Memo to the Chancellor: think carefully about pension tax changes

Rachel Reeves has laid the ground for tough measures in her budget – but the Chancellor should be wary of treating pensions as a soft option.

In her statement to the House of Commons on 29 July, Reeves said she had inherited a projected £22 billion overspend for this fiscal year. The Conservatives reject this assertion, but the political narrative has been set. Reeves says she will make "difficult decisions" in her first budget on 30 October.

The Chancellor has already announced the scrapping of winter fuel payments for millions of pensioners – and this may be the tip of the iceberg.

We have said before that pensions may be too tempting a target as Reeves addresses the dual challenge of tight government finances and depleted public services. She now seems highly likely to prop up the public finances by making changes to how pensions are taxed.

So, with the gross cost of pension income tax and national insurance contribution relief rising from £68.1 billion in 2021/22 to £70.6 billion in 2022/23, what are Reeves's options – and the potential unintended consequences?

Obvious revenue-raising measures include:

- Changes to higher rate pensions tax relief
- Restricting how much tax-free cash people can draw from their pension
- Making more pensions liable for inheritance tax
- Limiting or scrapping salary sacrifice

Broadly speaking, these changes would create complexity for pension savers and possibly undermine the government's aims of increasing retirement saving and investment in UK businesses.

Higher rate relief is on the radar

During the election campaign, Labour said Reeves had "no plans" to reduce the rate of tax relief for higher earners – an idea she had previously supported.

Nevertheless, press reports suggest Reeves is considering introducing a flat rate of 30%, replacing the current regime that allows relief at the pension saver's marginal income tax rate.

This would slightly benefit basic rate taxpayers while charging more tax to higher earners who pay 40% or 45% income tax. For a Labour chancellor, this cross-subsidy might seem like an easy decision.

But the government's own figures show that more than 12 million people aren't saving enough for a comfortable retirement. This group includes many 40% taxpayers whose annual income may be little more than £50,000. Reducing tax relief would also go against the grain of the growing consensus in favour of widening auto-enrolment and increasing minimum contributions.

The measure would also introduce extra complexity for schemes and their members when they are already overloaded with regulatory and legislative change. And implementation is likely to be difficult – marginal rate relief has been in place for decades and the changes needed to move to a single rate couldn't realistically happen

by 6 April 2025.

Other options pose problems too

The same concerns about complexity and disruption apply to the other potential measures we have listed. For example:

- Reducing tax-free cash withdrawals to less than the current 25% would be horribly complicated – and will the change apply to savings already built up? This allowance has already been trimmed significantly over the past decade or so
- Inheritance tax rules allow defined contribution pensions to be passed on tax-free if the scheme member dies before the age of 75. Applying inheritance tax to all pensions would need complicated arrangements to prevent penalising people who made plans under the current arrangements
- Salary sacrifice allows scheme members – and their employers – to pay less national insurance by reducing the member's pay and diverting the money into their pension. This piece of tax avoidance might seem like an easy option politically, but abolition would create complications for millions of people whose contributions are effectively collected through salary sacrifice

Change could undermine the government's ambitions

The government has launched a review of the pensions market to examine how to improve retirement outcomes for members and increase investment in the UK economy. We urge Reeves to tread carefully if she wants to support these goals.

First, every move that makes pensions more complicated or changes the rules can chip away at confidence among pension savers when we need them to be more engaged. The review is welcome and overdue – so why make changes to taxation of pensions before the review has really started?

Second, as well as the market review, pension schemes and their members already face a mass of change – from abolition of the lifetime allowance to the Pension Schemes Bill and the introduction of pensions dashboards. We need to keep further disruption to a minimum.

Third, pension savings support the wider UK economy at a time when the government's goal is economic growth. As a group of financial industry leaders told the Chancellor last month, inadequate long-term savings and low investment in the UK go hand in hand. "The availability of a growing pool of long-term investment capital is critical for allowing UK businesses of all shapes and sizes to grow and flourish," they said.

Pension reform needs careful consideration

It looks like a matter of how, and not if, the government will make changes to the taxation of pensions. But pensions are a long-term, complex policy area with knock-on effects lurking in every measure.

We urge Reeves to consult widely and carefully consider the potential consequences of ideas presented by her officials. We hope that Emma Reynolds, the pensions minister whose job spans the Treasury and the Department for Work and Pensions, will present the case for caution.

Without thinking things through, the government risks further disrupting pension schemes and their members – and undermining its own broader ambitions

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Reeves insights



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Insights

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