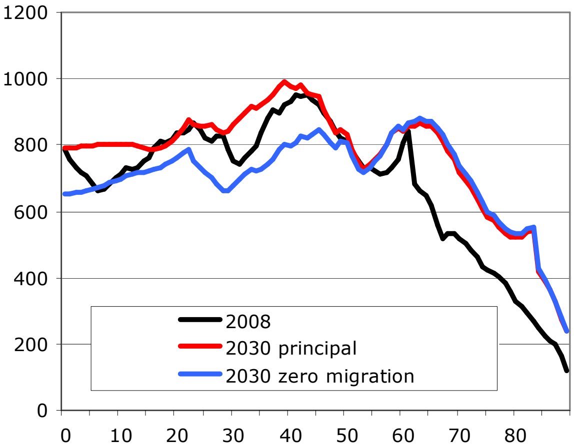
with a 30 year employment record and a final salary of £75,000 will in conjunction with the basic state pension just about make it into the 40 per cent tax band. They will hence benefit from a net subsidy to them over their lifetime. The higher tax allowance for people aged 65 years and over will have a similar effect.

Looking ahead: net tax relief over the coming decades

Given that the size of the working-age population is currently buoyed by the large baby boom cohorts and substantially larger than the number of people aged 65 years and over (or more generally in retirement), it is perhaps not surprising that net tax relief to registered pension schemes currently represents a significant share of GDP. The system is not in a steady state yet.

Demographic change could impact on the size of future net tax relief. Chart 3 shows the age structure of the British population today and as projected in 2030, the latter using the principal and zero migration population variants from the latest, 2008-based ONS population projections. In the principal population projections there would actually be more people aged 30 to 50 years in 2030 than now. The zero migration variant shows what would happen in the absence of any migration: those cohorts would be around 15 to 20 per cent smaller than today. Everything else equal, gross tax relief in the principal population projection could therefore be expected to increase as a share of GDP over that period. Whether this would actually lead to an increase in net tax relief is less clear as the number of people aged 65 years and over will also rise rapidly, which in turn should lead to an expansion of the tax base for income tax on retirement income.

Chart 3: Age distribution of population ('000)



Source: ONS 2008-based population projections.

Assuming that net migration turns out to be somewhere between the principal and zero migration assumptions, the future working-age population would be similar to today's, leading to a similar amount of gross tax relief. In combination with a likely increase in income tax revenue on pension incomes, net tax relief could therefore be expected to fall as a share of GDP.

The above is obviously a simplistic approach to gauging future developments in net tax relief but nonetheless illustrates the importance of demographic change. More sophisticated approaches have been developed, including by the Organisation for Economic Co-operation and Development (OECD), which *inter alia* model labour market trends, annuity rates and investment returns explicitly. In 2004 the OECD projected that the share of net tax relief in GDP in the UK will increase to around 2¼ per cent up to the mid 2030s and then fall again to around 2 per cent by mid decade – still higher than now.[15]

To put this into context, state spending on pensions was less than 5 per cent of GDP in 2006-07 and is projected to increase to around 6 per cent by 2030 and around 6½ per cent by 2040.[16] As such the projected cost of net tax relief to pension contributions to the exchequer is around a third of projected state pension spending itself.

More generally the OECD argues that:

"*In all countries except Sweden and Denmark, the flow of net fiscal revenues is projected to decline over the next 10 to 20 years, but in a number of countries it increases significantly thereafter. By the end of the projection period, an improvement in the budget contribution relative to 2005 is expected in several countries. The improvement is particularly pronounced in Denmark, Iceland, the Netherlands and Sweden. In contrast, net fiscal revenues are expected to remain below their 2005 level at the end of the projection period in Ireland, Japan, Poland, Portugal, Slovak Republic, Switzerland and the United Kingdom.*"[17]

[15] *Long-term budgetary implications of tax-favoured retirement saving plans*, Pablo Antolín, Alain de Serres and Christine de la Maisonneuve, 2004.
[16] More precisely on basic State Pension, Second State Pension, Pension Credit, Winter Fuel Payments, Over 75 TV licences and Christmas Bonus. See *2008 Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, March 2008.
[17] *Long-term budgetary implications of tax-favoured retirement saving plans*, Pablo Antolín, Alain de Serres and Christine de la Maisonneuve, 2004, page 42.

It needs to be noted that recent changes in individuals' behaviours or policy (most obviously those recently announced aimed at those on high incomes) could lead to different results if this exercise were repeated today. Nonetheless, the existing results remain illustrative and insightful.

Concluding comments

This briefing note discussed, first, the rationale for governments around the world to offer tax relief on pension contributions and, second, the magnitude and distribution of pension tax relief in the UK. The focus of attention ought to be on net rather than gross tax relief as this takes account of the income tax revenue paid by pensioners on their pension incomes.[18]

Taking account of income tax revenue in retirement as a result of pension income allows for an assessment of the true impact of the policy on the public finances and also corrects the distributional picture, which would otherwise emerge: individuals on higher incomes benefit disproportionately from tax relief but are also likely to pay higher income tax in retirement. At least in theory it is entirely feasible then to set up tax relief on pension contributions to be fiscally and distributionally neutral over an individual's lifetime. This is not the case in the UK though, with the 2004 OECD projections showing net tax relief to remain significant over the coming decades. It is likely that higher income earners would be the main beneficiaries in that case. The current Government is aware of this and recently announced policies to address this. Given the dire state of the UK's public finances and the need to control spending, a future government might find it necessary to go down this route even further.

References and data sources

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[18] An even more sophisticated analysis would estimate the additional income tax on pension incomes generated as a result of previously given tax relief on pension contributions. If the European Commission's concern presented in the main text is valid, then tax relief on pension contributions during someone's working life should generated little additional pension income and hence income tax.

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Dr Frank Eich holds an MSc and PhD in Economics from the London School of Economics, and has worked as a professional economist both in the private and public sector. Before joining HM Treasury as an economic adviser in 2000, he worked for three years as a country economist for the Economist Intelligence Unit. In 2008 Frank worked on European and international economic policy issues in the German Finance Ministry in Berlin; he joined Pension Corporation as senior economist in October 2008.

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