

# Tax relief on Defined Contribution pension contributions

## PPI Briefing Note Number 122

### Key findings

This Briefing Note considers the potential effect that changes to the current system of tax relief on Defined Contribution (DC) pension contributions may have upon individuals and the cost to the Exchequer.

- A flat rate of tax relief on DC pension contributions would increase the proportion of DC pension tax relief associated with basic rate taxpayers from 26% to 42%.
- A basic rate tax-payer, who works and contributes continuously to a pension could get around one fifth more from their savings under the current tax advantaged system than under a non-advantageous structure. A higher rate tax-payer could receive around half as much again from their savings.
- For every £100 of DC pension contributions made from gross earnings or by an employer, £32 of income tax has been relieved.
- The total value of contributions to DC pensions schemes was £29bn in 2018 from individuals and employers. Around £9.3bn of income tax was relieved in respect of these contributions.
- Since the implementation of automatic enrolment the proportion of pension tax relief going to those earning less than £30,000 has only increased from 23% to 24% despite the proportion of claimants increasing from 52% to 63%.
- 71% of tax relief on DC pension contributions goes to men, who make 69% of the contributions.
- Introducing different tax relief regimes for Defined Benefit (DB) and DC pensions would require careful consideration as there may be unintended consequences including arbitrage opportunities.

This Briefing Note looks at the beneficial tax and National Insurance treatment associated with DC workplace pensions:

- The cost of the current system of pensions tax and National Insurance contributions relief and how its benefits are distributed amongst workplace DC pension savers.
- The cost and impact of alternative future approaches to tax relief on DC pension contributions, including flat rates of relief to all pension savers.
- The implications of other changes to pensions tax advantages.
- The repercussions that changes to the tax relief on DC pension contributions may have upon DB pensions.

### Background

The principle of the current system of tax relief on pension contributions is to defer income from working ages and pay tax upon it when the individual retires and draws an income from their savings. The rules provide tax incentives for both individuals and employers to save into pensions, to encourage people to take advantage of pension saving towards their retirement income.<sup>1</sup>

The current, advantageous, tax system can boost the amount of money taken from a Defined Contribution (DC) pension after tax is taken into account. A basic rate tax-payer, earning £15,000 in 2015, who works and contributes continuously to a pension could get nearly one fifth (18%) more from their savings under the current tax advantaged system than under a non-advantageous struc-

ture. A higher rate tax-payer, earning £60,000, would receive around half as much again (52%) from their savings from the advantages of the current tax system.<sup>2</sup> Improving outcomes acts as an incentive and helps to improve the chance of individuals achieving adequacy in retirement.

While the tax treatment acts as a financial incentive for saving, the obligation to use such savings for retirement income was removed in the 2014 Budget when it was announced that *pensioners will have complete freedom to draw down as much or as little of their pension pot as they want, anytime they want.*<sup>3</sup> This weakened the link between the incentive offered and the behaviour it is intended to encourage.

# Tax relief on Defined Contribution pension contributions

## PPI Briefing Note Number 122

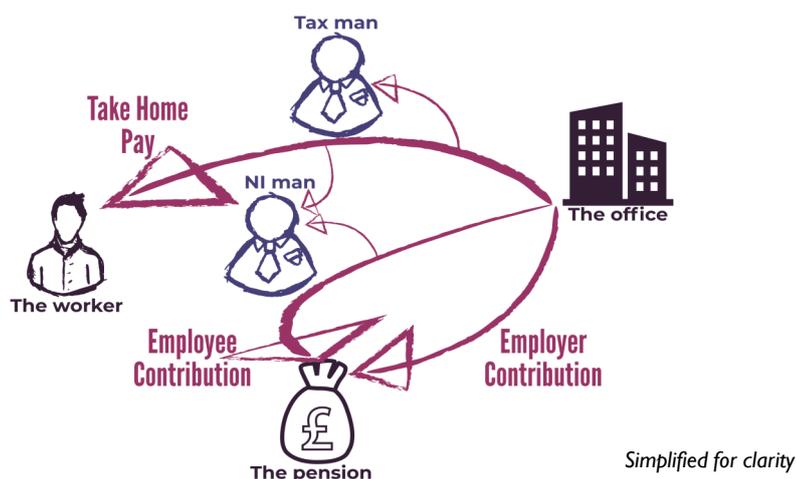
Pension tax relief in the UK is based upon an **EET** system providing a pensions tax system that is:

