LCP on point

How to avoid an 'Omnishambles' Budget: Why raiding pension tax relief is riskier than it looks

September 2025

Contents

Executive Summary

It seems highly likely that the Autumn 2025 Budget will contain significant revenue-raising measures. And, with increases in the headline rates of income tax, VAT and (employee) NICs ruled out by manifesto commitments, the Chancellor will be scouring the fiscal landscape for areas where extra revenue can be found.

Against this backdrop, it would not be surprising if the Treasury took a long, hard look at pension tax relief.

On the surface, a raid on tax relief could be very tempting. The Treasury's own estimate is that the net cost of the system is over £50bn per year and that much of the benefit goes to those on higher incomes.

But the purpose of this paper is to warn of the traps for the unwary if the Chancellor goes down this route. Previous Chancellors (and notably the 2012 'Omnishambles' Budget) have come up with lists of tax-raising measures which seemed straightforward, but which turned out to be so controversial they had to be reversed or scaled back within weeks or never delivered the promised revenue.

In the case of pension tax relief, there are two 'big ticket' changes which the Chancellor might be advised could raise substantial sums and which are often the source of fevered speculation in the run up to each Budget.

These are:

- Abolishing the higher rates of tax relief enjoyed by higher earners
- Capping or scrapping the ability to take a 25% tax-free lump sum

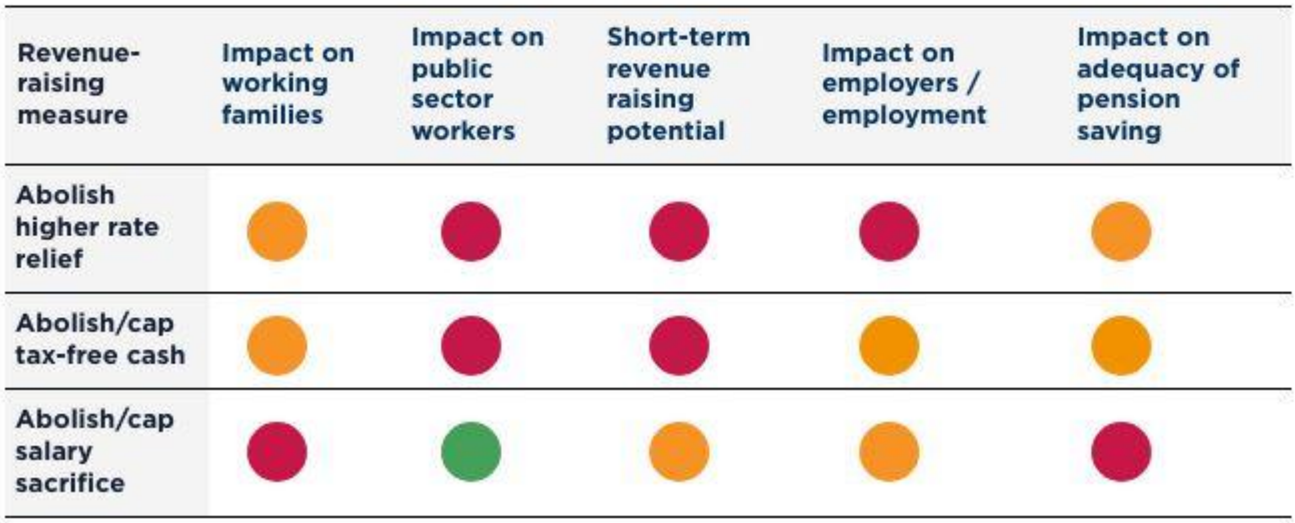
This year, there is also some speculation around capping or scrapping the use of 'salary sacrifice' for pensions as a result of a report released by HMRC in May.

However, in each case there are hidden 'traps' which mean that if any of these changes were made, there could be real challenges for the Chancellor.

Some of the issues we identify that could stand in her way are:

- Does this breach the manifesto commitment not to increase tax on 'workers', and wider rhetoric about protecting 'hard-working families'?
- Does this have a disproportionate impact on public sector workers, who may be core government supporters and where industrial relations are currently tense?
- Does the change generate serious revenue before the next General Election?
- Does this represent a further hit on employers, still dealing with measures in the last Budget on employer NICs?
- Does this undermine already inadequate levels of saving for retirement?

In this paper, we look at these three speculated measures and consider how they fare against these five challenges. Our red/amber/green ratings are summarised in the chart, with red ratings indicating major challenges.



As the chart shows, all of the potential measures have multiple challenges. In particular:

- **Abolishing higher rate relief** would be complex and take years to implement, yielding very little revenue in this Parliament. It would be a clear breach of the manifesto commitment not to tax workers more and would affect many middle and higher-income employees in the public sector who receive substantial benefits from tax relief on the contributions they and their employer make to relatively generous DB pension schemes.
- **Capping tax-free cash** would be hugely unpopular, especially amongst those closest to retirement. Extensive transitional protection might therefore be needed, which would delay any major revenue-raising potential. The effects would be disproportionately felt on those with long service in public service schemes, including those on relatively modest incomes.
- **Capping or scrapping salary sacrifice** for pensions would particularly affect over three million basic rate taxpayers who currently benefit from such arrangements. It would also risk undermining the attractions to employers of providing high quality workplace pensions and could well lead to a sharp downturn in pension saving, storing up trouble for the years ahead.

A fundamental challenge for the Chancellor is that manifesto commitments prevent her from taxing workers more, whilst the heavy recent increases in employer NI contributions will make her very reluctant to go much further in increasing the tax burden on employers. Changes to pension tax relief of the sort described here could hit employees, employers or both, and would likely face considerable opposition as a result.

If the Chancellor is to avoid a repeat of the experience of George Osborne in 2012, with a Budget which unravels within days, she must avoid the superficial attractiveness of chipping away at the cost of pension tax relief and look beneath the surface.

Otherwise, she may discover to her cost that ‘here be dragons’.

01 Introduction

It is not often that a Budget causes a new word to be crowned by the Oxford English Dictionary as ‘word of the year’.

