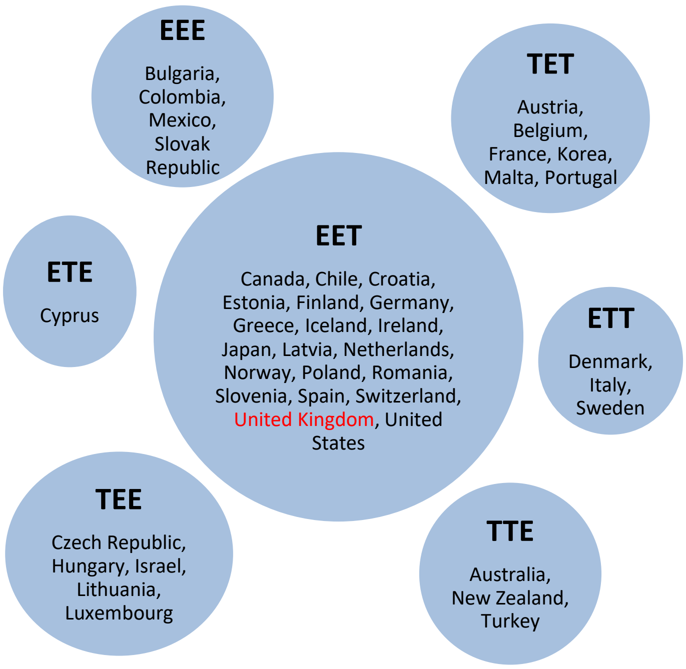
Country note
United Kingdom

Like many other OECD countries, the United Kingdom encourages people to save in funded private pension arrangements through tax incentives by making contributions deductible from taxable income, exempting returns on investment and taxing income and withdrawals. Half of OECD countries apply a variant of this "Exempt-Exempt-Taxed" ("EET") regime to retirement savings (Figure 1).

Figure 1. Tax treatment of retirement savings in private pension plans, 2018



Note: Main pension plan in each country.

Some aspects of the UK tax regime of private pension arrangements may limit the incentive for peope to save for retirement. First, there are two systems to provide tax relief on contributions: net pay arrangement and relief at source. With the net pay arrangement, the employer takes the pension contribution from the individual's pay before deducting income tax. With relief at source, the employer takes the pension contributions from the individual's pay after deducting tax. The pension provider claims tax back from the government at the basic rate of 20%. Individuals paying tax at higher rate (40%) or additional rate (45%) can claim the difference through their tax return. Most people are indifferent between the two systems, except individuals not paying income tax, who get a 20% tax refund in their pension account with relief at source, but not with the net pay arrangement.

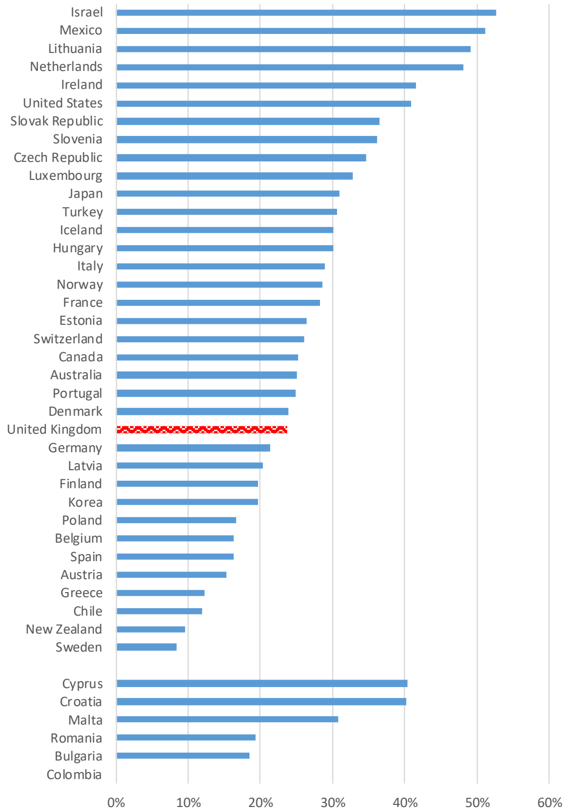
Second, there are two ceilings that limit how much people can accumulate in private pension plans. The annual allowance (currently GBP 40 000) is the maximum amount of pension contributions that an individual can get tax relief on in each tax year. The lifetime allowance (currently GBP 1.03 million) is the maximum amount of assets that can be accumulated before paying tax.

