Pensioners and the tax and benefit system

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Executive Summary

- This paper was commissioned by the Nuffield Foundation to aid discussion about ways in which the proposals produced by the Dilnot Commission on the Funding of Care and Support could be funded. These proposals would provide a greater degree of insurance against the costs of residential care, which would tend to be welfare-improving as individuals tend to be risk-averse. They also strengthen incentives to save for retirement.
- The Dilnot Commission proposed a more generous system of state support for care costs. The main beneficiaries of this would be pensioners with higher levels of income, and those with significant assets. The Dilnot Commission therefore suggested that if a particular tax rise or benefit cut were introduced to pay for its proposals, then it should affect this group.
- Pensioners (those over state pension age) have seen their incomes increase more quickly than those of working age over the last fifteen years. This has come about partly because more recent cohorts of pensioners have received higher levels of income from state and private pensions as these schemes have come to maturity. Also, tax and benefit changes introduced under the Labour government of 1997–2010 favoured pensioners, particularly those with lower levels of income. Furthermore, pensioners will lose less on average than those of working age from the tax and benefit changes being introduced by the current government as it deals with the fiscal deficit. On average, these measures will reduce incomes by 1.8% or £316 per year for pensioners compared to 4.7% on average or £1,781 per year for households with children and 2.3% or £751 per year for working-age households without children.

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- Pensioners of course receive support from the state through the system of state pensions and through means-tested benefits, most importantly Pension Credit. Together, these form a coherent system of support for older people. However, pensioners are also treated more favourably by other aspects of the tax and benefit system which, arguably, sit less easily with a well-designed system of support.
- Examples of such treatment include the exemption from employee and self-employed National Insurance contributions (NICs) for pensioners, as well as Winter Fuel Payments, free TV licences and free bus passes received by older people. Focusing stronger work incentives on older people by exempting them from employee and self-employed NICs may be desirable as they seem to be more responsive to financial work incentives. However, it is less clear that Winter Fuel Payments and free TV licences are preferable to simply increasing the Basic State Pension and/or other benefits.
- In Budget 2012, the Chancellor announced plans to phase out one of these benefits for older individuals, namely the higher personal allowances for those aged 65 and over. As the PAYE system of income tax works less well for pensioners than for those of working age, there is some justification for providing support for pensioners through higher tax allowances that keep pensioners out of paying income tax and hence avoid administrative costs for HMRC and compliance costs for pensioners. However, this argument in favour of the age-related allowances is weakened by the increases in the personal allowance for those aged under 65 being implemented in 2012–13 and 2013–14, which reduce the difference in the personal allowances for different age groups. Abolishing the higher personal allowances avoids the complicated system for withdrawing these personal allowances from richer pensioners. The government proposals do, though, represent a straightforward reduction in generosity to pensioners. Those worst affected by this change – people retiring in 2013-14 with incomes between £10,820 and £26,000 – will be left £323 worse off than they would have been had no change been made. The average loss among those who lose out will be £83.
- This government has though introduced one very important change which favours pensioners over those of working age: the so called “triple lock” on the value of the state pension. This ensures that it will rise each year by the greater of earnings growth, Consumer Price Index (CPI) inflation and 2.5%. Benefits for people of working age generally rise only in line with the CPI.

- Saving in a private pension is particularly tax-favoured, typically receiving a more generous treatment than the tax-neutral treatment given to ISAs. Although it is probably desirable from the government's perspective to encourage individuals to save for a pension, it is questionable whether the current system does this in the most efficient way. In particular, the 25% tax-free lump sum seems overly generous for those who have saved large amounts and can take up to £435,000 tax-free. The treatment of employer pension contributions in National Insurance (much more generous than that given to employee contributions) is also hard to justify.
- Other elements of the tax system which arguably favour older people include forgiveness of capital gains tax at death. This introduces a significant distortion into the tax system which ought to be rectified.
- We conclude that there are many ways of paying for the Dilnot Commission proposals which would both see better off pensioners as a group paying for the cost of the proposals and make the tax and benefit system for those above State Pension Age more coherent. These options include restricting Winter Fuel Payments and free TV licences to those on Pension Credit, reducing the generosity of the tax-free lump sum, reforming the NICs treatment of employer pension contributions to ensure they attract NICs at some point and imposing capital gains tax at death. Not all of these changes would be required to raise the required revenue, but, as the Mirrlees Review of the tax system argued, whatever choice is made should be in the context of a clear strategy for tax reform and for the design of a coherent tax and benefit system that works well as a whole for those both above and below the State Pension Age. Poorly-designed changes could increase distortions that already exist, introduce new ones or significantly weaken the incentive for individuals to continue in paid work at older ages or save for retirement.

1. Introduction

The last fifteen years have seen those over State Pension Age significantly strengthen their position in the income distribution relative to those of working age. In the 1960s and 1970s, only a quarter of the population was poorer than the median (middle) pensioner; by 2009 more than 40% were. The growth in pensioner incomes over this period has come about both as a result of increased private pension coverage and tax and benefit changes which have particularly benefited pensioners.

At the same time, the 'assessed costs'[1] of long-term care for older people have been increasing: the average cost of care for a man aged 65 over the

[1] Assessed care costs are the amount councils deem necessary for individuals given their level of need, which may be different from the amount they actually choose to spend.

rest of his lifetime is £25,000 and for a woman aged 65 £44,000.[2] There is little help from the state for residential care costs until individuals have exhausted almost all of their assets. As individuals tend to be risk-averse and the market is unable to provide insurance against these costs, the provision of social insurance to cover these costs is likely to be welfare-enhancing. For this reason, the Dilnot Commission, which was set up in 2010 to investigate this issue for the Government, recommended an increase in the generosity of state support for long-term care costs. Box 1 discusses the Dilnot proposals in more detail.

Box 1: The Dilnot Commission's proposals

Currently, those with assets greater than £23,250 do not receive any support for their residential care costs, and individuals have to contribute all their income above a small 'Personal Expenses Allowance' (PEA, currently £22.60 a week) towards these costs. The Dilnot Commission recommended increasing the asset limit to £100,000 and also proposed a cap of between £25,000 and £50,000 as the total amount individuals have to pay towards their residential and domiciliary care costs (though not their living costs for residential care) throughout their lifetime.

To introduce the whole Dilnot package of reforms with a cap of £35,000 would cost 0.14% of GDP, which is equivalent to £1.7 billion a year in 2010–11. £1.4 billion of this cost is to pay for the proposals affecting older people, with the remainder for younger people requiring care. As the main beneficiaries from the Dilnot proposals would be pensioners with higher levels of income, and those with higher levels of wealth (since those without income or assets do not have to pay for their long-term care under the current system), Dilnot suggested that the cost be paid at least in part by this group.[3]

[2] Source: Modelling work carried out for the Dilnot Commission as part of the core programme of the policy research unit in economics of health and social care systems also referred to as ESHCRU (at the University of York, London School of Economics and Political Science (LSE) and University of Kent) and builds on the microsimulation and aggregate models originally developed by the Personal Social Services Research Unit (PSSRU, at the University of Kent and LSE).

[3] However, it is also worth bearing in mind that low income and consumption among pensioners is thought to be a causal factor for poor physical and mental health, which drives the need for care in the first place. See for example McMunn, A. et al. (2009) "Inequalities in health at older ages: a longitudinal investigation of the onset of illness and survival effects in England" in Age and Ageing, Vol. 38, Issue 2, p181-187, Matthews, R. et al. (2005) "Socioeconomic factors associated with the onset of disability in older age: a longitudinal study of people aged 75 years and over" in Social Science & Medicine, Vol., Issue 7, p 1567-1575; Grundy, E. and Sloggett, A. (2003) "Health inequalities in the older population: the role of personal capital, social resources and socio-economic circumstances" in Social Science & Medicine, Vol. 56, No. 5, p935-47.

The Dilnot proposals tend to strengthen individuals' incentives to save for retirement. In particular, the £35,000 lifetime cap on care costs to be paid by individuals themselves strengthens the incentive to save in any form: the cap reduces the amount of pension income and other savings that might be lost through reduced entitlement to means-tested support for care costs in later life. The other main proposal of the Dilnot Commission is to make the treatment of assets in the means-test for residential care costs more generous by increasing the upper asset limit above which individuals must pay for all their care costs to £100,000 (though those with assets between £14,250 and £100,000 would still have to make a contribution of £1 a week for every £250 of capital they had above this level). However, the Dilnot proposals do not alter the treatment of income in the means test: individuals would still have to contribute all their income above the Personal Expenses Allowance. Thus, although the Dilnot proposals strengthen the incentive for individuals to save in any form, they particularly strengthen the incentive to save in forms other than a pension. This is because the treatment of capital in the means test would be made more generous but the treatment of income would not and pension income is treated as income for the means test, whereas other forms of saving are treated as capital. That said, it is questionable how much of an effect these changes would have on the amount of saving undertaken: it is unclear to what extent working-age individuals take into account the existence of means-tested support for residential care when making retirement savings decisions.

In this paper we document how pensioners' position in the income distribution has strengthened over the last 15 years and describe how the tax and benefit system treats those above State Pension Age differently. Bearing in mind the Dilnot Commission's proposals, we then investigate reforms that might both rationalise the tax and benefit system for pensioners and raise revenue to pay for the Dilnot proposals.

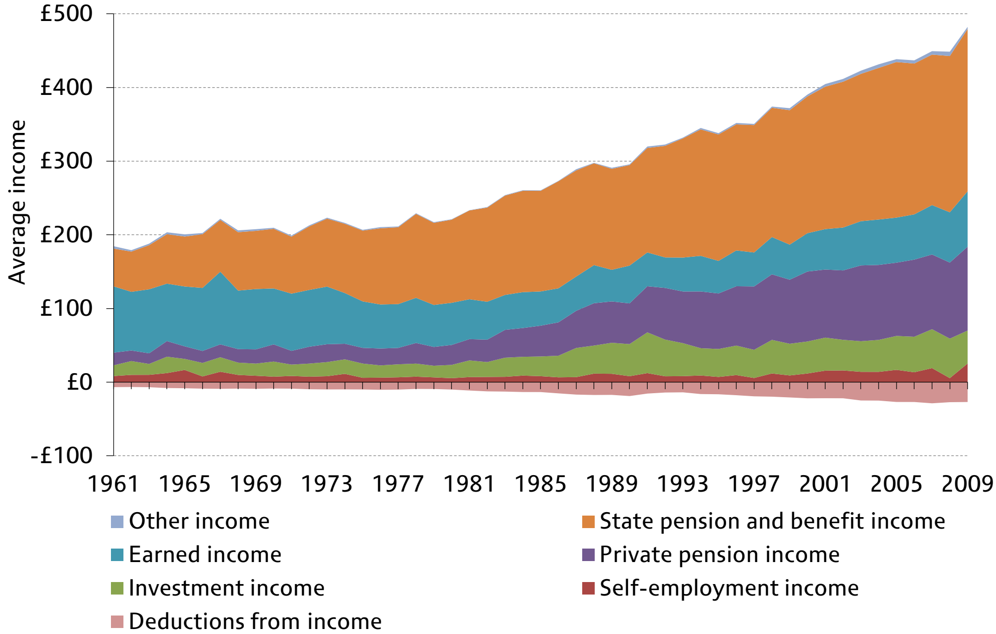
2. How have pensioners' incomes evolved over recent decades?

This section examines how the composition and level of pensioners' incomes has changed over time relative to those of other groups.

Where do pensioners get their income from, and how has this changed over time?

Figure 2.1 shows the different components of mean pensioner income from 1961 to 2009–10. Pensioners are defined as those above the State Pension Age (throughout this period 65 for men and 60 for women) and incomes are measured at the household level, meaning that some of this income belongs to other individuals living in the household, some of whom may be of working-age.