But George Osborne’s 2012 Budget will forever be known as the ‘Omnishambles’ Budget. The Chancellor’s Budget contained a set of revenue-raising measures, many of which looked apparently innocuous, but created a political storm and, in some cases, led to the policy being largely reversed (see box below).

The purpose of this paper is to highlight the risk that a potential Budget 2025 raid on pension tax relief could quickly be viewed in much the same way.

We examine areas of the system of pension tax relief which are likely to attract particular attention from a cash-strapped Chancellor and show the traps which await the unwary. These include negative impacts on people with modest incomes, a risk of alienating public service workers (which is likely to be of particular concern to a Labour Government), and implementation challenges that could mean changes announced in Autumn 2025 generate little serious revenue this side of the 2029 General Election.

The paper is structured as follows:

- In Section 2, we provide a brief explanation of how the current system of tax relief works and how much it costs.
- In light of this, in Section 3 we consider three major changes to pension tax relief which would raise revenue and for which there has already been speculation in the run-up to the Budget.
- In Section 4, we identify five ‘traps’ – negative and possibly unexpected side-effects – which could arise in the event of changes to pension tax relief. We assess how far each of the three potential changes to tax relief could fall foul of these traps.
- Section 5 offers some concluding thoughts.

The 2012 'Omnishambles' Budget – what happened?

The 2010-15 Parliament was marked by a series of budgets which combined a squeeze on certain areas of public spending with a range of revenue-raising measures, designed to put the public finances on a firm footing.

Revenue-raising measures in the 2012 Budget included[1]:

- The freezing of pensioner tax-free allowances (later dubbed the 'granny tax')
- A range of measures to 'close loopholes' in the VAT system. These included:
    - Extending VAT to 'certain hot food' (later dubbed the 'pasty tax')
    - Extending VAT to static holiday caravans, to align with the treatment of mobile homes

Although the changes to pensioner tax allowances were the biggest revenue raisers in the Budget, it was the detailed changes to VAT which created the biggest controversy.

In response to the extension of VAT to certain hot food:

- A national newspaper ran a hostile campaign entitled 'Who VAT all the pies?'
- A nationwide petition against the changes was launched by the Cornish Pasty Association
- Ministers were challenged as to when they had last eaten a pasty, with allegations that they were out of touch with 'ordinary people'

Because of this criticism, the Government modified its proposal, so that food which was 'cooling down' on a shelf rather than being kept warm in a cabinet would remain exempt.

At the same time, the proposal to apply 20% VAT to static holiday caravans was also watered down, with a reduced 5% rate.

The combination of these concessions meant that around half of the expected revenue from the VAT changes announce on Budget Day was lost.

[1] Budget 2012 HC 1853, Session 2010-2012

02 How pension tax relief works and how much it costs

1. How pension tax relief works

In this section, we provide a summary of the key features of the system of pension tax relief[2].

Income tax treatment

The basic idea of pension tax relief is that you pay tax when you take money out of a pension rather than when you pay in. Contributions into approved pension arrangements attract tax relief (subject to various annual limits), money inside a pension accumulates broadly tax-free, but money coming out of a pension is generally subject to income tax, excepting a percentage – typically 25% - which can be taken out tax-free. Contributions made by employers are also exempt from income tax.

The system, as described above, is subject to various complex restrictions, but the most important of these for our purposes are:

- The 'Annual Allowance' (AA), which limits the contributions into a pension (or the increase in value of a pension depending on type) which can be made each year whilst benefiting from tax relief; contributions above this level attract a tax charge; the AA was increased from £40,000 to £60,000 in 2023/24.
- The 'Lump Sum Allowance' (LSA) is a lifetime limit on the amount of tax-free pension lump sums which can be taken without paying income tax; the figure was set at £268,275 for 2023/24 and has remained at this level since then.

Because people who pay into pensions pay tax at different rates, the value to them of tax relief also varies. For example, someone who pays £100 gross into a pension initially saves £20 in income tax if they are a basic rate taxpayer, £40 if they are a higher rate taxpayer and £45 if they are an additional rate taxpayer compared to receiving the same income in the form of a wage. Indeed, in some cases, the savings can be greater than these figures, for example, due to Personal Allowance and Child Benefit tapers – these savings also generally accrue to higher rate taxpayers.

Not only do higher earners get more tax relief because their income tax rate is higher, but higher earners also tend to pay much more into their pensions than lower earners.

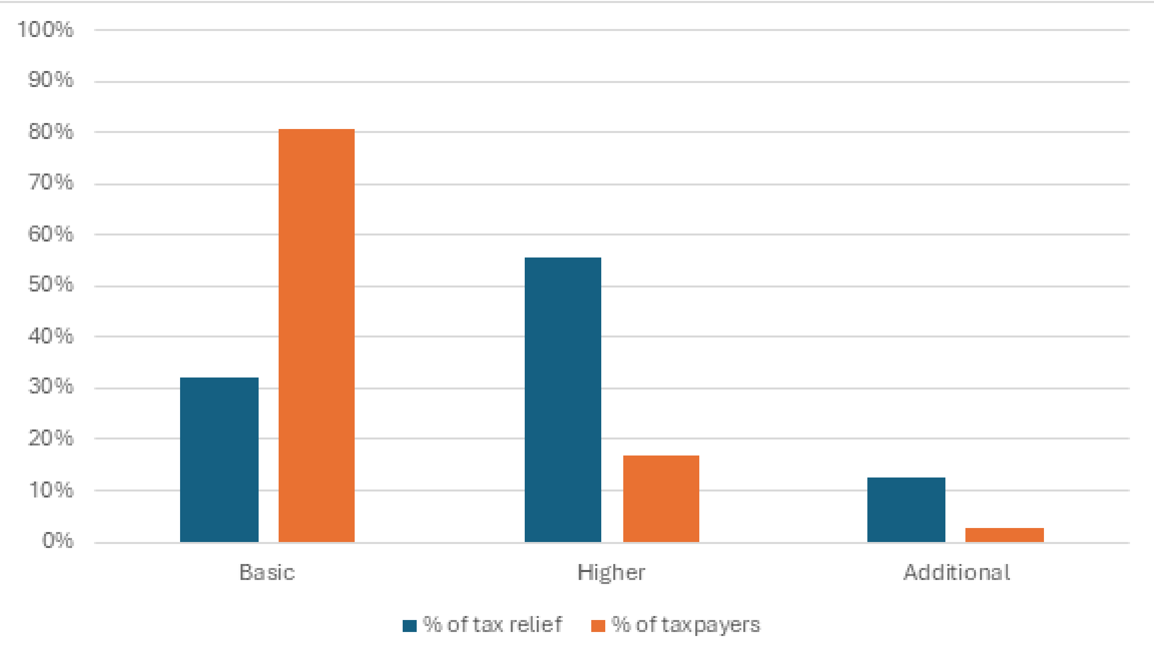
The combined effect of these two factors – tax relief at a higher rate on larger contributions – means that those on higher incomes tend to benefit from the lion's share of tax relief.