Third, pension freedoms may lead some people to pay a lot of taxes on their pension withdrawals. Since 2015, individuals aged 55 and over can access their DC pension savings as they wish (annuities are no longer mandatory). This means that they may take the whole amount as a lump sum, paying no tax on the first 25% and the rest taxed as income (at the marginal tax rate). As lump sum payments can be quite large, they can potentially increase the individual's marginal income tax rate the year of withdrawal.

The tax treatment of private pension plans, compared to that of traditional savings accounts ("TTE"), translates into lower taxes paid over the lifetime for people saving in private pensions. This overall tax advantage amounts to 24% of the present value of all contributions for the average earner. Compared to other OECD countries, the United Kingdom lies in the bottom half (Figure 2). This stems from the fact that the average earner pays income tax at a relativey lower rate than in some other countries (20%, compared to 25% in the United States or 30% in France for instance) and interest income in savings accounts benefits from tax allowances.

Figure 2. Overall tax advantage provided to an average earner

Present value of taxes saved over a lifetime, as a percentage of the present value of contributions

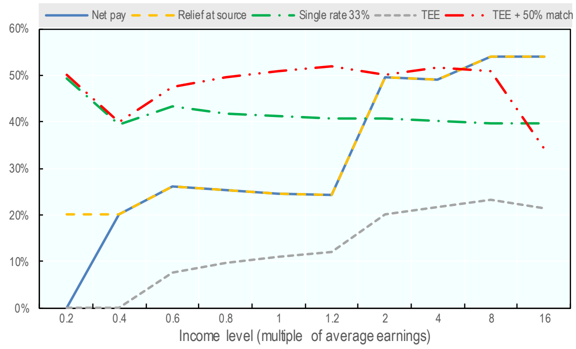


Note: Calculations based on the 2018 tax treatment of the main pension plan in each country. The calculations assumes that the average earner enters the labour market at age 20 in 2018 and contributes yearly until the country's official age of retirement (67 for the UK) at a rate equal to the minimum or mandatory contribution rate fixed by regulation in each country (8% in the UK automatic enrolment system) or 5% of wages in the case of voluntary plans. The total amount of assets accumulated at retirement is converted into an annuity certain with fixed nominal payments (after deducting the 25% tax-free lump for the UK). Inflation is set at 2% annually, productivity growth at 1.5%, the real rate of return on investment at 3% and the real discount rate at 3%.

There are discussions currently about reforming the tax treatment of private pensions in the United Kingdom. Alternative proposals include providing tax relief on contributions at a single rate (rather than at the individual's marginal rate) or switching to the "TEE" tax regime possibly with a government matching contribution. Figure 3 presents the impact of alternative approaches to designing financial incentives in the UK context by income level.

Figure 3. Overall tax advantage provided by alternative designs, by income level

Present value of taxes saved over a lifetime, as a percentage of the present value of contributions



Note: The calculations assume a 5% contribution rate up to the annual allowance, except for the "TTE" regimes (no annual allowance). The lifetime allowance applies to all designs, as well as the 25% tax-free lump sum.

A single 33% rate of tax relief on contributions and a "TEE" tax regime with a 50% government matching contribution would achieve a smoother overall tax advantage across income groups than the current "EET" tax regime. Under the current net pay arrangement, there is wide gap between non taxpayers, who get no tax advantage when saving in private pensions, and taxpayers on the additional rate of income tax, who save in taxes paid over their lifetime an amont equivalent to about 50% of their pre-tax contributions. A single rate of tax relief on contributions would increase the tax advantage for low to middle-income earners, while reducing it for higher earners. By contrast, the "TEE" tax regime with no match from the government would reduce the overall tax advantage across the income scale.

Finally, it is expected that the tax expenditure related to private pension plans will increase in the near future before declining. The automatic enrolment policy indeed increases significantly the number of pension savers. Everything else equal, this will lead to larger tax revenues forgone on contributions and investment income. Because of the lag in the growth of benefits behind that of contributions and assets, the net tax expenditure will start declining ony when the new cohorts of pension savers start retiring and paying taxes on their withdrawals.