Figure 2.1: Components of real mean pensioner income, 1961 to 2009–10



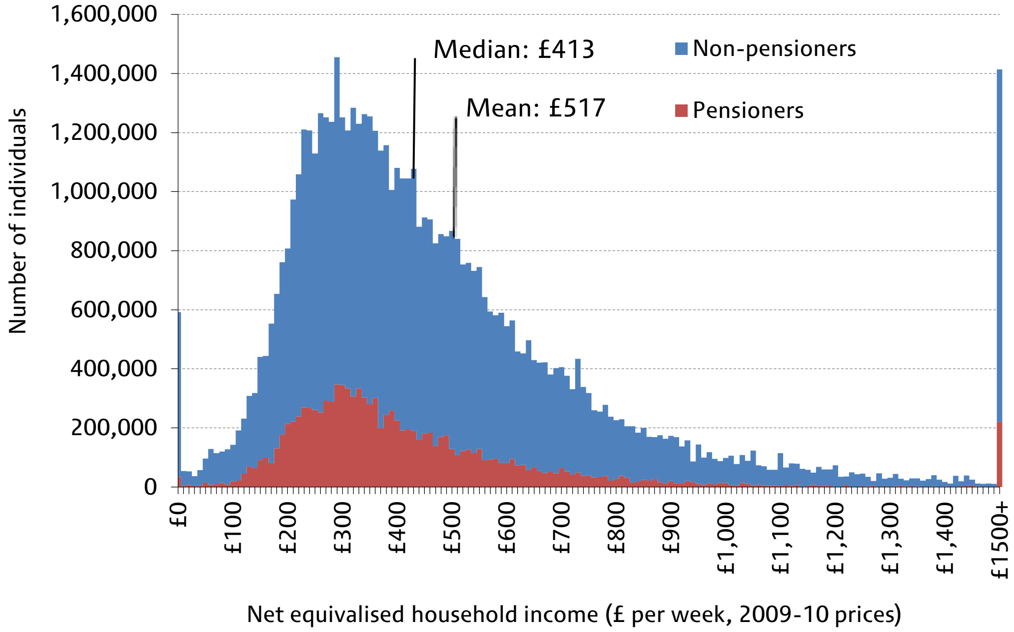
Notes: Income measured at household level before housing costs have been deducted, adjusted for household size using OECD equivalence scale. Years are calendar years until 1993 and financial years thereafter.
Source: Authors' calculations using the Family Expenditure Survey and Family Resources Survey, various years.

Most of the real increase in pensioners' incomes over the last thirty years has come from private pension income and increased state pensions and other benefits. More recent cohorts of pensioners have higher entitlements to SERPS and other earnings-related pensions and are more likely to be members of private pension schemes. Income from earnings and investments has become less important over time: fewer people remain in work above State Pension Age than in the 1960s and 1970s and there has been a shift towards saving in pensions rather than other assets.

How do pensioner incomes compare with those of other groups, and how has this changed over time?

Figure 2.2 shows the income distribution in 2009–10, and where pensioners and non-pensioners fit in. We can see that pensioners are most heavily concentrated in the range just below the middle of the overall distribution (£413 per week), though a sizeable fraction of pensioners, around 40% of the total, are in the top half of the income distribution. Very few pensioners have either very low incomes of less than £100 per week or very high incomes of £1,000 per week or more.

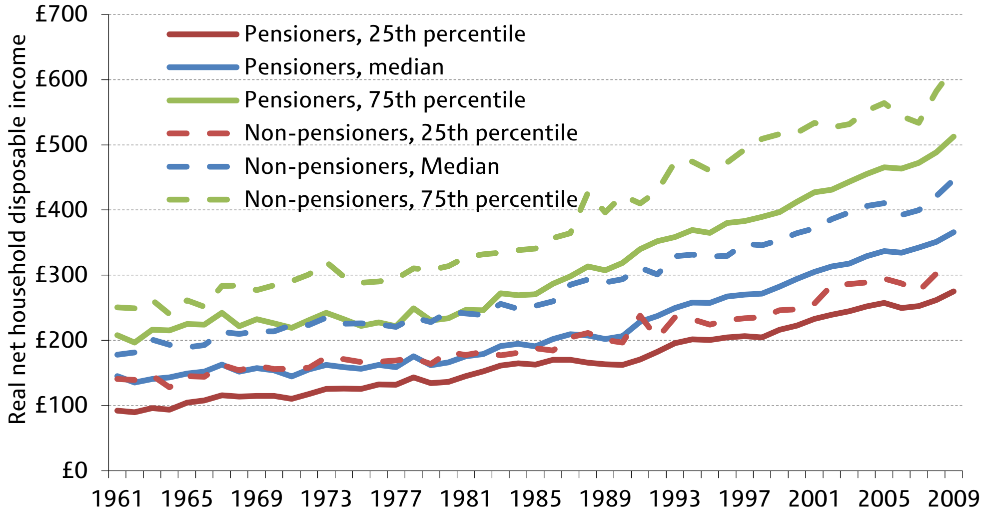
Figure 2.2: The income distribution in 2009–10



Notes: Incomes have been measured before housing costs have been deducted and adjusted for family size using the OECD equivalence scale. The right-most bar represents incomes of over £1,500 per week.
Source: Authors' calculations using the Family Resources Survey 2009–10.

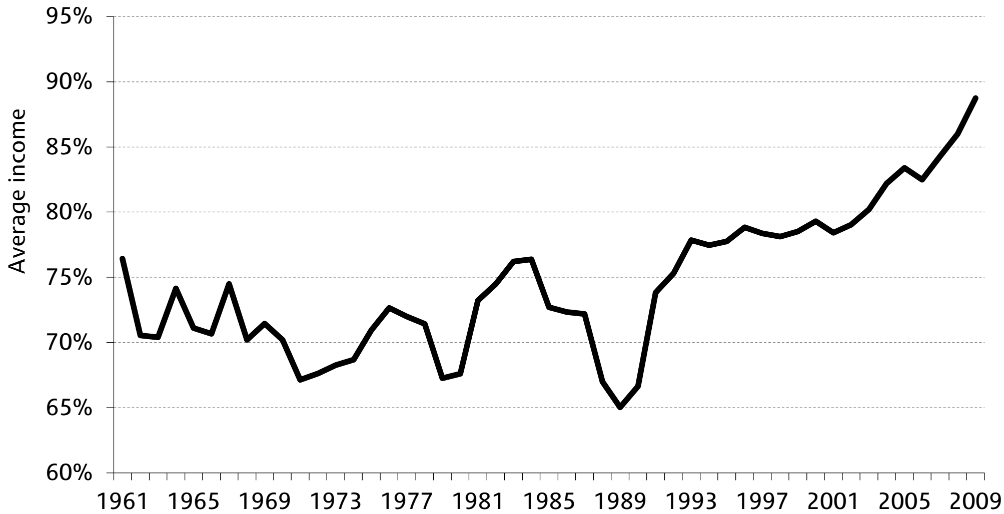
Figure 2.3 shows the key points of the distribution of income among pensioners and non-pensioners since 1961. It is clear that in the last twenty years incomes have grown more quickly among pensioners than among non-pensioners throughout the income distribution. We can see this more clearly in Figure 2.4, which compares the income of the median pensioner to the overall median income over time.

Figure 2.3: Key points in the distribution of income among pensioners and non-pensioners, 1961 to 2009–10



Notes: Income measured at household level before housing costs have been deducted and adjusted for household size using the OECD equivalence scale. Years are calendar years until 1993 and financial years thereafter.
Source: Authors' calculations using the Family Expenditure Survey and Family Resources Survey, various years.

Figure 2.4: Median pensioner income as % of overall median income

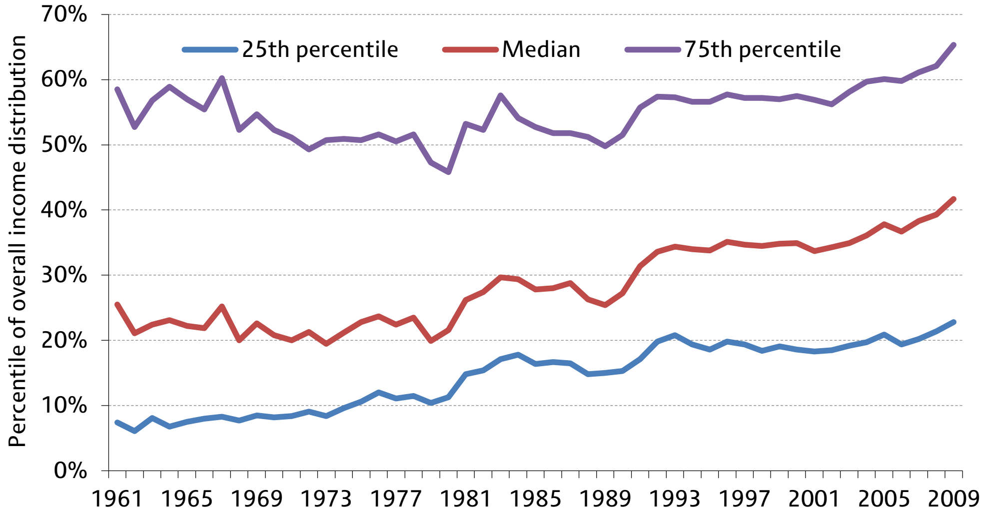


Notes: Income measured at household level before housing costs have been deducted and adjusted for household size using the OECD equivalence scale. Years are calendar years until 1993 and financial years thereafter.
Source: Authors' calculations using the Family Expenditure Survey and Family Resources Survey, various years.

We can see that, during the 1960s, 70s and 80s pensioners roughly maintained their position relative to the working-age population. The variance that occurred was largely down to the economic cycle, which affected those of working age more than pensioners: for example, the recessions of the early 1980s and early 1990s increased the ratio of the median pensioner income to the median income overall. This arose because pensioner incomes remained constant while those of working-age households fell. By contrast, during the boom of the mid- to late-1980s, incomes of working-age individuals increased much more strongly than those of pensioners. Since the early 1990s however, a different pattern has emerged: the median pensioner income kept pace with the growth in median income over the 1990s, and has been growing more quickly since 2000. In the decade from 1999 to 2009, the income of the median pensioner increased by 29.4% whereas the income of the median non-pensioner increased by 26.0%. The difference in income growth between pensioners and non-pensioners has been more dramatic among higher-income groups: the 75th percentile of pensioner incomes (the income of the pensioner who has a higher income than three-quarters of pensioners) grew by 29.1% over this period, whereas the 75th percentile of non-pensioner incomes grew by 19.8%.

Another way of comparing how well off pensioners are relative to the rest of the population is to consider where the median pensioner (and other key percentiles of the pensioner income distribution) fits into the overall income distribution. Figure 2.5 shows how this has changed over time and shows a broadly similar pattern. During the 1970s around a quarter of pensioners were in the bottom 10% of the overall income distribution and only a quarter of pensioners were in the top half of the income distribution. The recession of the early 1990s improved the position of pensioners within the overall income distribution as incomes of other groups fell (in much the same way as the recession of the early 1980s had previously), but this time the position of pensioners did not fall back during the economic recovery. Indeed, the position of pensioners within the income distribution continued to strengthen during the 2000s, to the point where by 2009 the median pensioner was richer than 40% of the population whereas thirty years previously they had only been richer than 20% of the population. More than 40% of pensioners were in the top half of the income distribution in 2009, compared to just 25% twenty years earlier.

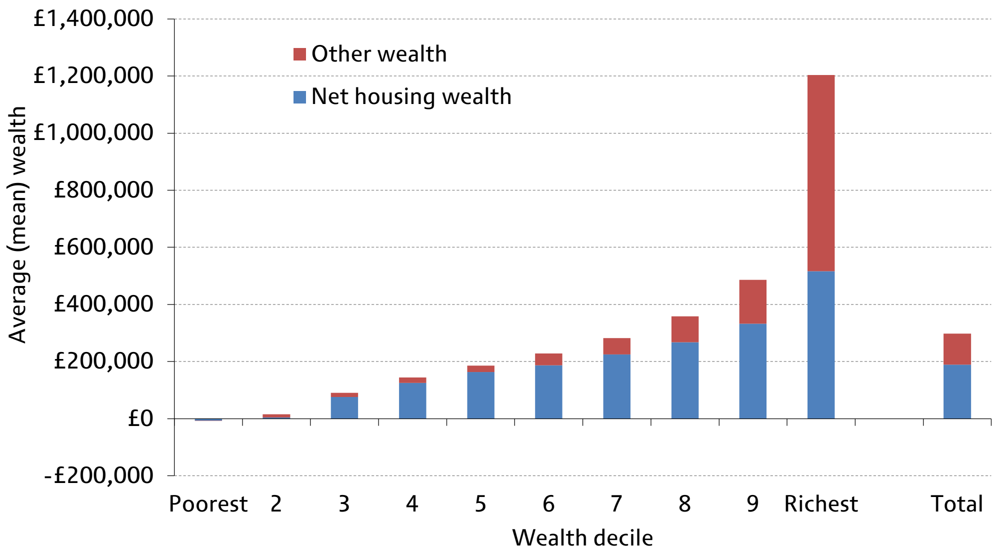
Figure 2.5: Pensioners' position in the overall income distribution, 1961 to 2009–10



Notes: Income measured at household level before housing costs have been deducted and adjusted for household size using the OECD equivalence scale. Years are calendar years until 1993 and financial years thereafter.
Source: Authors' calculations using the Family Expenditure Survey and Family Resources Survey, various years.