[2] This is designed to help with the interpretation of government estimates of the 'cost' of pension tax relief but is not designed to be an exhaustive description of the system.

This can be shown in Chart 1, based on the latest government estimates for 2023/24, which shows how the total cost of income tax relief on pension contributions (by both employees and employers) is split between basic, higher and additional rate payers compared with the size of each of those groups.

One of the knock-on effects of income tax allowances having been frozen in recent years is that, whilst doing so generates additional tax revenue as earnings grow with inflation, the "cost" of pension tax relief increases too (as more individuals move into higher tax bands).

Chart 1. Percentage of tax relief attributed to taxpayers at different rates and percentage of taxpayers paying at different rates 2023/24



Source: Author's calculations based on Table Pen6 and HMRC (Number of Individual Income Taxpayers)

As Chart 1 shows, basic rate taxpayers make up around 4 in 5 of all taxpayers, but benefit from less than one third of the total cost of pension tax relief. By contrast, higher rate taxpayers (paying at 40%) benefit from over half the cost of tax relief despite being less than a fifth of the taxpaying population. Additional rate taxpayers (paying at 45%) accounted for less than 3% of all taxpayers in 2023/24 but benefited from around 12% of all tax relief[3].

For these reasons, it is often argued by some that pension tax relief is 'unfair' and that a fairer system would involve, for example, giving all taxpayers relief at a single rate. Setting to one side the subjective assessment of what is 'fair', even such a system would still allocate much of its cost to higher earners (assuming unchanged behaviour), simply because they tend to save more into pensions, but the position would be less uneven than shown in Chart 1.

[3] [3] These figures do not take account of the tax paid by these contributors when they start to draw out their pensions. However, in 2023/24 around 9 in 10 taxpaying retirees were paying at the basic rate. Where such retirees benefited from higher rate relief when they paid in, they have gained from 'rate shifting' by gaining relief at a higher rate when they contributed compared to the rate of tax they pay in retirement.

National Insurance treatment

A key feature of the pension system is that where employers make contributions to a pension on behalf of an employee, those contributions are not subject to employer (or employee) NI contributions. By contrast, if the same amount was paid as a wage and the employee then put it into a pension, both employer and employee would face an NI bill on that wage.

This differential treatment provides a strong incentive for employees to agree to 'sacrifice' part of their salary and ask their employer in return to make all of the pension contribution. This is known as 'salary exchange' or 'salary sacrifice' and is a means, recognised by HMRC as legitimate, to restructure pension contributions to reduce NI costs. We return to this topic later.

b. Cost to the Exchequer

Table 1 shows the total cost of pension tax relief in 2023/24, taking account of the income tax and National Insurance advantages of pension saving, netting off the income tax paid by current retirees on their pensions[4].

A number of key points emerge from this table:

- The impact of pension tax relief on the public finances is substantial; in a single year, the public purse is estimated to miss out on around £78bn in income tax and NI revenue because of the breaks given to those who pay into pensions;
- The cost of income tax relief is more than double the cost of National Insurance relief, but both are significant sums;
- Within the income tax figure, income tax relief on regular contributions paid by employers (£28.9bn) accounts for around half of the total cost, with a further £7.2bn coming from the tax-free status of contributions made by employers on behalf of their employees via salary sacrifice arrangements;
- Within the National Insurance figure, relief on employer contributions accounts for around two thirds of the total cost; in part this reflects that the fact that the rate of employer NI is higher than that for employees and that there is no ceiling on the earnings over which employer NI contributions are payable.

The scale of pension tax relief costs is such that it undoubtedly comes under the Treasury spotlight on a regular basis. In the next section we consider some of the major changes which might come under consideration by a Chancellor looking for additional revenue but constrained by manifesto commitments in terms of more obvious changes such as raising headline rates of income tax, VAT or employee NICs.

[4] For the purposes of this paper, we have not analysed the mismatch in this table between tax relief being granted to current savers (who will pay income tax on those savings in the decades to come) and income tax being collected on current retirees.

Table 1. Estimated cost of pension income tax and NICs relief 2023/24 (£m)

Total pension Income Tax relief	**54,200**
- of which relief on contributions by employees	10,600
- of which relief on contributions by employers	28,900
- of which relief on contributions by the self-employed	1,000
- of which relief on salary sacrifice contributions by employees	7,200
- of which on Deficit Reduction Contributions[5] by employers	2,100
- of which on Investment income of pension funds	4,300
Total pension National Insurance Contributions (NICs) relief	**24,000**
- of which Class 1 Primary (employee) NICs on employer contributions	6,400
- of which Class 1 Secondary (employer) NICs on employer contributions	13,500
- of which Class 1 Primary (employee) NICs on salary sacrificed contributions	1,200
- of which Class 1 Secondary (employer) NICs on salary sacrificed contributions	2,900
Total pension Income Tax and NICs relief (gross of tax charges)	**78,200**
Less total pension tax charges	**-25,600**
- of which income tax liable on payments from pension schemes	-25,400
- of which annual allowance charges[6]	-200
- of which lifetime allowance charges[7]	0
Total net pension Income Tax and NICs relief	**52,500**

Source: Author's calculations based on HMRC Table Pen6

[5] These are contributions made by employers into Defined Benefit pension schemes which are short of the money that they need to pay pension promises in full.
[6] Those who make contributions worth in excess of the AA limit (£60,000 in 2023/24) face a tax charge on the excess.
[7] The Lifetime Allowance (LTA) charge was set to zero from 2023/24 before being abolished in 2024/25

03 Potential revenue-raising changes to pension tax relief

With a system costing over £50bn per year, the Treasury can be expected to have looked closely at the potential for changes which could raise meaningful amounts of money. In this section we consider three in particular:

- Abolition of 'higher rate' pension tax relief
- Capping or scrapping of tax-free lump sums
- Capping or scrapping of 'salary sacrifice' for pensions

We consider each in turn.