- **Exempt** on contributions. Employers making pension contributions on behalf of employees have an additional tax advantage for the employer, as employers' pension contributions are not subject to National Insurance (NI) [Figure 1]. Employee contributions can be offset against income tax: individuals receive tax relief at their highest marginal rate.
- **Exempt** on investment return.
- **Taxed** on withdrawal as income. 25% of pension savings can be withdrawn tax free either as a single lump sum or incrementally through Uncrystallised Funds Pension Lump Sum (UFPLS), the remainder is taxed at the individual's marginal rate of income tax.

The income tax regime is structured in a progressive manner, that is those who earn more pay at a higher rate. This results in the pension tax relief system being naturally regressive as it offsets against a progressive structure. As a result, higher earners may make greater personal benefit of tax relief by making larger pension contributions which are relieved at a higher marginal rate. For a higher or additional rate

**Figure 1: Relief on contributions depends on who makes the contribution**

Take home pay is subject to tax and NI, pension contributions made by an individual are subject to NI, pension contributions from an employer have no deductions for income tax or NI



taxpayer making pension contributions, the deferment of the tax until retirement may allow them to pay tax at a lower rate on their withdrawals than they had relieved on their contributions.

### Restrictions in the current system

To help control the cost of pension tax relief, there are restrictions upon the system which adds a layer of complexity. These limit the benefit to those making high levels of contribution (through the Annual Allowance), or with high levels of saving (through the Lifetime Allowance) [Box 1]. These re-

strictions act to even the distribution of the benefit, not through enhancing the benefit to the less well off but by curtailing the advantages to those able to make large contributions and who have accumulated high levels of wealth.

While these restrictions help to limit the cost of providing pension tax relief they also have unintended behavioural consequences. For example, some doctors have decided to retire early or not take on additional work, citing pension concerns as one of their reasons.<sup>4</sup>

### Box 1, the Annual Allowance and the Lifetime Allowance

The **Annual Allowance** limits the annual contribution upon which tax relief can be claimed to £40,000 in 2020-21 (tapered since 2016 for high earners, the income thresholds for which have increased in 2020-21 to restrict the impact to those earning in excess of £200,000). This allowance is reduced to £4,000 after pensions have been first accessed (the Money Purchase Annual Allowance). Over 37,000 individuals paid charges for exceeding the annual allowance in 2017-18. The number incurring such charges has increased significantly since the allowance was reduced from £255,000 in 2010-11 to £50,000 in 2011-12.<sup>5</sup>

The **Lifetime Allowance** limits the total pension value that attracts preferential tax treatment to £1,073,100 in 2020-21, this allows for an income of up to £52,750 from a DB pension. In the case of DC pensions this limit may be reached through a combination of contributions and asset growth. Over 4,500 individuals paid charges for exceeding the allowance in 2017-18.<sup>6</sup>

# Tax relief on Defined Contribution pension contributions

## PPI Briefing Note Number 122

### The cost of the current system

The cost of income tax relief on pension contributions has increased from £14bn at the beginning of the millennium to over £30bn in recent years.<sup>7</sup> Including the cost of National Insurance Contribution relief, the cost to the Government was over £53bn in 2017-18 (though some of this amount is offset by the income tax liable on payments from pension schemes). Over this period HMRC income tax receipts have risen from £108bn to £180bn,<sup>8</sup> a slower rate of increase [Figure 2].