It is also important to consider the wealth of pensioner households, as we would expect pensioners to run down their wealth during retirement to enable them to have a higher standard of living. Wealth is also taken into account when determining how much an individual has to contribute towards their long term care costs. Therefore, wealthy households stand to gain more from the Dilnot proposals as they would have to make a lower contribution to their long-term care costs. As Figure 2.6 shows, the distribution of non-pension wealth among older households is very unequal: although around 20% of older households have almost no pension wealth at all, there are significant numbers of older households with considerable amounts of wealth.

Figure 2.6: Distribution of wealth among households containing someone aged over 50, 2002–03

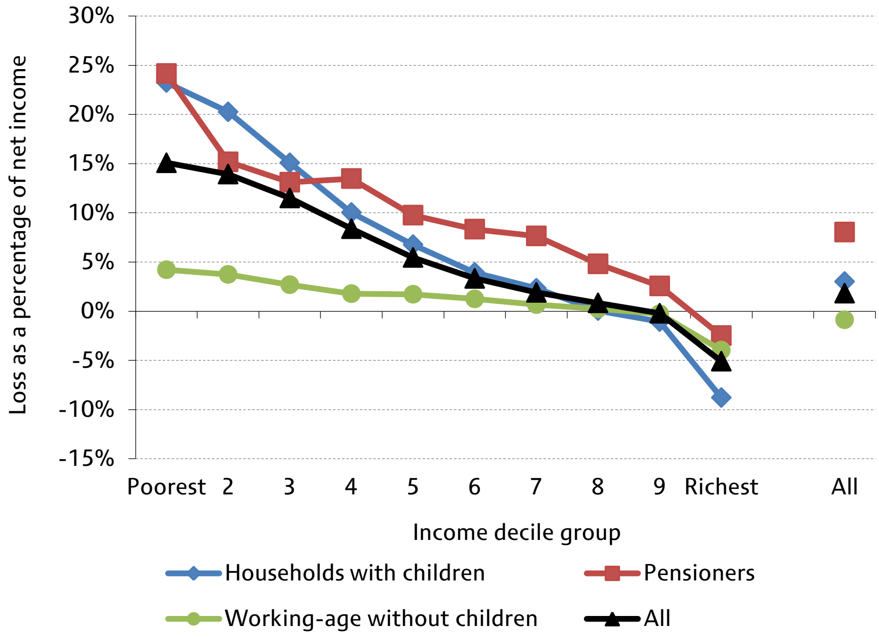


Notes: Unweighted. Sample size = 9,093.
Source: Figure 4.6 of C. Emmerson and A. Muriel (2006), 'Financial resources and well-being' in J. Banks, E. Breeze, C. Lesoff and J. Nazroo (eds.), *Living in the 21st Century: older people in England: The 2006 English Longitudinal Study of Ageing (Wave 3)*, London: Institute for Fiscal Studies.

How have pensioners benefited from tax and benefit reforms over the last 15 years?

Pensioners particularly benefited from changes to the tax and benefit system made by the Labour government of 1997–2010. Figure 2.7 shows the distributional impact of changes made between 1997–98 and 2010–11 relative to the baseline used by the Treasury in costing measures in Budgets and Pre-Budget Reports at this time (which involved price-indexation of most tax thresholds and benefit amounts). It shows that pensioner households, particularly those towards the lower end of the income distribution, gained a particularly large amount from these changes. This is mainly the result of large increases in the generosity of means-tested benefits for pensioners (particularly the introduction of the Minimum Income Guarantee in 1999 and subsequent increases in its generosity) and the introduction of Winter Fuel Payments. Overall, Labour's reforms increased pensioner incomes by 8% on average or £1,400 per year, compared to 3% or £1,120 per year for those of working age with children and -0.9% or -£280 per year for those of working age without children. Note that these discretionary increases in generosity are over and above increases in income from state benefits that have resulted from the maturing of SERPS and increasing numbers of women retiring with full basic pension entitlement.

Figure 2.7: Distributional impact of tax and benefit changes introduced between 1997–98 and 2010–11 by income decile and household type



Notes: Income decile groups are derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth.
Source: Based on J. Browne and D. Phillips (2010) 'Tax and benefit reforms under Labour', IFS Briefing Note 88, http://www.ifs.org.uk/bns/bn88.pdf.

Pensioners are also largely protected from the cuts to welfare spending being introduced as part of the current government's deficit reduction package, as shown by Figure 2.8. For thirty years until 2011 the Basic State Pension had risen in line with the RPI each year. The last government announced that it would start to be indexed in line with earnings from 2012. The current government has gone further and introduced a 'triple lock', whereby it will increase by the highest of earnings, CPI inflation and 2.5% each year.[4] By contrast indexation procedures for benefits for those of working age have been made less generous. They will now increase in

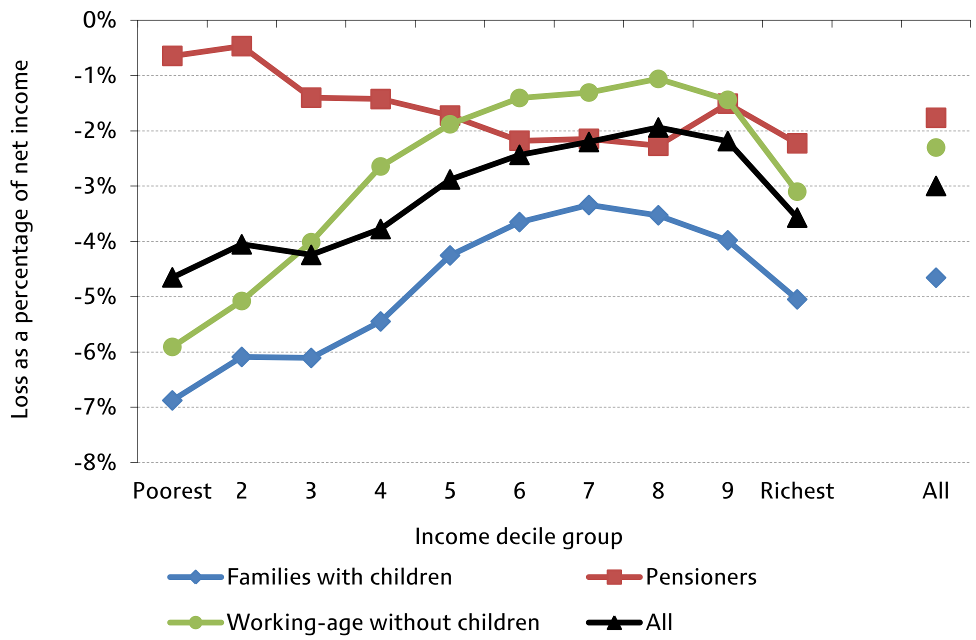
[4] Note however that the 'triple lock' does not apply to the Pension Credit Guarantee, which increases in line with earnings each year. Thus, when earnings increase by less than CPI inflation or 2.5%, it increases by less than the BSP unless the government intervenes. In practice, the government has ensured that the PCG has increased by the same cash amount as the BSP in 2011 and 2012 (when earnings growth has been particularly weak), though this has still meant that it has not increased by as much in percentage terms as the PCG is higher than the BSP. It is also interesting to note that the 'triple lock' is less generous than the previous policy of RPI-uprating in years when RPI inflation exceeds both earnings growth, CPI inflation and 2.5%. This is the case for the April 2012 uprating: the respective figures were 5.6% for RPI inflation, 5.2% for CPI inflation and 2.3% for earnings.

line with CPI inflation each year, which tends to be lower than RPI or Rossi inflation, the previous measures used. Also, specific cuts have been announced to many working-age benefits but benefits for pensioners have escaped unscathed: for example, local authorities in England will not be allowed to cut Council Tax Benefit for pensioners when responsibility for council tax rebates is localised from 2013–14.

The one change that will affect pensioners specifically is the abolition of the higher personal allowance which was announced in the 2012 budget and which we discuss in more detail in the next section.

Even taking into account this reduction in the generosity of the tax pensioner tax allowance, overall, the effect of the austerity measures being introduced by 2014–15 will reduce incomes of pensioners by 1.8% or £316 per year compared to 4.7% or £1,781 on average for households with children and 2.3% or £751 per year for working-age households without children.

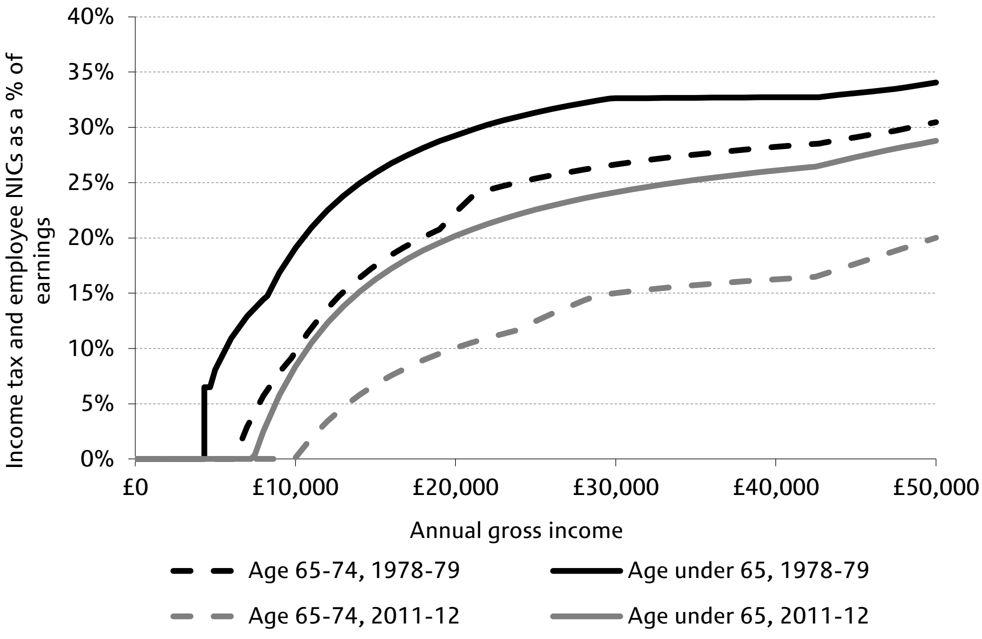
Figure 2.8: Losses from tax and benefit changes to be introduced between January 2011 and April 2014 by income decile group and household type, without Universal Credit



Notes: Income decile groups are derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth. Assumes increases in employer NICs are passed on to employees in the form of lower wages. Does not include impact of Universal Credit.
Source: Based on R. Joyce (2012), 'Tax and benefit changes, excluding those affecting mainly the very rich', presentation at IFS post-Budget briefing, http://www.ifs.org.uk/budgets/budget2012/budget2012robjoyce.pdf.