The total cost of income tax relief on pension contributions by today's contributors is around £54.2 billion (see Table 1), of which £4.3 billion is for the tax break on the investment income of pension funds, and the remaining £49.9 billion is relief on the contributions made by employees, their employers and the self-employed.

HMRC provide estimates of the split of this £49.9 billion figure according to whether the contributor pays income tax at the basic (20%) rate, the higher (40%) rate or the additional (45%) rate. We have already shown these in percentages in Chart 1, but we give the cash figures in Table 2.

Table 2. Split of the cost of income tax relief on pension contributions by rate of tax paid (£bn) – 2023/24

	Cost of relief
Basic rate	£16.6bn
Higher rate	£27.7bn
Additional rate	£6.2bn
Total	**£49.9bn**

What might seem striking is the amount of pension tax relief which is attributable to the minority of taxpayers who pay at higher or additional rates. According to HMRC estimates, in 2023/24 (the latest year for which the tax relief breakdown is available) there were 35.9 million taxpayers, and of these 29.4 million (82%) paid at the basic rate, 5.6 million (16%) paid at the higher rate and 0.9 million (2%) paid at the additional rate. Yet Table 2 suggests that roughly two thirds of the total cost of tax relief is going to higher and additional rate taxpayers who account for less than one in five of all taxpayers.

In theory, moving to a system where everyone receives relief at the same rate could be a major revenue raiser, depending obviously on the standard rate that was chosen.

As an extreme example, consider simply abolishing all higher rates of relief and giving everyone relief at the basic rate. Assuming that this could be done in practice and that there were no behavioural changes, this could roughly halve the £27.7bn cost of higher rate relief (because relief would now be at 20% rather than 40%) and more than halve the £6.2bn cost of additional rate relief (because relief would now be at 20% rather than 45%). The annual saving from this theoretical reform would work out at over £16bn per year. With behavioural changes, the saving would likely be higher than this as many higher and additional rate taxpayers may choose to reduce their contributions, meaning they earned a higher taxable income, with more income tax and NI due.

A variation on this extreme proposal would be to offer relief at a standard rate above the basic rate. This would create gains for any of the 29.4m basic rate taxpayers who currently save into a pension and might provide some political offset to complaints from those who lost (most of) their higher or additional rate relief.

1. Capping or scrapping of ‘tax-free lump sums’

Those who save in a pension can typically draw out up to 25% in the form of a tax-free lump sum. This is one of the most widely known features of the pension tax relief system and is regarded as one of the principal attractions of saving into a pension. Although there is now a Lump Sum Allowance of £268,275 which caps lifetime tax-free cash, this limit does not bite for the vast majority of pension savers.

The Government does not provide separate figures on the cost of this element of the system (though it is reflected in a reduced amount of tax paid by pensioners compared with a system where there was no tax-free cash). But estimates produced by the Institute for Fiscal Studies suggest[8] that abolition of the tax-free treatment of pension lump sums could, on unchanged behaviour, generate revenue of over £5 billion per year. A more likely reform would be simply to lower the existing lifetime cap, but this would of course raise significantly less money.

2. Capping or scrapping ‘salary sacrifice’ for pensions

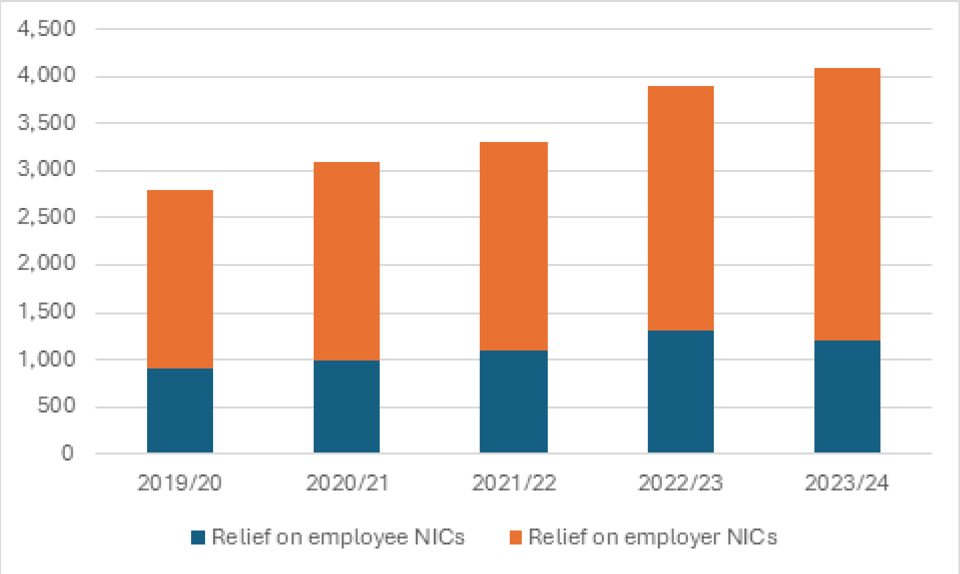
In our description of the National Insurance treatment of pension contributions, we pointed out that employer contributions are free of NI, whereas employees make contributions out of wages which have already been subject to both employee and employer NICs. This asymmetry provides a strong incentive to shift contributions entirely onto the employer via a process known as ‘salary sacrifice’. Over the last decade this has been used by government as a mechanism to encourage pension saving and soften the impact of auto-enrolment on take-home pay.

