Cutting the Gordian knot on pensions [1]

Written by **Dr Eamonn Butler** [2] | Wednesday 9 January 2013

The UK Labour party wants to end higher-rate tax relief on pension contributions, arguing that current reliefs are a subsidy to higher earners. As I argued on Monday [3], they are not ? they simply defer tax on that part of a person's income that they defer drawing, and put into a pension investment instead. But what should the right policy on pensions be?

The straight libertarian argument is that governments have no business trying to encourage savings, whether through tax deferral, outright subsidy, or anything else. To do so distorts the market and puts the values of the authorities ahead of the values of the general public.

But of course we are not living in a libertarian paradise. The fact is that we have a large state welfare apparatus, with something like one-eighth of government spending going on transfer payments. And unless people are encouraged to make provision for their retirement, some (or perhaps many, given the natural human tendency to value present income more than future income) will consciously choose not to save while they are in work and rely on state welfare once they have retired. There is, therefore, a case for subsidising pension contributions as a way of incentivising people to provide for their own income in retirement, rather than relying on state benefits.

If that is so, then the state has no business encouraging people to save more than they need to save in order to keep themselves off the welfare rolls. That would suggest that any state encouragement of pension contributions should be limited. Once you have saved enough to prevent yourself being a charge on the welfare system in retirement, you should receive no further tax relief.

It also suggests that you should indeed convert the bulk of your pension pot into an annuity, providing you with a regular retirement income ? or that you draw down your pension pot at a steady rate. Otherwise there would be 'double dipping' - people using the tax relief to accumulate pension pots that they then spend liberally, before declaring themselves impoverished and then relying on state welfare.

Again, though, practicality may intervene. It may be complicated to grant tax relief to some contributors rather than others; there is a bureaucratic cost to checking how much people have actually saved. Likewise, annuity rates may fluctuate considerably, perhaps leaving people with much lower pension income than they anticipated. And drawdown arrangements can be hard for people to understand and for the tax authorities to police.

Inevitably, such considerations make pensions complicated ? and that complexity must discourage people from paying in to pension plans. A simple regime has much going for it ? say a straight pound-for-pound matching by government of everything you put into a pension ? up to a total or annual limit, calculated to be enough to keep folk off the welfare rolls in retirement. Easy. The only trouble is, you can't just tear up the existing pension contracts that people have, as pensions are inherently long-term commitments. And there are lots of those different arrangements, because the pension rules have been changed many times in the past. Which means that pensions will continue to confuse the general public. Annoying, but true.

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