Looking specifically at direct taxes, this government, like many of its predecessors, has chosen to increase the rate of National Insurance Contributions rather than the basic rate of income tax. This shift in the balance of taxation benefits pensioners for two reasons. First those who are in work do not pay NI on their earnings. Second, and much more importantly, pensioners receive most of their income from pensions and interest on which no NI is payable. The effect of this shift is illustrated in Figure 2.9 which compares the combined income tax and employee National Insurance schedule for a single person aged under 65 and an individual aged between 65 and 74 under the current tax and benefit system and under a price-uprated 1978 system. What this shows is that someone under age 65 earning £50,000 a year in 2011-12 would face an average tax rate (including income tax and employee NI) of nearly 30%. A pensioner with same income faced an average tax rate of just 20%. The size of the gap in average tax rates has roughly doubled over the past 30 years or so as there has been a shift from income tax to National Insurance.[5]

Figure 2.9: Total income tax and employee NICs rate by income for individual aged under 65, and individual aged 65–74, 1978–79 and 2011–12



Notes: Assumes single man, no children, all income earned for individual aged under 65, one job, contracted in to S2P/SERPS.
Source: Authors' calculations.

[5] Note that we do not include employer National Insurance in this analysis. This would not affect the difference between individuals of different ages as this continues to be payable above State Pension Age.

Summary

Pensioners' incomes have increased more strongly than those of working age people over the last decade. Levels of wealth and home ownership have also grown. This increase in income has come about both because of an increase in private pension income as more recent cohorts of pensioners are more likely to be members of a private pension scheme, and because of higher income from the state. This is both the result of earnings-related state pension schemes (SERPS and S2P) coming to maturity and discretionary changes in tax and benefit policy made by the previous Labour government: pensioners were a group who particularly benefited from Labour's reforms, and they have also been largely unaffected by the austerity measures brought in by the current government. A number of aspects of the tax and benefit system have developed in ways which benefit all pensioners, including the better off, relative to those of working age, which we describe in the next section.

3. The treatment of pensioners in the tax and benefit system

Our benefit system is of course deliberately designed to provide an income for people once they reach a certain age. Those above State Pension Age are entitled to a Basic State Pension (conditional on having made sufficient National Insurance contributions during their working lives) and whatever entitlements to the Second State Pension (S2P) they have accrued. Those with low incomes who are above the female State Pension Age are also are entitled to claim the means-tested Pension Credit. Disability benefits, in particular Disability Living Allowance and Attendance Allowance, are also important for those above State Pension Age. These core benefits are not the focus of this discussion (details are available in the appendix).

What we do focus on is the variety of other ways in which the tax and benefit system treats pensioners relatively favourably, arguably in ways which sit uneasily with a well designed system of support. We look at some of these features of the system in section 3.1 and discuss ways in which these could be rationalised. In section 3.2, we discuss the tax treatment of private pension saving.

3.1 Ways in which the tax and benefit system treats pensioners more favourably

This sub-section discusses other ways in which the tax and benefit system treats pensioners more favourably. These additional benefits start to arise from the female State Pension Age (currently just above 61). At this point, the following entitlements change:

- Women can claim their state pension and no longer pay employee and self-employed National Insurance Contributions,

- Single people and couples where either partner has reached the female state pension age can claim the Guarantee Credit component of Pension Credit rather than other means-tested income-replacement benefits for those of working age such as Income Support, Jobseekers' Allowance or Employment and Support Allowance,[6]
- Households containing someone who has reached the female state pension age are entitled to a Winter Fuel Payment of £200 each year and
- Individuals are entitled to a free bus pass (which since 2008 has allowed free local bus travel anywhere in England).

At age 65, the following changes occur:

- men can claim their state pension and no longer pay employee and self-employed National Insurance Contributions,
- single people and couples where at least one partner is aged 65 or over are entitled to claim the Savings Credit component of Pension Credit (this benefits those who are entitled have small amounts of private income) and
- individuals have a higher income tax allowance of £10,500 rather than £8,105 in 2012–13 (though individuals who turn 65 after 5 April 2013 will no longer be entitled to this, and the personal allowance for existing claimants will remain frozen at its 2012–13 level until the personal allowance for those aged under 65 reaches this level).

At age 75, the following changes occur:

- The income tax personal allowance increases again, to £10,660 in 2012–13 (though, again, it will be frozen at this level until the personal allowance for those aged under 65 reaches this level) and
- Individuals are entitled to a free television licence.

At age 80, the following changes occur:

- Individuals receive a 25p/week increase in their Basic State Pension and
- Winter Fuel Payments increase to £300 per year.

Finally, at death, unrealised capital gains at death are exempt from capital gains tax.

[6] For more on these benefits, see W. Jin, P. Levell and D. Phillips (2010), 'A survey of the benefit system', IFS Briefing Note 13, http://www.ifs.org.uk/bns/bn13.pdf.

In this section, we examine the costs and distributional impacts of each of these benefits and calculate how much the Basic State Pension and Pension Credit could be increased if the support were instead provided in this way. We do this to illustrate what a simpler and more coherent system of support might look like.

Income tax

Currently, those aged 65 and over receive a higher income tax allowance than those under 65, and those aged 75 and over have a higher personal allowance still, as shown in table 3.1.

Table 3.1: Personal allowances, 2012–13

Type of allowance	*Allowance (£ per year)*[a]
Aged under 65	8,105
Aged 65–74	10,500
Aged 75 or over	10,660

[a] For higher-income individuals, personal allowances are reduced or eliminated as described in the text.

Source: HM Revenue and Customs, http://www.hmrc.gov.uk/rates/it.htm.

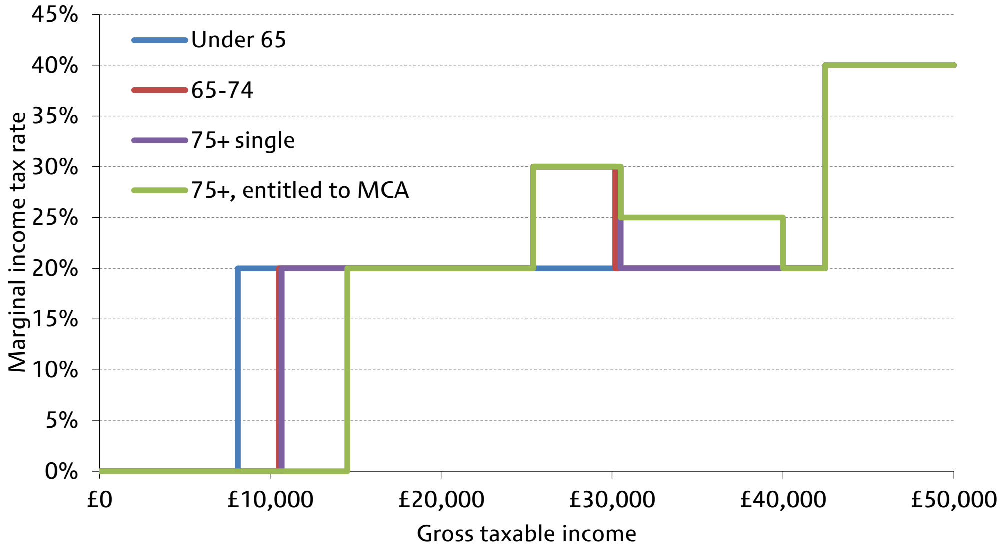
The higher personal allowances for older individuals are reduced once an individual's income exceeds a certain threshold (£25,400 in 2012–13). The personal allowance is reduced by 50 pence for every pound of income above the £25,400 threshold, gradually reducing it to a minimum level equal to the allowance for the under-65s for those with incomes above £30,190 (£30,510 for those aged 75 or over). Therefore, under the current system, increases in the personal allowance for those aged under 65 only benefit pensioners with incomes above these levels.

Those who were born before 6 April 1935 and are married or in a civil partnership are also entitled to the Married Couples Allowance (MCA). The MCA does not increase the personal allowance; instead, it simply reduces final tax liability, by £770.50 in 2012–13. Couples may choose which of them claims the MCA, or they can claim half each. Like the higher personal allowances for those aged 75 and over, the MCA is gradually withdrawn from higher-income pensioners: once the higher personal allowance for those aged 75 and over is fully withdrawn at £30,510, the MCA is withdrawn at a rate of five pence for each additional pound of income until it reaches a minimum level of £296 for those with incomes above £40,000. Note that the date of birth cutoff will remain the same over time: new pensioners are unable to claim this allowance; eventually it will disappear altogether as the existing claimants die.

The withdrawal of these two additional tax allowances from pensioners with higher incomes in effect creates additional bands in the income tax structure where the marginal income tax rate is 30% and 25%

respectively, as shown in Figure 3.1 below where we compare the income tax schedule for those aged below 65, 65 to 74 and 75 or over. We also show the impact of the MCA by including the tax schedule for someone who is married and was born before 6 April 1935.

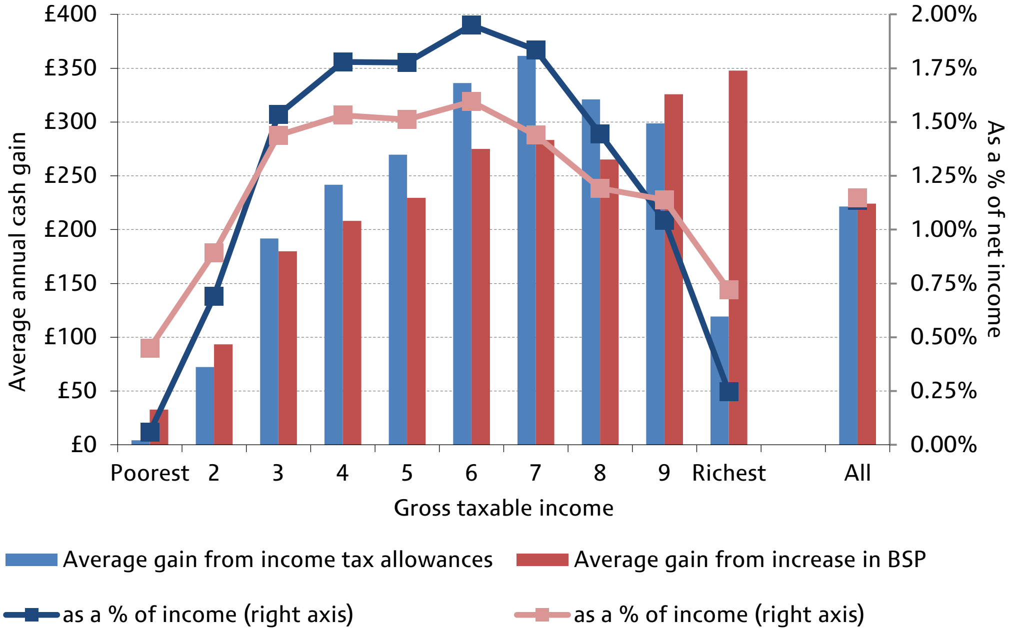
Figure 3.1: Income tax schedule by age, 2012–13



Notes: Assumes all income from earnings or pensions.
Source: Authors' calculations.

Instead of having these higher tax allowances for pensioners in 2011–12, it would have been possible to increase the Basic State Pension by around 8.3%, a change that would broadly benefit the same group of pensioners. The distributional impact by tenth (or decile) of the pensioner income distribution of the additional tax allowances for pensioners and an increase in the Basic State Pension that costs approximately the same amount is shown in Figure 3.2 below.

Figure 3.2: Distributional impact among pensioners of higher income tax allowances for pensioners and equivalent increase in Basic State Pension, 2011–12



Notes: Income decile groups are derived by dividing all families containing someone over State Pension Age into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth.
Source: Author's calculations using the IFS tax and benefit microsimulation model, TAXBEN run on uprated data from the 2008–09 Family Resources Survey.

We can see that the two policies have roughly the same distributional effect: it is pensioners around the middle of the distribution that gain the most as a proportion of income from both policies. Poorer pensioners do not have incomes that are high enough to pay tax and do not benefit from an increase in the Basic State Pension because they see their entitlement to Pension Credit reduced pound-for-pound when the Basic State Pension increases.[7] The higher tax allowances are tapered away from richer pensioners as shown in Figure 3.1, meaning that richer pensioners also do not benefit from them. They do however benefit from the increase in the Basic State Pension, although this represents a smaller proportion of their income than for those lower down the income distribution. Some poorer pensioners with a small amount of private income who are entitled to the Savings Credit component of Pension Credit also benefit from the higher

[7] Note that when we increase the Basic State Pension we also increase the Savings Credit threshold to the new level of the BSP to prevent those on the Pension Credit Guarantee (who do not benefit from higher tax allowances for pensioners) from benefiting from the increase in the BSP.