In simple terms, a deal is done between employer and employee whereby the employee takes a pay cut whilst the employer takes on responsibility for paying pension contributions for both the employee and the employer. This deal can benefit both parties (through reduced NI liabilities and in other ways discussed later) though the way in which the gain is shared between the two parties can vary from scheme to scheme.

[8] Adam, S, et al, A blueprint for a better tax treatment of pensions, IFS, 2023

As Chart 2 shows, the cost of salary sacrifice has increased steadily in recent years and now stands at around £4 billion per year – enough to attract the attention of Ministers looking for potential revenue gains.

Chart 2. Cost of NI relief on salary sacrificed pension contributions (£m) 2019/20 – 2023/24



Source: HMRC Table PEN6

A clue as to thinking on this issue within HMRC came with the publication earlier this year of HMRC research two years earlier into employer attitudes to potential caps in salary sacrifice or to outright abolition[9].

In that research, employers were asked for their views on three potential scenarios, described as below by HMRC:

- Scenario 1 removed the NI exemption for salary sacrifice pensions, which would result in employer and employee NI charges on the salary the employee sacrificed.
- Scenario 2 removed the NI exemption for employers and employees, and the income tax exemption for employees, on the salary sacrificed.
- Scenario 3 removed only the NI exemption for salary sacrifice pensions beyond a threshold of £2,000 per year. This would mean that employers and employees would not need to pay NI on any salary sacrificed up to £2,000 but would need to pay NI on any salary sacrificed above this amount.

It would be fair to say that employers were pretty negative about all three options, as all would result in increased NI bills for them and their employees. They were particularly critical of the

[9] See: HMRC's latest research shows potential cuts 'firmly on the agenda' says Steve Webb, LCP

first two scenarios which wipe out in full the NI benefits of salary sacrifice.[10]

Whilst this research was commissioned under a previous government, it is notable both that HMRC had started looking into how a change of this nature might be implemented in the event that politicians were to try to raise money from this source and chose to publish details earlier this year.

[10] To us Scenario 2 appears to be something of a red herring, in that in addition to removing the NI benefit of salary sacrifice it would have led to double application of income tax to pension savings (once when they were made and again when the pension was received). One wonders if it was included to make the other two scenarios appear less unattractive to respondents than if they had been put forward in isolation.

04 Five traps for the unwary when changing pension tax relief

At first glance, changes to pension tax relief could look very attractive to a Chancellor who is severely constrained and is under pressure to identify substantial extra revenue. A superficial look would suggest that changes to pension tax relief could:

- Raise substantial additional revenue
- Be presented as improving the 'fairness' of the system
- Raise money from a complex and poorly understood system, potentially reducing the political impact compared with a more straightforward revenue raising measure (such as increasing income tax or NI rates or applying NI to pensions in payment)

However, our analysis suggests that there are (at least) five 'traps' which lie in wait for those who want to make major changes to the system of pension tax relief in order to raise additional revenue.

In this section we describe those 'traps' and consider how far they apply to each of the potential revenue raising measures set out in Section 3.

Trap 1. Impact on 'ordinary working families', including breach of Manifesto

The Labour Manifesto for 2024 said:

"We will ensure taxes on working people are kept as low as possible. Labour will not increase taxes on working people, which is why we will not increase National Insurance, the basic, higher, or additional rates of Income Tax, or VAT"[11].

In addition, there is often political talk of protecting 'ordinary working families' and of asking those 'with broadest shoulders to bear the greatest burden'.

Whilst measures such as removing higher rate tax relief or capping large tax-free lump sums might be seen as not impacting 'ordinary working families', closer examination of all three revenue-raising measures we have discussed, suggests that they would breach the manifesto pledge and in some cases affect people on relatively modest incomes.

[11] Source: https://labour.org.uk/change/strong-foundations/

Specifically:

- The number of people paying higher or additional rate tax has risen dramatically in recent years, mainly because of the repeated reduction in the real value of the starting points for 40% and 45% tax; for example, in 2010/11 (when the additional rate was introduced) there were 3.0m higher rate taxpayers and 236,000 additional rate taxpayers; this year there are 7.1m higher rate taxpayers and 1.23m additional rate taxpayers. A reduction in higher rate relief will therefore affect far more people than would once have been the case and will affect people on much lower real incomes than in the past. In addition, it is very hard to see how taking away this extra relief – which in many cases will result in lower take-home pay – could be seen as anything other than a direct breach of the pledge not to 'increase taxes on working people';

- It is a quirk of the system of pension tax relief that even some people who pay basic rate tax are still benefiting from 'higher rate' relief on part of their pension contributions. This means that abolishing higher rate relief could lead to losses even beyond those mentioned above. To give an example, consider an NHS worker whose gross salary is £55,000 per year. For those at this pay level, the employee contribution rate into the NHS pension scheme is 10.7%, so £5,885 in this case. If we deduct that figure from the gross pay we end up with £49,115 which is below the starting point for higher rate tax (currently £50,270). As a result, this person is a basic rate taxpayer. But if higher rate relief was abolished and everyone only received 20% relief on their contributions, this person would be a loser because they currently enjoy a tax saving of far more than 20% of their pension contribution[12].

- In the case of tax-free lump sums, those saving into a Defined Contribution pension can currently build up a pot of say £1m and still be within the existing cap on tax-free cash; given that most people have DC pots at only a fraction of this level, it might at first seem that there would be scope for cutting the limit on tax-free cash without affecting 'ordinary' savers. But those who have long service in a Defined Benefit pension scheme (such as many long-serving public servants) can build up a significant entitlement to a tax-free lump sum, even if their wage was not especially high. Clamping down on tax-free lump sums would have a particularly adverse effect on this group. The IFS estimate[13] that a cap of £100,000 would affect around 1 in 5 retirees and that around half of these would be public sector workers, so this would be particularly difficult politically.

- For salary sacrifice, HMRC figures suggest that the majority of the cost (in terms of income tax relief) is in respect of higher and additional rate payers. This is shown in Table 3.