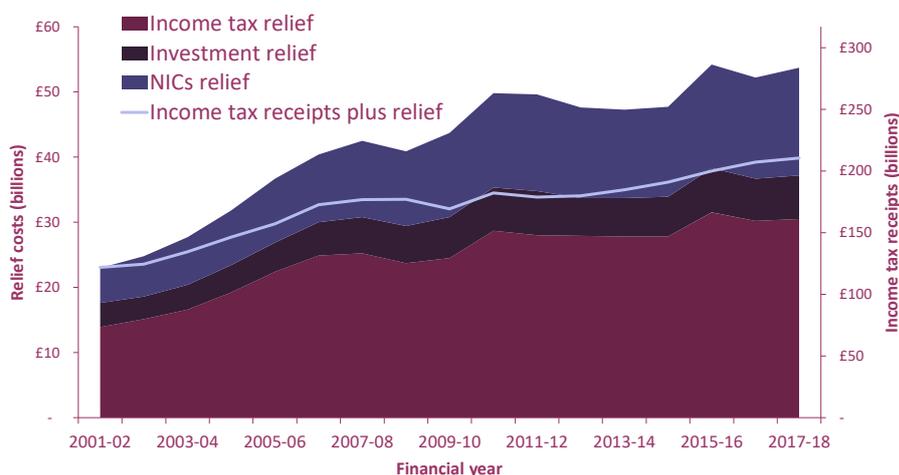
There are a number of macroeconomic circumstances which have driven this rise in income tax relief, including the bull market of the early 2000s preceding the financial crisis of 2008. On top of this are pension-targeted policies including the increase in pension savers driven by automatic enrolment. Automatic enrolment has driven the proportion of staff in a workplace pension scheme to increase from 55% in 2012 to 87% in 2018.<sup>9</sup> Over the same period, of those with pensions tax relief (relating to member contributions, excluding employer contributions):

- The proportion of the **number of people** earning tax relief who earn less than £30,000 rose from **52% to 63%**;
- The proportion of the **value of the reliefs** for people earning less than £30,000 rose from **23% to 24%**.<sup>10</sup>

This is against the tide of wage inflation of 2% a year over the period,<sup>11</sup> increasing the proportion of people earning above the £30,000 threshold. So, while the number of pension contributions made by lower paid individuals has become more significant this has not translated to a significant in-

**Figure 2: The cost of tax relief has more than doubled this millennium**

Cost of pensions reliefs, Tax and NICs



HMRC (2019) Table 6: Registered pension schemes cost of tax relief

crease in the relative value of the associated tax relief due to the low value of these contributions which only attract the lowest rate of tax relief.

### Alternative approaches to tax relief of Defined Contribution pension contributions

Alternative approaches to tax relief on Defined Contribution (DC) pension contributions vary different aspects of the current system:

- **Flat rate of tax relief upon contributions:** the same, single, rate of tax relief would be available to all DC pension savers, rather than at their marginal rate of income tax.
- **The relief of National Insurance Contributions on employer contributions:** removing the financial disparity between employer and employee contributions.
- **Tax free withdrawals, through either lump sums or UFPLs:** capping the value of the benefit available to an individual.

These approaches would affect different individuals, and different parts of the income distribution, in different ways. These are analysed below.

If the Government were to change the current system, it might also take the opportunity to alter the parameters to lower cost, better target incentives or close loopholes.

### **The cost of different approaches to tax relief on DC pension contributions**

Tax relief on DC pension contributions is weighted more significantly towards those with higher incomes who can better afford to make pension contributions above minimum levels. As a result of this bias income tax relief is paid at an aggregate rate of 32% across all DC pension contributions.<sup>12</sup> That is, for every £100 of DC pension contributions made from gross earnings or by an employer, £32 of income tax has been relieved.

# Tax relief on Defined Contribution pension contributions

## PPI Briefing Note Number 122

The total value of contributions to all DC pensions schemes was £29bn in 2018 from individuals and employers.<sup>13</sup> Around £9.3bn of income tax was relieved in respect of these contributions.

Under an alternative approach of a flat rate, if the rate is set at less than this current aggregate level it would represent a saving for the Government [Figure 3]. This is before taking account of the behavioural response of pension savers.