BSP but do not have incomes high enough to benefit from the higher tax allowances for pensioners.

In Budget 2012, the Chancellor announced that the higher tax allowances for those aged 65 and over would be abolished for new claimants, and that these allowances would remain frozen at their 2012–13 level until the personal allowance for those aged under 65 reaches this level, at which point the age-related allowances will be abolished. This will therefore eventually abolish the complex arrangements for withdrawing the additional allowance from better off pensioners. But as the Budget did not contain any compensation measures, this represented a straightforward reduction in generosity to pensioners.

There are reasons why we might wish to provide support for pensioners through higher tax allowances rather than through a higher Basic State Pension. Higher tax allowances for pensioners mean that fewer of them have to pay income tax: we estimate that around 1.5 million more pensioners would have had to pay income tax in 2011–12 if the additional tax allowances they receive had been abolished, though this number will be lower in future years as a result of real increases in the personal allowance for those aged under 65 being introduced in 2012–13 and 2013–14. The PAYE system for withholding income tax works less well for pensioners than for those of working age as many pensioners have multiple private pensions, which requires manual intervention from the pensioner's tax office to ensure the correct amount is deducted each month.[8] But it is likely that pensioners with a substantial amount of private pension income will be paying income tax at the moment, meaning that this is likely to be less of an issue for those who would be brought into the income tax system by the abolition of these additional tax allowances. Nevertheless, abolishing the additional tax allowances for pensioners will undoubtedly involve increased costs of administration for HMRC and private pension providers and increased compliance costs for pensioners themselves.

National Insurance

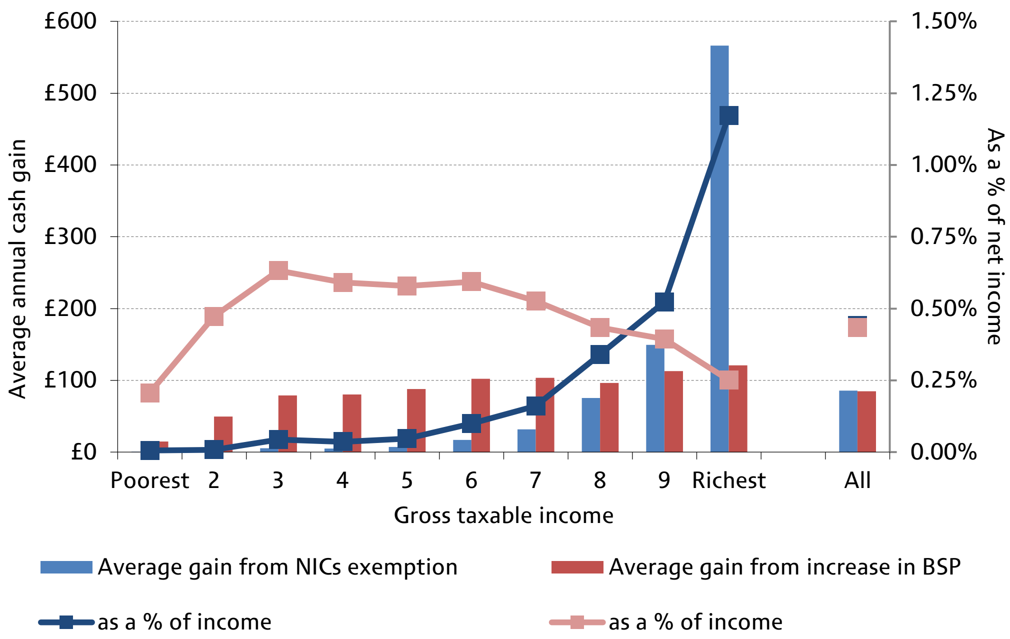
Those above State Pension Age do not have to pay employee and self-employed National Insurance Contributions (NICs), although their employers do have to pay employer NICs in respect of employing them. Abolishing this concession would raise around £0.8 billion a year if introduced immediately. This would fall as the State Pension Age rises

[8] See B. Mace (2010), Commentary on 'Administration and Compliance' in J.A. Mirrlees et al., *Dimensions of Tax Design: The Mirrlees Review*, Oxford: OUP, http://www.ifs.org.uk/mirrleesreview/dimensions/ch12.pdf.

over the next decade – though increasing levels of employment at ages above the state pension age would increase the effective amount raised.

If this money were instead used to increase the Basic State Pension, it could be increased by around 2.9%. This would involve the revenue being spread much more widely across pensioners: relatively few of those above State Pension Age remain in paid work, meaning the broadly speaking those in paid work above the State Pension Age would lose out from this change and those not in paid work but entitled to the BSP would gain. Figure 3.3 shows the distributional impact of the two policies among families containing a pensioner:

Figure 3.3: Distributional impact among pensioners of exemption from employee and self-employed NICs and equivalent increase in Basic State Pension, 2011–12



Notes: Income decile groups are derived by dividing all families containing someone over State Pension Age into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of pensioner families, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth.
Source: Author's calculations using the IFS tax and benefit microsimulation model, TAXBEN run on uprated data from the 2008–09 Family Resources Survey.

This exemption of pensioners from employee and self-employed NICs of course only benefits those who remain in work above State Pension Age.[9] They tend to be those pensioners with the highest current incomes. This

[9] As National Insurance only applies to earned income, it does not affect the majority of pensioners who only receive income from pensions and other savings. We discuss the treatment of private pensions in National Insurance in the following section.

policy also therefore strengthens the incentive for individuals to continue in paid work beyond State Pension Age in a way that increasing the BSP does not. There are reasons to believe that it is sensible to give stronger incentives for older workers: evidence suggests that older workers are relatively more responsive to work incentives.[10] Indeed, as the Mirrlees Review of the Tax System suggested, it may be desirable to extend these stronger work incentives to those just below State Pension Age also. One option that the Mirrlees Review put forward was to lower the age at which individuals stop having to pay NICs on employment and self-employment income to 55 in order to achieve this.[11]

Winter Fuel Payments, free TV licences and free bus passes

On top of the Basic State Pension and Pension Credit, there are various smaller benefits that pensioners are entitled to. Those aged over the female State Pension Age are entitled to a Winter Fuel Payment of £200 per household each year, with those aged over 80 entitled to a further £100. Households containing someone aged 75 or over receive a free TV licence. Since 2008, all individuals aged over the female State Pension Age have received a free bus pass which entitles them to travel for free on all bus services nationally.

Winter Fuel Payments and free TV licences are relatively recent additions to the benefit system: WFPs and free TV licences for those aged 75 and over were introduced by the previous Labour government in 1997 and 2000 respectively. They are slightly unusual in that they are worth the same amount to all pensioners regardless of income, being neither means-tested (like Pension Credit) nor taxable (as the Basic State Pension is). Total spending on WFPs is forecast to be £2.2 billion in 2011–12 and spending on free TV licences £586 million.[12] Total expenditure on concessionary travel in England was around £1 billion in 2010–11;[13] although not all of this is for free bus passes for pensioners.

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[10] See Gruber, J. and Wise, D. (eds.) (1999), Social Security and Retirement around the World, Chicago, IL: University of Chicago Press and Gruber, J. and Wise, D. (eds.) (2004), Social Security Programs and Retirement around the World: Micro Estimation, Chicago, IL: University of Chicago Press for evidence on this.

[11] Mirrlees, J.A. et al. (eds.) (2011), *Tax by Design: the Mirrlees Review*, Oxford: Oxford University Press.

[12] Source: Table 2a of Department of Work and Pensions Benefit Expenditure Tables, December 2011, http://statistics.dwp.gov.uk/asd/asd4/index.php?page=medium_term.

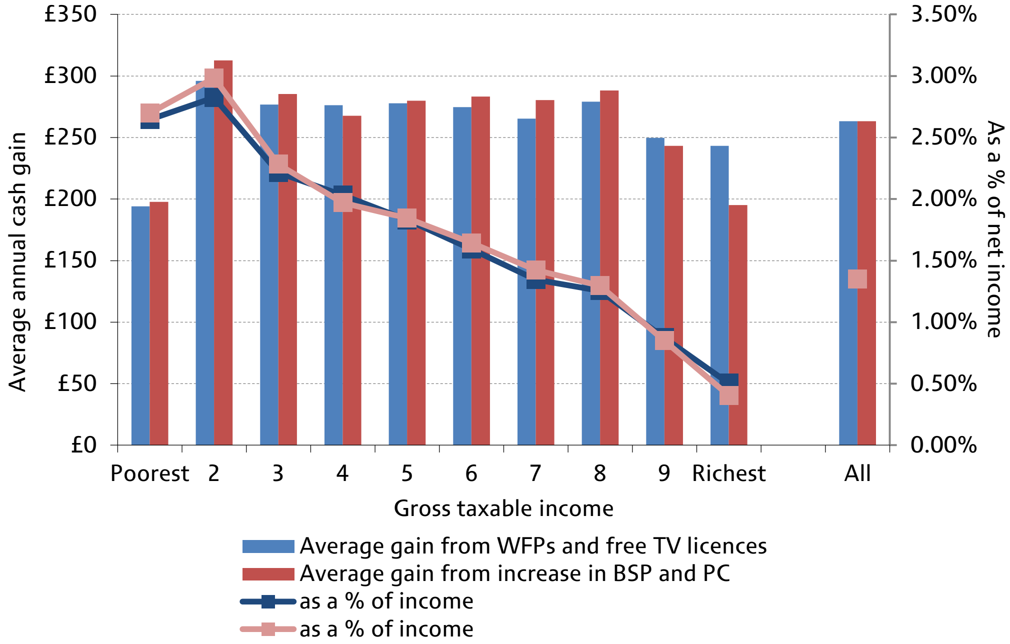
[13] Source: Table BUS0502 of Department for Transport statistics, http://assets.dft.gov.uk/statistics/tables/bus0502.xls.

It would be possible to use other aspects of the tax and benefit system to allocate the same revenue in almost the same way as these benefits do at the moment. This means that incentives for individuals to save for retirement or for pensioners to undertake paid work would be unaffected. This is particularly easy for those pensioners with low incomes who are eligible for Pension Credit as, like WFPs and free TV licences, these are allocated on a joint basis meaning that the equivalent amount of support can be achieved by increasing Pension Credit amounts for single and couple pensioners by the appropriate amount.[14] However, for those with higher incomes, increasing the Basic State Pension by an amount such that the total level of expenditure is unchanged benefits couples more than single pensioners in the case where both members of a couple are entitled to the BSP.[15] Providing this support in this way would also mean that men aged above the female State Pension Age but under 65 would not benefit unless they were entitled to Pension Credit. Nevertheless, as Figure 3.4 shows, the distributional impact of increasing Pension Credit and the BSP in this way is very close to that of Winter Fuel Payments and free TV licences.

[14] This is not strictly true for free TV licences as these are allocated on a per-household basis whereas Pension Credit is allocated on a family basis. Thus if two pensioner families on Pension Credit are living in the same household, they would both benefit from an increase to Pension Credit but only one would lose out from the withdrawal of free TV licences. Winter Fuel Payments however are allocated on a per-family basis for those on Pension Credit, but on a per-household basis for those who are not.

[15] Precisely, in the analysis below we increase the Pension Credit Guarantee by £200 a year for those aged 60–74, £345.50 a year for those aged 75–79 and £445.50 a year for those aged 80 or more and the BSP and the Savings Credit threshold by £250 a year.

Figure 3.4: Distributional impact among pensioners of exemption from employee and self-employed NICs and equivalent increase in Basic State Pension, 2011–12



Notes: Income decile groups are derived by dividing all families containing someone over State Pension Age into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of pensioner families, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth.
Source: Author's calculations using the IFS tax and benefit microsimulation model, TAXBEN run on uprated data from the 2008–09 Family Resources Survey.

