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New Chancellor Rishi Sunak must prove the Conservatives haven't forgotten good tax policy

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Three things are now certain in life: death, taxes, and Conservative chancellors flirting with curbing pensions tax relief before budgets.

Since at least 2013, occupants of No 11 Downing Street have seen relief as an "eye-wateringly expensive" policy – a pool of foregone revenue. With Gaelic bridges to finance and new Ofcom online regulators to fund, a looting on March 11 was being actively discussed. At least, until the dramatic change of personnel at the apex of the Exchequer.

Campaigners claim that reliefs are "regressive" because richer taxpayers "receive" the lion's share of the near £30bn recorded "cost." Changing to a "flat-rate relief" system of 20pc or 30pc, they say, would raise revenue and improve "fairness." For the former Chancellor, Sajid Javid, this redistributive case for a revenue grab was said to appeal.

New Chancellor Rishi Sunak must steer clear. His predecessors ultimately backed off this policy for a reason. A flat-tax relief for pensions would bring incoherence, complexity, and require extensive new regulations. It would introduce arbitrary new subsidies and penalties for pensions saving. And it would mean lifetime incomes being taxed differently depending on a person's income volatility. This would heedlessly introduce new tax code injustices.

Pensions tax relief is not just a savings "incentive," as some claim, but a means of avoiding double taxation. When making contributions to a pension, basic rate taxpayers currently avoid their 20pc income tax rate on the money going to contributions. Higher and additional rate taxpayers likewise avoid paying 40pc or 45pc, in line with their marginal rates.

But this is no gift from the Government. Pension income is ultimately taxed when received in retirement. It's not "tax relief", so much as "avoiding penalising people for pension saving". Taxing both contributions and withdrawals would tax-disadvantage pension saving relative to ISAs or even just holding money. So when you read about how much pension tax relief "costs", first consider "relative to what?" The numbers cited often compare against a world of destructive double-taxation and ignore that, for most people, this is just a case of tax deferral.

One can in principle save for retirement out of post-tax income into an ISA, obtaining investment returns tax free and then not paying tax on withdrawals. Or else you can contribute to a pension tax free, avoiding tax on normal investment returns but paying tax when the fund is accessed.

Both are coherent frameworks and would be functionally equivalent over a lifetime under a flat-rate income tax system.

Confusion seeps in because, under our progressive tax system, someone can obtain 40pc relief when making contributions, but only pay a 20pc basic income tax rate on pension income in retirement. For these people, the current framework appears to provide a big monetary incentive to save relative to an ISA-like framework.

Proponents of flat-rate tax relief see this as an unjustified bung to the rich. But, in fact, this is a tax code feature, not a bug, that corrects for a real progressive income tax injustice. Those with highly volatile incomes would otherwise pay much more in tax over their lifetimes than those with steady incomes. As Philip Booth and I wrote in 2016, consider Mrs Volatile, whose income alternates between £90k and £30k each year (average income £60k). She would currently pay around £2,000 more in tax each year, on average, than Mr Steady with a stable income of £60k, because more of Mrs Volatile's income would be subject to the 40pc higher rate.

The only way she can match Mr Steady's tax bill is to make greater pension contributions in her high-income years, paying a lower tax rate in retirement. Curbing pensions tax relief would disable such income smoothing, introducing lifetime "unfairness" into the tax code.

In fact, one reason "the rich" account for such a large share of the tax relief "cost" today (other than that they pay more tax) is precisely because many basic rate payers wait until they earn higher incomes before making meaningful pension contributions. Before then, an ISA is just as attractive. To use those rational decisions as evidence of relief being unfair is perverse.

A flat-rate pensions tax relief would instead introduce arbitrary new penalties and subsidies for pension saving. Some higher rate taxpayers might get relief of 20pc or 30pc for contributions but ultimately be taxed at 40pc in retirement – effectively paying a fine. Meanwhile, any flat-rate relief above 20pc would incentivise basic rate taxpayers to load up on contributions just before retirement to obtain "free money" from paying less tax just years later.

HMRC would get bogged down closing loopholes and counteracting new behaviours. To give one example, they'd have to clamp down on the incentive for higher rate taxpayers to accept lower salaries in return for higher employer contributions to pensions (something it would be extraordinarily complex to counteract).

Rather than all this absurdity, why not focus on the aspect of pensions taxation that defies economic reasoning? The current 25pc tax-free pension lump sum at retirement has no logical basis, given the whole point of pensions is to obtain a regular retirement income stream. It also requires huge amounts of accompanying legislation and a lifetime allowance restriction. Severely curtailing it would improve tax coherence, while raising revenue in the desired progressive way.

New Chancellor Rishi Sunak has 26 days to finalise his Budget and prove that today's Conservatives haven't forgotten the lessons of good tax policy. A key early test will be whether he jettisons this misguided assault on pensions tax relief.

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