The amount an individual contributes to a DC pension primarily depends upon levels set through automatic enrolment minimums and affordability for those on lower incomes.

There would be a greater expected behavioural response from those with higher incomes to any change to tax relief on DC pension contributions who may vote with their feet when considering their savings options. These are individuals with a greater degree of discretion over their savings and who are more drawn to higher returns, potentially through advantageous tax treatment. However, this response may be of a limited scale as tax relief is acknowledged as [...] *not an effective or well targeted way of incentivising saving into pensions*<sup>14</sup> and as such any response may be dulled by a lack of understanding of the system.

There is a clear case for intervention where an individual may be unknowingly made worse off through making pension contributions that will increase their tax burden. This is primarily restricted to those who would pay higher rates of income tax in retirement than they had relieved on their contributions made in working life. This is a high bar, as to be a higher rate tax payer in retirement would require pension savings of over £870,000 used to generate taxable income.<sup>15</sup> Drawdown, UFPLS and

**Figure 3: The cost of alternative approaches to tax relief on DC pension contributions**

Flat rates of pension tax relief on Defined Contribution pension scheme contributions

	Current system	20% Flat Rate	25% Flat Rate	30% Flat Rate	33% Flat Rate
Aggregate rate of tax relief on DC pension contributions	32%	20%	25%	30%	33%
Saving / additional cost (relative to the current system)	-	-37%	-22%	-6%	+3%
Total cost of income tax relief on DC pension contributions to the exchequer (£billions)	9.3	5.8	7.3	8.7	9.6

PPI analysis of: ONS (2019) *Wealth and Assets Survey round 6*; ONS (2019) *MQ5 4.3 Self-administered pension funds' income and expenditure*; HMRC (2019) *Table 2: Personal Pensions (including stakeholder pensions): Scheme members' annual contributions*

tax free lump sums may be used to reduce tax liability when accessing pension savings and pensions freedoms have increased these opportunities for tax-efficiencies.

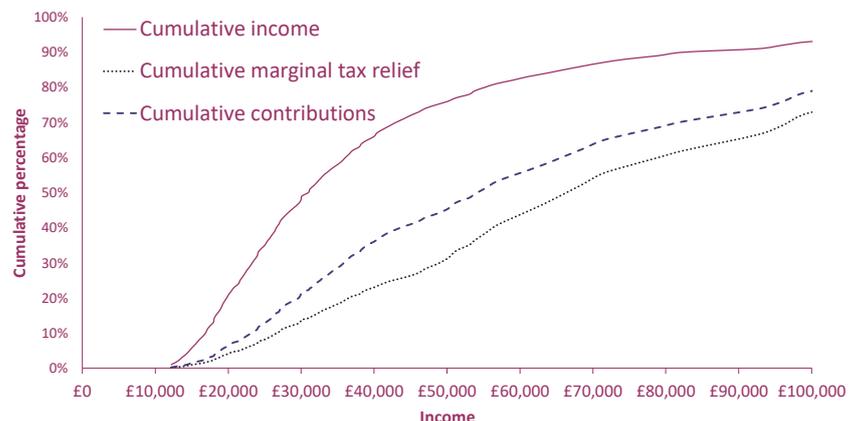
### The distribution of tax relief on DC pension contributions

Under the current system around 50% of tax relief on DC pension con-

tributions is associated with individuals whose income is above £60,000 a year, which means that half the value of the tax relief is claimed by the 15% with the highest incomes [Figure 4]. This skew towards those on higher incomes is compounded because they make both higher contributions and are entitled to a higher rate of relief.