[12] This point would be even more acute if (as would presumably be necessary) higher rate relief on employer contributions was also abolished. That would however expose a further trap, in that employer contributions to a DB scheme might reflect not just the cost of benefits to current employees but also an adjustment for any surplus or deficit in the scheme in respect of former employees.
[13] https://ifs.org.uk/articles/raising-revenue-reforms-pensions-taxation

Table 3. Split of the cost of income tax relief on salary sacrificed pension contributions by rate of tax paid (£bn) – 2023/24

	Cost of relief
Basic rate	£1.6bn
Higher rate	£4.4bn
Additional rate	£1.2bn
Total	£7.2bn

However, although Table 3 shows that only around 22% of the cost of tax relief on salary sacrificed contributions is at the basic rate, more than 22% of the people in salary sacrifice schemes will be basic rate taxpayers. This is because higher and additional rate taxpayers get greater weight in this table because a) they get relief at a higher rate (40% or 45% versus 20%) and b) they contribute far more in cash terms.

Unfortunately, we do not have figures for the number of individuals in each category, but we can make a rough estimate to take account of a) but not b). In particular, we can strip out the higher 'weighting' given to the contributions of those paying 40%/45% tax by scaling them down as if they had received 20% relief (for consistency with basic rate taxpayers). On this basis, at least 37% of the people getting tax relief on salary sacrificed contributions must be basic rate taxpayers[14].

We also know, from the HMRC research cited earlier, that in 2019 30% of private sector and 9% of public sector employees used a salary sacrifice arrangement for their pension contributions. This equates to roughly 8.8m workers in all. Applying the 37% figure from our previous calculation, this would suggest over 3m basic rate taxpayers could lose out if salary sacrifice was abolished. This would be a clear breach of the message that 'only those with the broadest shoulders' should bear the burden of tax increases.

- There is a further respect in which the abolition of salary sacrifice would disproportionately hit those on more modest incomes. This relates to the way the ceiling on (employee) NI contributions operate. At present there is a standard rate of 8% of employee NICs between the starting point of £12,570 and the Upper Earnings Limit of £50,270. Beyond this a rate of just 2% applies. This means that a worker who earns above the upper limit saves just 2% of the sacrificed salary in reduced NI, whereas a lower earner saves 8%. If salary sacrifice were to be abolished, it is those who are in the basic rate tax band (earning under £50,270) who would be the largest proportionate losers.

[14] And in reality, the actual proportion will be significantly higher than this, because the figures in Table 3 also reflect the fact that higher rate taxpayers tend to pay larger absolute amounts into pensions.

- Another beneficial byproduct of salary sacrifice schemes, is that the reduction in gross pay which it entails may feed through into lower student loan repayments. The exact regime depends on when a student graduated, but those who took out undergraduate loans in England and Wales typically repay at 9% of pay above a salary threshold. Salary sacrifice currently reduces their student loan repayments. Especially for the majority who will never fully clear their debt (and have the balance written off), this is a welcome reduction which could be lost if salary sacrifice for pensions were to end.

For basic rate taxpayers the abolition of salary sacrifice for pension contributions could therefore result in a hit on take-home pay of 17% of their pension contributions.

Trap 2. Impact on public sector workers

Relations between the Government and the public sector workforce (and their trade unions) are of crucial importance to any government, and perhaps especially a Labour government. Controlling public sector pay is a key part of the Chancellor's objective of improving the public finances and there are currently live disputes with a number of public sector trade unions. Budget measures which disproportionately hit public sector workers could therefore cause wider problems for the government.

Because of the relative generosity of public sector pensions, workers in the public sector account for a disproportionate share of the total cost of pension tax relief.

To give a rough idea, the public sector workforce currently stands at a little over 6 million out of a taxpaying population of around 39 million. Public sector workers therefore account for less than 1 in 6 of all workers. But HMRC's breakdown of the cost of income tax relief on pension contributions (including employer contributions) says that relief on public sector schemes costs £17.1bn out of a total cost of £49.8bn, or just over £1 in £3 of all spending on pension tax relief. It is clear therefore that any reduction in the generosity of pension tax relief is likely to be of disproportionate interest to the public sector.

Considering the specific measures in turn:

- Abolition of higher rate relief is likely to affect more private sector workers than public sector workers (primarily because of the relative size of the two sectors), but public sector workers who lose could lose substantial cash sums; the combined rate of employer and employee contributions in major public service schemes can be in excess of 30% of pay, especially for higher earners, so a reduction in relief from 40% to 20% could amount (in crude terms) to a pay cut of at least 6%;

- As discussed earlier, given the relative immaturity of DC saving in the UK (which is the dominant form of provision in the private sector), a cut in the lifetime limit on tax-free cash would be unlikely to affect the large majority of pension savers. But long-serving public servants, even on relatively modest wages, could be affected by a cap in the lump sums generated from generous DB pensions. This measure, in particular, is almost 'laser-targeted' on affecting public sector workers.

- By contrast, salary sacrifice is a method of reducing NI bills which is almost exclusively found in the private sector. HMRC estimates suggest that out of the £4.1bn NI relief cost on salary sacrificed contributions, just £400m relates to those working in the public sector.

Trap 3. Limited short-term revenue-raising potential

With a General Election due in early 2029/30, the Chancellor will hope to see the benefit of additional tax revenue from Budget measures flowing in 2028/29 or preferably earlier. But there are two major reasons why some of the revenue-raising measures people are speculating about and we are analysing in this paper may not deliver against these objectives. These are:

a. Protecting losers

In the case of a change such as capping tax-free cash, there would be substantial opposition from those who had planned to use their lump sum for a particular purpose (perhaps to clear a mortgage before retirement or for other spending plans) only to find this substantially reduced at short notice. If people on the brink of retirement suddenly lost out, they may well feel that this was a case of changing the rules of the game just before the final whistle. This could lead not just to political fallout but also to challenge in the courts.