It is unclear why these separate benefits have been introduced rather than increasing other already-existing benefits. That said, labelling a payment as a 'Winter Fuel Payment' might be that labelling it in this way might encourage pensioners to spend the money on fuel, whereas without this labelling pensioners would spend less on fuel than was considered socially optimal. Recent IFS research as shown that this is indeed the case, estimating that households spend around 41% of the Winter Fuel Payments they receive on fuel whereas if the payment were not labelled in this way they would be expected to only spend 3% of it on fuel.[16]

It is less clear from an economic standpoint why free TV licences for those aged 75 and over are desirable (though policy makers may wish to encourage engagement with the outside world among this group): if public service broadcasting is to be paid for by a system of TV licences, there

[16] Beatty, T., L. Blow, T.F. Crossley and C. O'Dea (2011), 'Cash by any other name? Evidence on labelling from the UK Winter Fuel Payment', IFS Working Paper W11/10, http://www.ifs.org.uk/wps/wp1110.pdf.

seems little rationale for excluding those aged 75 and over from having to pay.

One way of raising revenue to pay for the Dilnot proposals on social care by taking money from richer pensioners would be to means-test these benefits. Restricting Winter Fuel Payments and free TV licences to those on Pension Credit would save around £1.4 billion a year. Another option would be to tax these payments: again, only higher-income pensioners would lose out from this as many pensioners' incomes are less than the income tax threshold. This would raise much less, only around £250 million per year – those pensioners who do pay tax would only lose 20% of the value of these payments if they were basic-rate taxpayers (though the small number of pensioners who are higher- and additional-rate taxpayers would lose more).

Note that our analysis here assumes full take-up of means-tested benefits. In practice, take-up is less than complete, particularly among pensioners.[17] This would mean that some low-income pensioners would in practice lose out from the reform modelled here.

Forgiveness of capital gains at death

Currently, when an asset is bequeathed to another individual at death, any capital gains that have accrued up to that point are exempt from Capital Gains Tax: when the recipient comes to sell the asset, the base price is taken to be the value of the asset at the point they inherited it rather than the original purchase price.

HMRC estimates that this relief reduced CGT revenues by £600 million in 2011–12. This benefit goes to wealthy estates: only those estates with unrealised capital gains that are subject to CGT of more than £10,200 (the current CGT threshold) benefit from the exemption.[18] This would be sufficient to increase the Basic State Pension by around 2.2%.

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[17] See Department for Work and Pensions (2012), 'Income Related Benefits: Estimates of Take-Up', http://statistics.dwp.gov.uk/asd/income_analysis/feb2012/tkup_full_report_0910.pdf for more details.

[18] Remember that assets including an individual's primary residence, bank accounts and ISAs are not subject to CGT, meaning that only those with substantial holdings of property or shares outside an ISA would be affected by the abolition of this relief. If CGT were extended to the primary residence, imposing CGT at death would raise substantially more revenue than this, though the impact of imposing CGT on primary residences on the property market should not be underestimated: it is likely that people would not want to move house because doing so would trigger a CGT liability since CGT becomes payable at the point of sale. One way around these problems might be to introduce a rollover relief that enabled individuals to defer paying the tax if they were reinvesting the proceeds of the sale of one property in the purchase of another.

Forgiveness of capital gains tax at death is usually justified by the existence of inheritance tax (IHT), which also taxes these assets at this point. However, this is not a particularly convincing argument. Firstly, forgiveness of CGT at death does not eliminate double taxation or indeed zero taxation: assets transferred in the seven years before death attract both IHT and CGT and estates worth less than the IHT threshold are exempt from CGT despite having no IHT liability, and the two taxes exempt different asset classes (primary residences are exempt from CGT but not IHT whereas agricultural property and unquoted businesses are exempt from IHT but not CGT). More fundamentally, a wealth transfer tax like IHT serves a different purpose to CGT: CGT exists to ensure that capital gains are taxed in the same way as other returns to capital (e.g. interest and dividends, which are taxed as they accrue). Although imposing CGT at death makes the double taxation imposed by IHT more obvious, double taxation is an inevitable feature of any wealth tax where the investment was made out of taxed income. In addition, although forgiveness of CGT at death strengthens the incentive for individuals to save, it does so in a way that is highly distortionary – it encourages individuals to hold on to assets which have increased in value until they die when otherwise they would rather have sold it to buy another asset, to increase consumption or to give away before death. Also, if people intend to leave substantial assets when they die, it encourages them to invest in assets that receive returns in the form of capital gains.

The Mirrlees Review of the Tax System concluded that 'whatever else is done, forgiveness of capital gains tax at death should be ended. As a way to offset the impact of inheritance tax, it is poorly targeted. But, in any case, no choice of a tax regime for wealth transfers justifies creating the bizarre distortions to asset allocation decisions that this policy does.'[19]

Summary

Pensioners benefit from higher income tax allowances, exemptions from employee and self-employed National Insurance Contributions and Winter Fuel Payments and free television licences. There are some sensible arguments for providing this additional support in this way: higher tax allowances for pensioners mean that 1.5 million fewer have to pay income tax at all, reducing administrative costs for HMRC and compliance costs, and there are arguments for giving stronger incentives to work to older

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These issues are discussed in more detail in Brewer, M., J. Browne, A. Leicester and H. Miller (2010), 'Options for raising revenue: tax increases and benefit cuts' in R. Chote, C. Emmerson and J. Shaw (eds.) *The IFS Green Budget: February 2010*, http://www.ifs.org.uk/budgets/gb2010/10chap7.pdf.

[19] See pages 366–367 of Mirrlees et al. (2011) op. cit.

workers as they tend to be more responsive to them. However, there are fewer credible arguments for Winter Fuel Payments as a separate benefit and for the provision of free TV licences for those aged 75 and over. This support could easily be provided through the Basic State Pension and Pension Credit to produce an almost-identical distributional effect. Similarly, there is little justification for the forgiveness of CGT at death: £600 million could be raised while at the same time removing a damaging distortion in the tax system.

The Dilnot Commission on the Funding of Care and Support suggested funding its proposed expansion of support for long-term care by a specific tax rise or benefit cut that affected those who would benefit from its proposals, namely pensioners with significant levels of income or assets. Making pensioners' earned income subject to employee NICs or abolishing the forgiveness of CGT at death would be three ways of achieving this. Abolishing Winter Fuel Payments and free TV licences would also raise more than enough to pay for the Dilnot proposals, but lower-income pensioners would also lose out. If instead these benefits were limited to those on Pension Credit, approximately £1.4 billion could be saved (although as take-up of Pension Credit among those entitled is far from complete at between 62% and 68% in 2009–10,[20] this would still involve some low-income losers). The additional means-testing in the benefit system for those above State Pension Age would also weaken the incentive for individuals to save for retirement as a greater proportion of any income generated would be effectively lost through lower entitlements to means tested benefits, offsetting at least in part the strengthening of incentives to save provided by the Dilnot proposals themselves.

3.2 The tax treatment of private pension saving

The Mirrlees Review concluded that a generally desirable feature of a tax system is that it be neutral towards saving: individuals should not be penalised for choosing to defer consumption rather than spend their income immediately.[21] Different routes to neutral taxation involve collecting taxes at different times. In simple terms, one route involves collecting tax up front and not taxing the later return to savings. Another route involves not levying tax on any income that is saved, but then taxing withdrawals. The second of these is broadly the way pensions are treated by the income tax system in the UK at the moment – contributions to private pensions attract tax relief, the returns made by money that is saved

[20] Source: Department for Work and Pensions (2012), 'Income Related Benefits: Estimates of Take-Up', http://statistics.dwp.gov.uk/asd/income_analysis/feb2012/tkup_full_report_0910.pdf.

[21] See chapter 13 of Mirrlees et al. (2011) op. cit.

in the forms of interest, dividends and capital gains are untaxed but pension income is subject to income tax in retirement. The National Insurance system broadly takes the first approach for employee contributions: pension contributions made by an employee are subject to employee and employer NICs at the time the income is earned (i.e. employee pension contributions do not attract NICs relief), but returns to pension saving and pension income in retirement are not subject to NICs.

However, the treatment of private pensions deviates from neutrality in two important respects:

- 25% of an individual's pension pot can be taken as a lump sum on retirement and escape income tax altogether: all pension contributions attract income tax relief and the 25% lump sum is untaxed at the withdrawal stage also.
- Employer contributions to pensions avoid both employee and employer NICs at both the contribution and withdrawal stage: employer pension contributions are not counted as earned income for NICs and pension income in retirement is not subject to NICs either.

Another advantage for higher-rate taxpayers of saving in a pension is the potential opportunity it offers for so-called 'tax smoothing', which arises when individuals anticipate being in a lower tax bracket in retirement than they are currently. Since private pensions effectively allow individuals to delay paying tax on income until retirement (as contributions attract tax relief at the taxpayer's marginal rate and pension income is taxed in retirement), if an individual is currently a higher-rate taxpayer but expects to only be a basic-rate taxpayer in retirement they can avoid paying the higher rate of income tax by investing in a private pension. This makes pension saving particularly attractive for many higher-rate taxpayers.

All that said, as the Mirrlees Review argued, there are good reasons to treat private pensions more generously than simple neutrality would dictate. Private pensions are a much more restrictive form of saving than other vehicles such as ISAs: funds cannot easily be accessed until retirement and at least 75% of the fund has to be used to purchase an annuity in most cases.[22] These features are desirable from the government's perspective: people may require commitment devices that prevent them spending money they have saved for retirement, and if

[22] Reforms introduced in Budget 2011 allow individuals to draw down each year the amount they could have received had they used the fund to purchase an annuity at the beginning of that year. An exception to this is that those who already have pension income of at least £20,000 a year can draw down the remainder of their fund at any time.

people save in a form that forces them to purchase an annuity, this will likely reduce the cost of means-tested benefits for pensioners as individuals are unable to spend all their retirement savings and then claim means-tested support.[23] But to encourage individuals to save in a pension rather than another tax-neutral savings vehicle that is less restrictive (e.g. an ISA), it may be necessary to give preferential treatment in the form of a subsidy to pension saving. The question is whether the ways in which the tax system provides this at the moment are proportionate and appropriate.

The remainder of this section discusses each of these ways in which private pension saving is particularly favoured in turn before discussing whether reducing or removing this additional generosity would be a sensible way of raising revenue to pay for the Dilnot Commission's proposals.

25% tax-free lump sum

Individuals can take 25% of whatever pension funds they have built up as a tax-free lump sum on retirement. This is income that escapes income tax being paid at any point. The tax-free lump sum is therefore effectively a bonus investors receive in exchange for investing in a pension, where funds are locked in until retirement and there is compulsory annuitisation, rather than in an ISA or another tax-neutral form of saving. HMRC estimates that this relief is worth a total of £2.5 billion a year under the assumption that this income would otherwise have been taxed at the basic rate.[24]

Given that it is probably desirable for pension saving to receive a tax treatment that is more favourable than neutrality, the question is whether a tax-free lump sum is an appropriate way of giving this support. Allowing individuals to take a tax-free lump sum is certainly a salient incentive to save in a pension. On the other hand a subsidy that encourages individuals to take a lump sum out of their pension rather than annuitizing seems perverse: if the aim of favouring private pension saving is to ensure that individuals have sufficient income in retirement, then it makes little sense

[23] Compulsory annuitisation also reduces the adverse selection problem that arises in annuity markets when only those with a high life expectancy purchase annuities – this tends to increase the costs of annuities and in the extreme can lead to the collapse of annuity markets.