**Figure 4: The distribution of DC tax relief**

Cost of Pension Tax and NICs Relief



PPI analysis of ONS (2019) *Wealth and Assets Survey round 6*

# Tax relief on Defined Contribution pension contributions

## PPI Briefing Note Number 122

### Gender split of tax relief

The pension tax relief system is a reflection of the current workplace situation, whereby there are more men in employment at higher income levels, hence benefiting by a greater amount of pension tax relief. **Of those benefitting from tax relief on DC pension contributions:**

- 71% of the value of the tax relief goes to men;
- 69% of the value of the contributions are made by men (or employers on behalf of men);
- 68% of the total income earned by individuals claiming tax relief goes to men;
- 63% of those who benefit from the tax relief are men.<sup>16</sup>

This gender divide is primarily driven by the different employment patterns and earnings levels which are correlated to gender. Women are more likely to take time away from work or work part-time, primarily to care for their family. Up to 20% of women in their 30s are looking after the family or the home rather than participating in the labour market, and by extension workplace pensions, with potentially long-term implications for their pay and employment prospects. As a result men will, on average, accrue a larger amount of pension saving through higher lifetime earnings and less time away from working, (hence benefitting more from tax relief). The pension income they generate may contribute to household finances, indirectly passing some of the benefit of tax relief back to women. However this will depend upon family composition and the management of finances within a family.

There is also a gender divide stemming from the sectors and industries

in which women are more likely to work. Women are disproportionately employed in roles and sectors with access to a DB pension scheme (which are principally offered through the public sector) so women are more likely to be an active member of a DB pension scheme. DB schemes generally have far higher contribution rates than DC schemes so some of the disadvantages of women's different working patterns and lower earning levels are offset by women being more likely to be a member of a more generous pension scheme.<sup>17</sup>

### Age distribution of tax relief

Automatic enrolment has increased participation in workplace pensions most significantly in younger age groups. The participation rate for men aged 22-29 has increased from 28% to 84% in the 10 years to 2018,<sup>18</sup> older ages have not been able to increase so much as they started from a higher base position. This has resulted in 42% of DC contributors being aged less than 40, however they only receive around 27% of the tax relief due

to the lower levels of contributions they make. Around two thirds (67%) of the value of tax relief on DC pension contributions goes to individuals aged in their 40s and 50s, two and a half times as much as the amount taken by those in their 20s and 30s.<sup>19</sup>

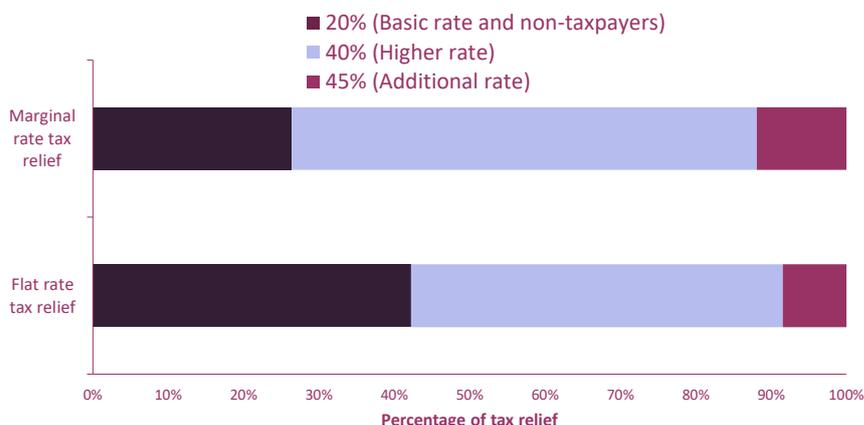
### The impact of a flat rate of tax relief on DC pension contributions

The introduction of a flat rate of tax relief on DC pension contributions would alter the distribution of the relief. The distribution of tax relief would simply match the distribution of contributions regardless of the level it is set at. Any behavioural response could affect the distribution of contributions, changing the distribution of relief. This would bring the proportion of tax relief associated with basic rate taxpayers up from 26% to 42% [Figure 5].