To mitigate opposition, the Government would be likely to need to introduce extensive 'transitional protection' so that those already over any new cap (or perhaps likely to be so soon) would not lose out. Similar forms of transitional protection have been regularly deployed where other caps on pension tax relief (such as reductions in the Lifetime Allowance) were reduced, such as in 2012, 2014 and 2016. And as the government found with the McCloud judgment, protecting just those close to retirement could leave them open to age discrimination claims.

Whilst transitional protection helps to reduce the number of losers, it also reduces the revenue from the change. If we assume that, for example, the government effectively protected all existing pension savings from any change, the policy might end up generating very little net revenue for a decade or more.

b. Implementation issues

Some tax changes can be implemented almost immediately, such as changing rates of duty on petrol, alcohol and tobacco on the day of the Budget. But others can take months or years to implement, requiring complex legislation and time for government and other systems to be re-written to bring into effect the new regime. One example is the decision to bring pensions into the IHT net, announced in October 2024, but not due to be implemented until April 2027, whilst the necessary legislation is developed and HMRC IHT processes brought into the digital age.

In terms of implementation issues, probably the simplest of the three measures we are considering implementing would be a lower cap on tax-free cash.

As described above, there would need to be transitional protection for losers (and the complexity of constructing this should not be underestimated, particularly for DB pension savings), but aside from this we do already have a lifetime limit on tax-free cash, so it is not a major administrative change to simply set this cap at a lower level.

The same cannot be said of abolishing higher rate relief.

Pension tax relief has been awarded at an individual's marginal rate of tax since it was first introduced, so doing away with this principle would be a major upheaval. It seems inconceivable that such a change could be made without extensive consultation with pensions schemes, employers and the pensions industry. The change could place large administrative burdens on the main public sector schemes in particular (as well as the remaining private sector DB schemes) who are currently swamped with administrative challenges around the 'McCloud' judgment, getting data ready for pensions dashboards and so forth.

Even if agreement could be reached on a specific policy proposal there would need to be detailed consultation on primary and secondary legislation as well as time for payroll and computer systems to be updated by both public and private sector schemes and workplaces. It is hard to see how all of this could be done at pace and there would be a real risk that even generating revenue in 2028/29 would be a challenge.

Implementation of changes to salary sacrifice would also be far from straightforward. Assuming that the Government decided to levy employer and employee NICs on sacrificed contributions, it would need to define the type of contributions which would now be subject to NICs.

One challenge is that there are some workplaces where firms simply operate a non-contributory pension with no sacrifice of salary but with 100% of the contributions coming from the employer, and it would be important not to accidentally include such arrangements in the new charge.

There would also be a challenge in levying employee NICs on contributions made on their behalf by an employer. Employers currently use tables provided by HMRC to work out how much NI to deduct for each worker based on their gross pay, but separate calculations would now be needed for employees who were on the salary sacrifice scheme and based on their individual level of sacrificed salary.

These problems can probably all be overcome but also mean that scrapping salary sacrifice for pensions might need at least a year of planning and so would be unlikely to generate additional revenues until 2027/28 at the earliest.

Trap 4. Negative impact on employers / employment

One of the biggest criticisms of the 2024 Budget was its adverse impact on employers and employment via the large increase in employer NI contributions. The Chancellor is likely to want to avoid significant further pain to employers this year, especially given the fragile state of the economy.

However, if money is to be raised from changes to pension tax relief this is either going to come from employees (thereby breaking the promise not to increase tax on workers) or on employers (thereby adding to the hit from the last Budget).

Considering first the impact of abolishing higher rate relief, it would be necessary for this policy to apply both to employer and employee pension contributions. If the restriction applied only to employee contributions, then it would be easy for employers to simply switch all contributions to the employer (presumably via salary sacrifice) and thereby avoid the restriction.

The problem with restricting higher rate relief, especially in the public sector where there are substantial employer contributions, is that either employers have to pay the additional tax charge on their share (which would be an additional cost to business), or the employee pays the entire bill for both employee and employer contributions, which could amount to a reduction in take-home pay of thousands of pounds a year for public sector workers in generous DB pension schemes. Neither of these is a particularly attractive proposition for government.

Capping tax-free lump sums would probably have limited impact on employers, except perhaps in the case of senior public sector workers who would potentially see a diminished incentive to go on working once they had 'maxed out' on their potential tax-free lump sum. We have already seen major issues in the NHS where senior doctors and others decided either to limit their hours or even retire early once they started to exceed annual and lifetime limits on pension tax relief, and there is a risk that something similar could happen if such workers could no longer add to their tax-free lump sum by continuing their career.

Capping or scrapping salary sacrifice would clearly also have an adverse effect on employers. This would in effect amount to levying employer NICs on the 'sacrificed' part of the total pension contribution, and yet more employer NICs costs as a result of a second Budget in a row could be politically difficult.

Trap 5. Negative impact on future retirement provision

It is easy to forget that the purpose of the pension system is to give people a decent standard of living in retirement. According to recently published DWP estimates[15], over 14 million people of working age are not saving enough for a decent retirement, and there is a real risk that cuts to pension tax relief could make this problem worse.

For example:

- One of the tax advantages of pension saving – exemption from IHT of pension pots – is to be eliminated from April 2027, and the abolition of higher rate relief would remove another major advantage of pension saving; workers may respond by saving less overall, thereby making the under-saving problem worse; and it is worth stressing that under-saving is not purely about people on low incomes; for many of those on low or modest incomes the state pension plays a significant role in replacing pre-retirement earnings, but it is those on middle and higher incomes who most need to supplement their state

[15] https://www.gov.uk/government/statistics/analysis-of-future-pension-incomes-2025

pension if they are to maintain their standard of living into retirement; these are the very people who have most to lose from the abolition of higher rate relief;

