

[Pensions tax relief is no stealth subsidy](#) [1]

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The UK Labour Party's plan to reduce the tax relief that higher-rate taxpayers can take when making private pension contributions (in order to fund job-creation programmes) is an intriguing one.

Labour finance spokesman Ed Balls argues that "When times are tough it cannot be right that we subsidise the pension contributions of the top two per cent of earners at more than double the rate of people on average earnings paying the basic rate of tax." Under his plan, those earning £150,000 would be able to claim only 20% tax relief on their pension contributions – the same rate as a person on average earnings – rather than the 50% that top earners can claim now (which will fall to 45% in April as the top rate of tax is reduced).

What Mr Balls forgets, however, is that the tax relief available on contributions to private pension plans is not, in fact, a straight subsidy. It is, rather, deferred taxation. And that makes a big difference, since if taxation is being deferred, it should be deferred at the rate it is paid.

Confused? You should be. Pensions are absurdly complicated. But here is how the tax relief actually works. Decades ago, governments wanted to encourage people to make private pension contributions. This, they reasoned, would help keep them off the welfare rolls when they retired and no longer had a wage coming in. And it would encourage thrift and self-help. So they decided to defer the tax on pension contributions. In other words, if you took all your salary now, you would pay tax on it. If, however, you chose to defer taking part of your salary and instead invested it in a pension, then part of your tax would be deferred too. That is, people would be taxed only when they actually consumed their pay: postpone the consumption, and the tax is also postponed. They would not pay tax on income that they were not actually enjoying right now.

Thus a 20% income tax payer would not pay the 20% tax on contributions to a pension, until they actually started drawing that income. Likewise a 45% income tax payer would not pay the 45% tax until they did the same. It is not a differential subsidy for high earners, just a postponement of their tax on income that they have decided to put off enjoying.

Under this logic, reducing the tax relief on higher-rate earners amounts to confiscation. They defer consumption, but still get landed with 25% tax on income they have not yet drawn.

However much governments might like to tax people on income they do not draw, it doesn't make it right.

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