Anyone for whom the flat rate of tax relief is set above their marginal rate of income tax would stand to benefit. Of the flat rates considered 25%, 30% and 33% would all increase the bene-

**Figure 5: Tax relief by rate of current tax relief**

Proportion of DC pensions tax relief by rate at which it is claimed



PPI analysis of ONS (2019) *Wealth and Assets Survey round 6*

# Tax relief on Defined Contribution pension contributions

## PPI Briefing Note Number 122

fit for basic rate taxpayers (as well as non-taxpayers with a relief at source scheme). All of the flat rates considered here would reduce the benefit for higher and additional income tax payers.

A flat rate of tax relief on DC pension contributions would bring the distribution of the relief into line with the distribution of DC pension contributions, offering a higher proportion of tax relief to women and younger individuals [Figure 6]. However, it will still predominantly benefit older men as they make the largest amount of DC pension contributions.

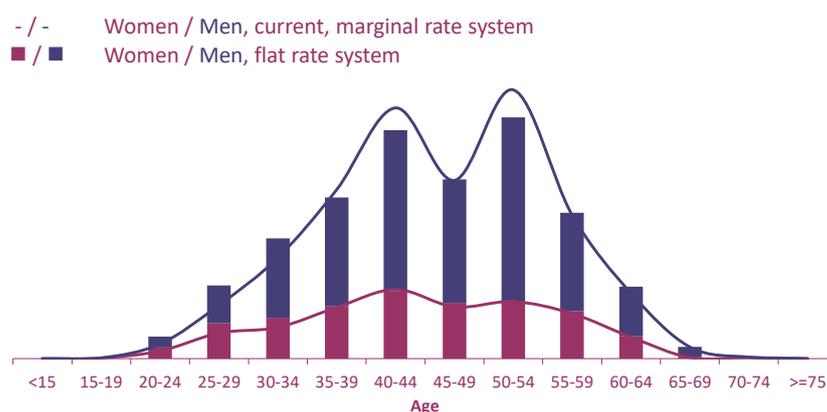
### Net Pay and Relief at Source

Tax relief on pension contributions works through two mechanisms, Net Pay arrangements and Relief at Source arrangements.

- **Net pay** arrangements are when pension contributions are deducted from income before it is subject to tax and are primarily associated with occupational pension schemes. Income tax relief is applied at an individual's marginal rate of income tax by default, which can lead to individuals who have no income tax liability (or are on the starter rate of income tax of 19% in Scotland) to miss out on relief available at 20%.
- **Relief at Source** arrangements are when contributions are made after tax and are primarily associated with personal pensions. The scheme applies income tax relief at a default rate of 20%, and any relief owing at a higher rate must be claimed through a self-assessment tax return (and may not make its way into pension saving).

Non-tax-payers who are contributing to a net pay arrangement scheme may take no tax benefit at all from the

**Figure 6: The distribution of tax relief on DC pension contributions by age and gender**



current system and could find themselves actively disadvantaged by increasing their lifetime tax liability when they draw upon their pension savings. If they were making contributions to a scheme under a relief at source arrangement their savings would be boosted by 25%.

Higher and additional rate tax-payers who are members of a relief at source pension scheme and are eligible for tax relief at a rate above 20% may not invest the additional tax relief (above 20%) into their pension. The relief claimed by the scheme at 20% is made as a contribution to the pension scheme however the extra amount of relief is used to offset their total tax liability and as a result may not result in any greater amount of pension saving.

It is not known how much relief goes unclaimed as a result of the current two arrangements as this is not reported. However, with 23% of all pension tax relief associated with relief at source schemes for individuals with income over £50,000<sup>20</sup> there is a po-

tentially very large gap between the actual cost of pension tax relief and the amount that could be claimed. This gap has been estimated at more than £750million based on the proportion of higher and additional rate taxpayers making claims through self-assessment tax returns,<sup>21</sup> with a further gap associated with non-tax payers in relief at source.

Moving from the two systems of applying DC pension tax relief to a single approach with a single rate of income tax relief would give an opportunity to ensure that people did not miss out on the benefit and that the relief was wholly directed towards pension saving.

### National Insurance contributions relief

Relief is given for employer and employee National Insurance (NI) contributions on employer pension contributions but not on employee contributions.