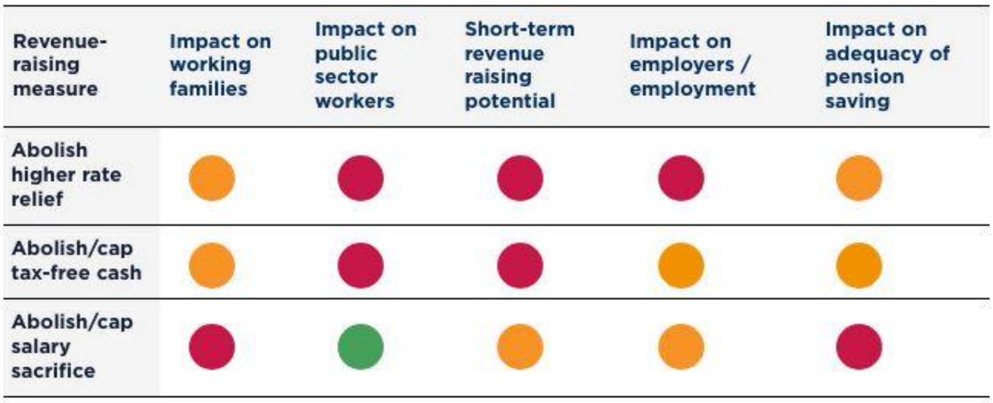
- Although the ability to take large tax-free lump sums at retirement has a limited impact on the adequacy of in-retirement incomes, lump sums can contribute by helping to clear outstanding mortgage debt (likely to be increasingly common at retirement based on current extent of issuances of long-term mortgages) or to replace vehicles or household goods; if there is less tax-free cash to be taken at retirement, this may further deplete the household's resources to sustain them through retirement;

- Removing the advantages of salary sacrifice would be likely to have a negative impact on workplace pension provision; salary sacrifice for a range of benefits in kind was reviewed by the Government as recently as 2016 and a decision taken to retain it for pensions and certain other benefits because they "…support those wider government objectives which rely on salary sacrifice"[16]. By implication, taking away this favourable treatment could discourage employers from offering generous workplace pensions and discourage employees from taking them up, by increasing the cost to both parties of doing so. Given that around £1 in £6 of the cost of pension tax relief is in respect of salary sacrificed contributions, the impact of removing this favourable treatment could be significant in terms of overall levels of pension saving.

[16] Source: Consultation on salary sacrifice for the provision of benefits-in-kind - summary of responses

05 Summary

As we have seen, the various ‘traps’ lying in wait for the unwary apply in different ways depending on the particular revenue-raising measure under consideration. The chart below provides a simple summary with a ‘red/amber/green’ rating showing our assessment of the seriousness of the risk of each measure for the government. A red rating shows an area of particular danger under each heading, whilst a green rating indicates that there is no particular problem.



The red/amber/green ratings shown in the chart reflect the detailed discussion in the paper so far, but in summary:

- All three of the potential measures scores at least two ‘red’ ratings, suggesting major risks from trying to raise money from any of these measures.
- Given that extra money from reducing pension tax relief has to come from either employees or employers, each of these measures either raises taxes on workers (breaking the manifesto pledge) or puts extra burden on employers (unwelcome coming on top of last year’s Budget) or both. In particular, salary sacrifice changes could adversely affect more than three million workers who currently only pay tax at the basic rate.
- None of the measures represents a ‘tap’ that can instantly be turned on to generate revenue to help, for example, improve public services in good time for the next General Election. Indeed, some may involve either such extensive transitional protection for losers or such major legislative and administrative change, that they will not raise significant revenue this side of the next Election.
- All of them, to varying degrees, make worse the fundamental problem of an inadequate level of pension saving in the UK.

06 Conclusion

In recent years the UK's worsening fiscal position has led successive Chancellors, of differing political persuasions, to seek out relatively painless ways of raising additional revenue. In the past this might have been achieved through increasing headline rates of tax such as National Insurance Contributions or VAT. But increases in employee NICs, VAT or income tax rates have all been ruled out in the manifesto on which the present government was elected.

Against this backdrop, it would not be surprising if the government turned its attention to other areas of the fiscal system where large sums of money are involved. Pension tax relief is clearly one such area that might be considered.

But the Chancellor should reflect on the fact that successive Chancellors have pulled back from major reforms to the taxation of pensions, typically relying on no more than 'salami slicing' of various annual and lifetime limits on relievable contributions, which raises little revenue. More far-reaching changes, of the sort described in this report, have been regarded as a step too far.

This report has explained in detail some of the pitfalls which any Chancellor might encounter if they sought to prop up the public finances through a raid on pension tax relief. Some of these are obvious, such as potentially large cash losses amongst higher earners in generous (predominantly public sector) pension schemes. But others are less obvious, such as the risk of creating losers even amongst basic rate taxpayers, particularly in the event that salary sacrifice schemes were to be capped or scrapped, but also if higher rate relief was scrapped.

We also highlight the formidable challenge of introducing such changes at a pace that would generate meaningful revenue for the Chancellor this side of the next Election. Whether it is the likely need for comprehensive transitional protection for losers or the need for a complete overhaul of pension systems and legislation which could be implied by some of these options, none represents a 'quick fix'.

A previous Chancellor's Budget has entered history – or notoriety – for its inclusion of measures which unravelled within weeks of Budget Day in a way which took the Treasury by surprise. Our counsel to the current Chancellor is that she would do well to steer clear of major changes to pension tax relief if she is to avoid the same fate.

Contact us

If you would like more information, please contact your usual LCP adviser or one of our specialists below.

Alasdair Mayes,
Partner
+44 (0)1962 872725
alasdair.mayes@lcp.com

Steve Webb,
Partner
+44 (0)20 3824 7441
steve.webb@lcp.com

Tim Camfield,
Principal
+44 (0)1962 672973
tim.camfield@lcp.com

At LCP, our experts help to power possibility by navigating you through complexity to make decisions that matter to your business and to our wider society. We are powered by our desire to solve important problems to shape a more positive future. We have market leading capabilities across pensions and financial services, insurance, energy, health and analytics.

Lane Clark & Peacock LLP
London, UK
Tel: +44 (0)20 7439 2266
enquiries@lcp.uk.com

Lane Clark & Peacock LLP
Winchester, UK
Tel: +44 (0)1962 870060
enquiries@lcp.uk.com

Lane Clark & Peacock Ireland Limited
Dublin, Ireland
Tel: +353 (0)1 614 43 93