[24] In reality, of course, some of this income would have been taxed at higher rates of tax and some would have been below the income tax personal allowance. Although one might think that the former is more likely as taking a lump sum means that an individual has a high income in a particular year, pushing them into higher tax brackets, in reality individuals would be less likely to take lump sums if they were not tax-free. Therefore, HMRC's assumption does not seem that unreasonable.

to encourage them to take lump sums rather than annuities. The Mirrlees Review suggested that one option would be to replace the tax-free lump sum with an explicit subsidy of 5% to all pension pots at the point of annuitisation, which would have a broadly equivalent effect for basic-rate taxpayers (as 5% is 25% of 20%). Furthermore, the incentive offered by the tax-free lump sum to save in a pension is very large: the 25% tax-free lump sum allows those who have saved the maximum amount in a private pension to receive £435,000 tax-free. A smaller cap would only reduce the incentive to save in a pension for those with higher lifetime incomes, who are presumably the group the government is least worried about not saving for retirement and claiming means-tested benefits. Although scrapping the tax-free lump sum completely would raise £2.5 billion a year, as most individuals have relatively small pension pots even a significantly lower cap would not raise anything close to this figure: a recent paper by Centre Forum estimated that even if the maximum tax-free lump sum was restricted to the income tax higher-rate threshold of £42,475, this would only lead to a long-run increase in tax revenues of £0.5 billion a year.[25]

NICs treatment of employer contributions

At present, NICs are charged on employee contributions to private pensions but employer contributions escape NICs at both the contribution and withdrawal stage. There seems little justification for such generous treatment of employer contributions, nor for treating employee and employer contributions so differently. (Indeed, it is perhaps surprising that any pension contributions are formally made by employees, given that employees and employers can enter 'salary sacrifice' arrangements whereby employees trade a lower salary for a higher pension contribution made by the employer.) HMRC estimates that NICs relief on employer contributions was worth around £8.3 billion in total in 2009–10.[26]

A solution to this problem proposed by the Mirrlees Review could be for private pensions to have the same treatment in NICs as in income tax, namely that contributions are exempt but pension income in retirement is taxable. This would involve giving NICs relief to employee as well as employer contributions, but then impose NICs on private pension income in retirement. To give a sense of scale, each 1% of NICs levied on private pension income would raise around £350 million a year. Figure 3.4 below

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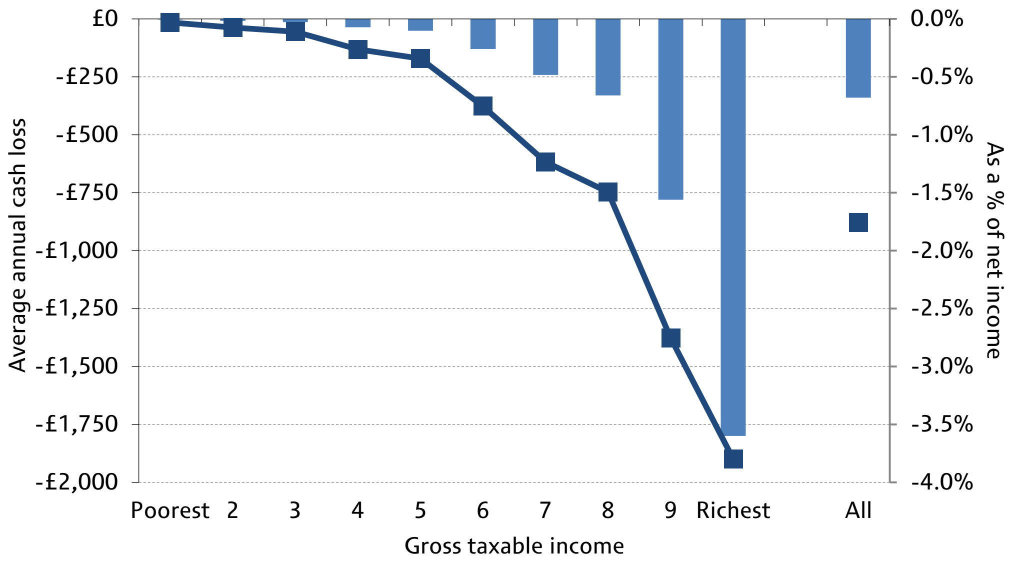
[25] Source: Lloyd, M. and C. Nicholson (2011), 'A relief for some: how to stop lump sum tax relief favouring the wealthy', Centre Forum Report, http://www.centreforum.org/assets/pubs/a-relief-for-some.pdf.

[26] Source: Table 7.9 of HMRC statistics, http://www.hmrc.gov.uk/stats/pensions/table7-9.pdf.

shows the distributional impact of imposing full employee NICs (at a rate of 12%) on private pension income, which gives an idea of the distributional impact among pensioners of this change if not necessarily the scale.[27]

Figure 3.4: Distributional impact of imposing employee NICs on private pension income in 2011–12



Notes: Income decile groups are derived by dividing all families containing someone over State Pension Age into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of pensioner families, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth.
Source: Author's calculations using the IFS tax and benefit microsimulation model, TAXBEN run on uprated data from the 2008–09 Family Resources Survey.

However, as the Mirrlees Review argued, it would not be appropriate simply to start charging this full rate of NICs on pensions currently in payment. That would imply double taxation—NICs will have been levied on any employee contributions already made—and undermine the legitimate expectations of those who have saved up to now.

One could start providing relief for employee contributions immediately and gradually increase NICs rates on pension income over an extended period. This would however initially reduce revenues as the costs of exempting employee contributions from NICs would begin immediately but receipts from NICs on pension income would only gradually increase over time as rates increased. (Of course, in the long run, there would be an

[27] For the purposes of this exercise, we assume that private pension income is treated as a single separate 'job' in National Insurance, thus the first £139 of weekly private pension income is exempt from NICs. It is therefore unsurprising that only the richest pensioners are significantly affected.

increase in revenue as employer contributions would be subject to full NICs when pensions were paid in retirement). An alternative that might be more palatable if the government were concerned about short term costs would be to end NICs relief for employer contributions, treating them in the same way as employee contributions. This would be straightforward for defined contribution schemes as employers are simply paying contributions into particular employees' accounts, meaning that these could be subject to NICs in the same way as wages and salaries. For defined benefit schemes, as employer NICs are already virtually flat rate (other than the earnings threshold), these could readily be charged at a flat rate on any contributions made by the employer. From the employer's point of view, pension contributions would then be treated like any other form of remuneration paid to the employee. This solution would, however, be harder to implement with respect to charging employee NICs on employer pension contributions to defined benefit schemes. The non-flat-rate structure of employee NICs would require employer contributions to defined benefit schemes to be allocated to individuals, which would cause significant administrative difficulties as a value would need to be attributed to the rights an employee accrued during the previous year. Estimates can be made of this, but it would be a complex and burdensome process.[28]

'Tax rate smoothing'[29]

Relatively few pensioners pay the higher or additional rates of income tax (though the numbers are growing rapidly – from 130,000 in 1992–93 to 370,000 in 2007–08).[30] Therefore, for most working-age higher rate

[28] The accrual of rights within a defined benefit scheme effectively involves the employer promising to pay the employee a certain stream of income in the future. The value of this entitlement will depend on things like the individual's pensionable salary (often final salary), the ultimate duration of their scheme membership, their life expectancy, the longevity of any surviving partner or qualifying dependent when the member dies, investment returns and inflation. It also depends on the likelihood that the employer will be unable to honour the pension promise – specifically the chance that it goes bankrupt without enough in the pension pot to cover all of the commitments. All of these things are very uncertain when the individual is some way from retirement, meaning that it is difficult to assess the value of the employer contribution for NICs purposes.

[29] This section draws heavily on section 5 of S. Adam, M. Brewer, J. Browne and D. Phillips (2010), 'Taxes and benefits: the parties' plans', IFS 2010 Election Briefing Note No. 13, http://www.ifs.org.uk/bns/bn100.pdf.

[30] Sources: answer to Parliamentary Question given to David Willetts MP, 2 July 2002, *Official Report* column 288W, http://www.publications.parliament.uk/pa/cm200102/cmhansrd/vo020702/text/20702w25.htm#20702w25.html_sbhd6, answer to Parliamentary Question given to Steve Webb MP, 23 March 2009, *Official Report* column 95W,

taxpayers, investing in a private pension effectively enables them to avoid paying the higher rate of income tax on that income: they receive tax relief at the 40% rate, but only end up paying the 20% basic income tax rate on their pension income in retirement. At the 2010 General Election, the Liberal Democrats proposed that higher-rate taxpayers only receive relief at the basic rate, which would in practice mean that these taxpayers pay a tax rate of 20% on the income they contribute to a pension and then pay another 20% in income tax when they receive their pension income in retirement. Of course those expecting to be higher rate taxpayers in retirement would see a 20% tax on contributions followed by a 40% tax on income in retirement. An answer to a Parliamentary Question in April 2011 revealed that restricting tax relief on pension contributions to the basic rate would increase income tax revenues by £7 billion a year.[31]

It is often argued that giving more generous tax relief to higher-rate taxpayers is unfair. However this is open to question: tax relief given on pension contributions should not be considered in isolation from the taxation of pension income in retirement – indeed, tax relief is only given on pension contributions because the tax is deferred until pension income is received in retirement. It is hard to see how it can be unfair for higher-rate taxpayers to receive 40% relief when basic-rate taxpayers receive 20% relief, yet at the same time not be unfair for higher-rate taxpayers to pay 40% tax on their pension income when basic-rate taxpayers pay only 20%. Of course, as previously stated, many of those receiving relief at the higher-rate will only pay basic-rate tax in retirement. But even then it is arguable whether it is really unfair for people to receive higher-rate relief and then pay only basic-rate tax: in effect such individuals are simply smoothing their taxable income between high-income and low-income periods, undoing the 'unfairness' that an annually-assessed progressive tax schedule creates by taking more tax from people whose incomes are volatile than from people whose incomes are stable. And even if receiving higher-rate relief and then paying basic-rate tax is seen as unfair, that does not diminish the case for accompanying the restriction of tax relief on contributions with a restriction of the tax rate on pension income to 20% (with perhaps some transitional arrangements to ensure that those who have been higher-rate taxpayers throughout their adult lives do not benefit from this change given that they have already received tax relief on contributions at the higher rate). The fact that few individuals pay higher-rate tax on their pension income merely suggests that such a policy would

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http://www.publications.parliament.uk/pa/cm200809/cmhansrd/cm090323/text/90323w0019.htm.

[31] Note that this ignores behavioural effects, which we would expect to be important as this change would significantly reduce the attractiveness of saving in a private pension for higher-rate taxpayers.

be cheap: pension contributions and pension income should always be treated symmetrically.

Restricting tax relief on pension contributions to the basic rate (whether or not it was combined with restricting tax relief on pension income to the basic rate) would certainly weaken the incentive for higher-rate taxpayers to save in a private pension. As Wakefield (2009) shows, a higher-rate taxpayer investing for 25 years in a pension through employee contributions expecting to be a basic-rate taxpayer in retirement receives a –48% effective tax rate at the moment, but this would increase to –8% if only basic-rate relief were received.[32] There would also be administrative difficulties relating to defined benefit schemes: as mentioned above, the additional rights an employee had accrued would have to be valued in order for the up-front component of the tax to be paid.

Summary

Private pensions are a particularly tax-favoured form of saving in the UK, typically receiving a tax treatment that is more generous than the tax-neutral treatment given to saving in an ISA or owner-occupied housing. Several aspects of the tax system contribute to this, in particular the 25% tax-free lump sum, the exemption of employer pension contributions from NICs and the opportunities the structure of taxation offers for so-called 'tax rate smoothing' for higher rate taxpayers. Although it is probably desirable to encourage individuals to save in a pension rather than through other savings vehicles, it is certainly questionable whether the size of the incentives offered is proportionate and the most efficient way of achieving this objective. Nevertheless, saving in a pension would become less attractive if any of these additional incentives were removed, and the amount saved would almost certainly be reduced.

The 25% tax-free lump sum seems overly generous for those who have saved large amounts in a pension, who can receive up to £435,000 tax-free. However, as most individuals only have small pension pots, placing a lower cap would not raise much additional revenue for the government: although the total exchequer cost of tax-free lump sums is £2.5 billion a year, even limiting the tax-free lump sum to the value of the income tax higher rate threshold of £42,475 would only increase tax revenues by £0.5 billion in the long run. It also seems perverse to have an incentive that encourages individuals to take lump sums rather than annuities when the

[32] See M. Wakefield (2009), 'How much do we tax the return to saving?', IFS Briefing Note 82, http://www.ifs.org.uk/bns/bn82.pdf for details of assumptions used. The effective tax rate is still negative in the case where tax relief is restricted to the basic rate because of the tax-free lump sum. This is of course the same rate an individual who is currently a basic-rate taxpayer and expects to remain so in retirement would receive on the same investment.

objective of encouraging pension saving is to ensure that pensioners have sufficient incomes in retirement.