The marginal rate of NI contributions for employees is 2% above the upper

# Tax relief on Defined Contribution pension contributions

## PPI Briefing Note Number 122

earnings limit (£50,000 per year) and 12% below the limit. The employer rate is 13.8% above and below the upper earnings limit.

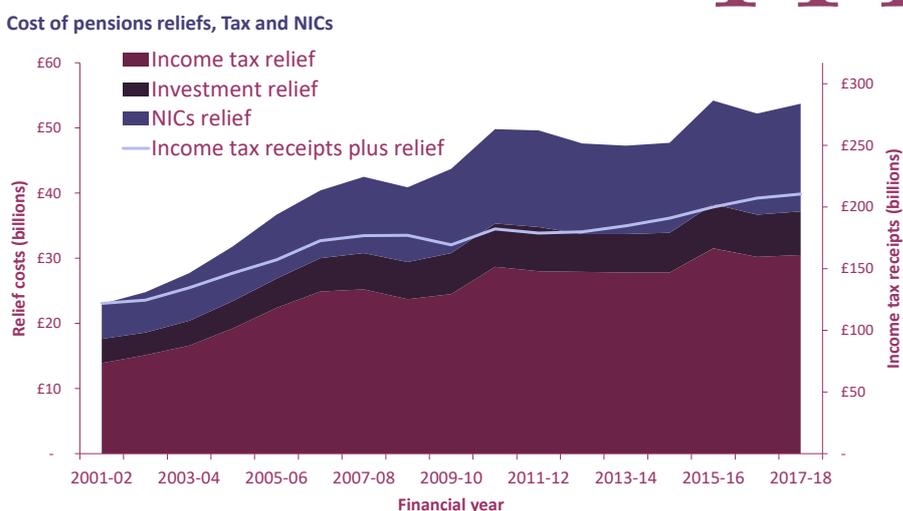
Under a salary sacrifice arrangement an employee may elect to have their salary reduced in lieu of a pension contribution made on their behalf by their employer. For a £1,000 salary sacrifice an employee below the upper earnings limit will reduce their NI contributions by £120, and their employer's NI contributions by £138, an arrangement that clearly benefits both parties. However at particular income levels between the primary threshold and the personal allowance (where an individual must pay NI contributions but not income tax) such an arrangement may not be beneficial to an individual.<sup>22</sup>

The total value of this relief was valued at £16.5bn 2017-18, [Figure 2].<sup>23</sup> NI contribution relief, unlike income tax relief on pension contributions, is progressive with around 85% of the employee NI contributions relieved associated with members earning below the upper earnings limit despite being connected with 45% of the contributions attracting such relief.<sup>24</sup>

Half of employee DC contributions (51%) are associated with individuals who are not members of a salary sacrifice pension scheme. On top of employer contributions made across all schemes if all employee contributions were made through salary sacrifice this could increase the cost of National Insurance relief by 25% on DC schemes.<sup>25</sup>

If NI contributions relief was removed this would increase payroll costs to all employers and it could be expected that employers may reduce wage inflation to mitigate this additional cost.

**Figure 2: The cost of tax relief has more than doubled this millennium**



HMRC (2019) Table 6: Registered pension schemes cost of tax relief

### The challenges of implementation

Multiple challenges would also need to be overcome, including the key issues of:

- Relief on employer and employee contributions would need to be aligned (all reform scenarios considered here include this alignment) or salary sacrifice could offer an unintended loophole;
- There would be one-off administrative costs and consequences for both providers and other related industries;
- Payroll systems would need to be updated.

Respondents to the 2015 HMT consultation highlighted the need for sufficient time to implement changes, as well as one-off administrative costs to providers, as well as the costs (and opportunities) for related industries who provide financial services and advice to individuals and businesses.<sup>26</sup>

As precedent, the implementation of automatic enrolment necessitated the

development of payroll systems to integrate with the changing pensions landscape. Challenges to this were identified and refinements to automatic enrolment were made after consultation.<sup>27</sup> For any change to the future administration of tax relief on DC pension contributions to be implemented the practicalities would need to be worked through with these and other key stakeholder groups.

### Interaction with DB pension schemes

Any change to pension tax relief associated with DC pension schemes would have consequences where it is no longer consistent with the system for DB pension schemes. This presents challenges and complications where the two pension systems interact.

Around 25% of those with a DC pension pot also have some level of DB entitlement.<sup>28</sup> Having both forms of entitlement does not, of itself, present a challenge as the future tax

# Tax relief on Defined Contribution pension contributions

## PPI Briefing Note Number 122

treatment of savings, when withdrawn, is the same. But there are challenges for any future accrual.

For any company running a DB pension scheme with a money purchase element (a hybrid scheme) they would need to apply separate tax treatment to the individual elements of the pension. This would complicate the tax position of the individual and where an individual is required to submit a self-assessment tax return (rather than through an automated payroll system) there is a far greater chance of error. This has consequences for compliance and the costs associated with personal accountancy.

For any transfer from a DB to a DC scheme the tax position becomes more complicated as there is an opportunity for arbitrage where an individual may have different rates of income tax relief upon contributions available through different schemes.

For example, consider the scenario where there is a flat rate of tax relief implemented at 30% for DC pension savings and the current system is maintained for DB pensions and the opportunity for a higher rate taxpayer to “wash” their pension contribution through a DB scheme:

- A £100 contribution (net of income tax) would be worth £143 (£100 contribution plus tax relief at 30%) to a DC pension pot.
- The same £100 contribution to a DB scheme would be worth £167 after income tax relief has been added. If this were transferred straight to a DC pension it could be worth more than the direct contribution.

This hazard would need to be addressed and would present further complications to the DB to DC transfer market.

If the pension tax relief system was to be changed for DB pensions this would change the financial situation of schemes. There would be implications for future contributions and the viability of schemes at current contribution levels as well as the cost of deficit reduction contributions. Schemes becoming more expensive to maintain could further accelerate the current trend of scheme closures.

Beyond the current DB system there needs to be consideration of future Collective Defined Contribution schemes and how the extra complexity they will bring to the pension tax relief landscape. Being a DC scheme primarily operating as an alternative to DB they present a potential conflict point in the system.

### UFPLS and tax-free lump sums

A portion of income tax is relieved when withdrawing DC pension funds, either as a lump sum or through Uncrystallised Funds Pension Lump Sums (UFPLS) where 25% of each withdrawal is not subject to tax. This additional tax advantage means that even when an individual is subject to the same rate of tax in retirement as when they were saving, they may still reduce their lifetime income tax liability. This feature could allow an advantage to still be obtained from pension saving where tax relief is offered at a lower rate than the marginal tax rate of income tax paid in retirement.

There are a number of scenarios where someone could lose out through pension saving, particularly since the introduction of freedom and

choice which has increased the opportunity for people to make suboptimal choices with significant tax ramifications. For example, withdrawing an entire pension pot in one go could result in a tax bill higher than the value of the relief while saving under either the current system or any of the alternatives discussed in this Briefing Note.

### Conclusions

A change to the system of tax relief on DC pensions could offer an opportunity to address the philosophy of the current system. For the same cost it would be possible to offer a higher benefit to basic rate taxpayers through a flat rate of tax relief. This would improve outcomes achieved by a large proportion of the new pension savers brought in through automatic enrolment. Women, in particular, would stand to benefit due to their higher likelihood of being a basic rate taxpayer.

This redistributive powers of a flat rate of tax relief would come at a cost to higher and additional rate taxpayers who make pension contributions when compared to the current system. However, there would still remain a tax advantage which would continue to make pension saving attractive, albeit the advantage would be reduced.

Any change to the tax relief system for DC pensions would present challenges from an implementation perspective. Any transition could be associated with significant cost to industry and would introduce uncertainty and confusion, at least in the short-term.

# Tax relief on Defined Contribution pension contributions

## PPI Briefing Note Number 122

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