It is particularly hard to see a justification for employer pension contributions having a much more generous NICs treatment than those made by employees. Complete exemption from NICs for employer contributions seems an overly-generous treatment of contributions. A partial solution would involve phasing in NICs on pensions in payment at a reduced rate. Each 1% charged would raise £350 million.

There is a clearer justification for higher rate tax relief on pension contributions and it is perhaps odd that this issue is much more debated than are either of the other two issues we have discussed. Arguably the current system simply undoes the unfairness of an annually-assessed progressive income tax taxing those with volatile incomes more than those whose incomes are stable. If higher-rate tax relief were removed for pension contributions, there would be a very strong case for also only taxing pension income in retirement at the basic rate as otherwise pensions would become a very unattractive investment choice for those with very high incomes expecting to remain higher-rate taxpayers in retirement.

4. Conclusion

As both private and state earnings-related pension schemes have come to maturity over the last fifteen years, the position of pensioners in the income distribution has strengthened. Current pensioners also benefited from the increase in property values from the early 1990s to 2007, and many now have substantial holdings of both financial and housing wealth. Pensioners also particularly benefited from the tax and benefit reforms introduced by the Labour government of 1997–2010, and have been relatively protected from the austerity measures being introduced by the current government.

That said one should be careful about assuming that these trends will continue into the future. The demise of defined benefit occupational pension schemes in the private sector is likely eventually to feed through into lower retirement incomes for some groups.

In this paper, we have examined the different ways in which pensioners receive additional support from the tax and benefit system. As well as the state pension system and means-tested support through Pension Credit, there are additional ways in which the tax and benefit system provides support for pensioners for which the justification is less obvious.

There may be a good case for the NI system favouring those over the state pension who are in work. Older workers are more responsive to work incentives so there is a case for having stronger incentives for this group and exempting them from NI is one way – though not necessarily the best way – of achieving this.

More generally, though, the shift which has seen income tax rates fall and rates of NI rise over the past 30 years has favoured pensioners at the expense of those in work since NI is not payable on incomes from pensions or from savings. This looks like an unintended consequence of a policy shifted for other reasons – essentially because NI rates are less salient than income tax rates.

There seems little justification for Winter Fuel Payments and free TV licences existing as a separate benefit: the same support could easily be provided through the State Pension and Pension Credit systems. The way in which capital gains tax is forgiven at death is an inefficient and anomalous and largely benefits well off pensioners – or rather their heirs.

We have also examined the tax treatment of private pension saving, which is much more generous than the tax-neutral treatment of saving generally recommended in the economic literature. Reforms could be made to the generosity of tax-free lump sums and the NICs treatment of employer pension contributions which would raise revenue and bring the system closer to neutrality. Ending higher-rate relief for pension contributions would be less desirable: there would be administrative difficulties involved and it is unclear that the current system represents an 'unfair' treatment in the first place. If relief were restricted to the basic rate, there would be a very strong case for tax on pension income also to be restricted to the basic rate, as otherwise saving in a pension would become very unattractive to the very highest earners.

The Dilnot Commission on the Funding of Care and Support recommended that state spending on care be increased to increase the amount of insurance offered to individuals against the risk of high costs of care. The main beneficiaries of this would be pensioners with either higher incomes or higher levels of assets, who would see a reduction in the risk that they would have to use their pension income or liquidate their assets to pay for care. The Dilnot Commission therefore recommended that if a particular tax rise or benefit cut were introduced to pay for their proposals, it should affect this group. Some suggestions to achieve this that might follow from our results would be to restrict Winter Fuel Payments and free TV licences to those on Pension Credit (or, better, to abolish these benefits and increase Pension Credit), reduce the generosity of the tax-free lump sum, reform the NICs treatment of pensions to apply NICs to employer contributions at some point or to impose Capital Gains Tax at death (see summary table below). But, as the Mirrlees Review of the Tax System argued, any changes that are introduced should be in the context of a clear strategy for the design of a coherent tax and benefit system that works well as a whole for those both above and below the State Pension Age. Poorly-designed changes could increase distortions that already exist, introduce new ones or significantly weaken the incentive for individuals to continue in paid work at older ages or save for retirement.

Table 4.1: Summary of options to pay for Dilnot proposals

Proposal	*Annual revenue raised*	*Advantages*	*Disadvantages*
Impose NICs on employment income of pensioners	£0.8bn	Overall likely to hit group which benefits from Dilnot proposals, though may not be well targeted on them	Weakens work incentives for a group who are particularly responsive to incentives
Only give Winter Fuel Payments and free TV licences to those on Pension Credit	£1.4bn	As above	Labelling payment may encourage spending on fuel Non take-up of means-tested benefits means some poor pensioners would lose out also
Impose Capital Gains Tax at death	£0.6bn	Removes distortion in asset choices and likely to be well targeted on wealthiest	Slightly weakens incentive to save
Reduce generosity of tax free lump sum in pensions	Up to £2.5bn if abolished altogether	Present treatment seems overly generous to those with large pension pots: this would be a move towards neutrality Those who would benefit from Dilnot proposals lose out	Imposing a high cash limit on lump sums would not raise significant revenues Would disrupt peoples' plans for retirement if introduced immediately May need to be replaced by another incentive to save in a pension
Impose NICs on pension income	£350m per percentage point	Treatment of employer contributions in NICs seems overly generous currently: this would be a move towards neutrality	Moving towards neutrality would also require NICs relief to be given for employee contributions, otherwise would make employee contributions very unattractive. This would reduce tax revenues in the short run

Restrict tax relief on pension contributions to the basic rate	£7bn	Those who would benefit from the Dilnot proposals would lose out	Administratively complicated: would require valuation of rights accrued each year for DB schemes Introduces a non-neutrality which reduces ability to smooth taxes over time and penalises those who are higher rate payers in work and in retirement.

Appendix: The Basic State Pension, Pension Credit and disability benefits for those over State Pension Age

This appendix describes the key aspects of the benefit system affecting those over State Pension Age, in particular the Basic State Pension, Pension Credit, Disability Living Allowance and Attendance Allowance.

Basic State Pension

The Basic State Pension (BSP) was introduced in 1948, following the Beveridge Report, with the aim of providing an income for old-age pensioners based upon their record of National Insurance contributions. Originally, the idea was for the BSP to operate on a funded basis, with each generation paying for its own pensions through NICs. This was abandoned immediately on introduction so that the pension could be made payable to the existing generation of pensioners. This left the current 'pay-as-you-go' pension system, whereby the NICs from those currently in work fund the pensions paid out to the generation currently in retirement.

The BSP is payable from the Basic State Pension age, which has been 60 for women and 65 for men until recently. From April 2010 until April 2016, the pension age for women is being increased by one month every two months so that it will be 63 in April 2016.[33] This means women born between 6 April 1950 and 5 April 1953 will reach pension age when they are between 60 and 63, with the precise date depending on the date of birth.[34] The female state pension age will then start increasing more quickly between April 2016 and November 2018 such that equalisation at age 65 will be achieved in November 2018. The equalized state pension age was set to be increased to 66 over two years starting from April 2024, as legislated in the Pension Act 2007,[35] but the Pensions Act (2011) brought this forward, so that it will now start in December 2018 and be completed by October 2020. All pensions are paid for life.

There are now three categories of state pension: category A based on an individual's own National Insurance contribution (NIC) record, category B based on the NIC record of one's spouse or civil partner or late spouse or civil partner, and category D for the over 80s who are not entitled to any

[33] As legislated in the Pension Act 2007. The current government's intention to speed up the increases has yet to be approved by the Parliament.

[34] A state pension age calculator is available on Directgov, http://pensions.direct.gov.uk/en/state-pension-age-calculator/home.asp

[35] Source: http://www.parliament.uk/briefingpapers/commons/lib/research/briefings/snbt-02234.pdf

other pension that pays more than category D. The rates applicable to different types are listed in table 3.1. For example, if only one member of a couple has sufficient NICs (see below), the other spouse or civil partner will be entitled to £64.40.[36] (The latter can of course claim Category A BSP based on his/her own NICs if that is higher than the lower rate in Category B.) The spouse or partner will inherent the full amount (£107.45 per week) if the contributor has died. The less generous Category D pension is non-contributory, and it applies if this is more than the entitlement based on one's own contribution record.

Table A.1: Current rates of Basic State Pension, £ per week

Category A	107.45
Category B for widow/widower/surviving civil partner	107.45
Category B for spouse/civil partner	64.40
Category D	64.40
Increase for dependants (Category A)[a]:	64.40

[a] Abolished for claims made on or after 6 April 2010. Existing increases are payable until the conditions are no longer met or until 5 April 2020, whichever is first.

A new single contribution condition has been introduced for Category A and B retirement pensions from 6 April 2010.[37] In order to qualify for the full BSP, the contributor must have paid sufficient Class 1, 2, or 3 NICs, or received NI credits for at least 30 years. If the condition is met for at least one year but less than 30 years, proportional reductions of the BSP will be made. One may get NI credits when looking for a job, claiming certain state benefits, or caring for someone. Thus, the new rules have made it easier for individuals, especially women with children, to qualify for a full BSP.

Individuals can choose to defer receipt of the BSP in return for a higher rate of pension. They can choose one of two options when they do finally claim. The first option is to earn extra state pension at 1 per cent for every five weeks they put off claiming. The second option (only available if the individual has deferred claiming for at least a year) is a one-off taxable lump-sum payment based on the amount of normal weekly state pension

[36] Prior to 6 April 2010 it was not possible for married men and female civil partners to claim state pensions based on the contribution records of their wives/partners. Before that date, married women could not claim state pensions based on their husbands NIC records either, if husbands were deferring their claims. Thus, the new rules extended coverage to include some married individuals and civil partners who reached pension age before 6 April 2010 but were not receiving BSP.

[37] The new rule applies to those reaching pension age on or after 6 April 2010. It applies to Category B only for widows, widowers and surviving civil partners, and on the condition that the contributor had not reached pension age before 6 April 2010 and died after that date.

they would have received, plus interest added each week and compounded.[38] Individuals then also get their state pension when they claim it, paid at the normal rate.

With total expenditure forecast to be £61.1 billion in 2012–13 and received by about 12.5 million pensioners, the BSP is the largest single benefit, constituting approximately 29 per cent of expenditure on all benefits and tax credits.

Pension Credit

Pension Credit (PC) was introduced in place of Income Support for those aged over the female State Pension Age (also known as the minimum income guarantee, MIG) on 6 October 2003 in an attempt to improve the incentives to save for retirement. Before this date, pensioners with small amounts of private income in excess of the Basic State Pension faced a 100 per cent marginal withdrawal rate (£1 of support lost for every additional £1 of their own income). The introduction of Pension Credit reduced this disincentive to save for those already on the taper by introducing a Savings Credit with a marginal withdrawal rate of 40 per cent but because the lower taper rate meant that means-testing extended further up the income distribution, it weakened the incentive to save for those who had incomes just above the MIG and were brought into the scope of means-testing by the reform.

Table A.2: Current rates of Guarantee Credit, £ per week

Standard amount:	Single person	142.70
	Couple	217.90
	Each additional spouse in a polygamous marriage	75.20
Additional amounts:	Severe disability	58.20[a]
	Carer	32.60[a]

[a] Double this amount is payable if both partners qualify.

There are two elements to the PC: Guarantee Credit and Savings Credit. Claimants may be entitled to one or both elements. Guarantee Credit works much like the MIG, topping up income to a specified minimum level (called the 'appropriate minimum guarantee'). The appropriate minimum guarantee is the sum of a standard amount and additional amounts for those with disabilities or who have caring responsibilities for others. To receive Guarantee Credit, claimants' family income must be below the

[38] The compounded rate will be 2 percentage points above the Bank of England's base rate (so if the base rate were 4.5 per cent, the annual rate of return would be 6.5 per cent). As the Bank of England base rate may change from time to time, the rate of interest used to calculate the lump sum could also change.

appropriate minimum guarantee. The sum payable is the difference between family income and the appropriate amount. Savings and investments are assumed to yield £1 of income each week for each £500 of capital, although the first £10,000 of savings or capital is disregarded. Unlike in other means-tested benefits, there is no upper limit on the amount of capital that can be held.

Recipients of Guarantee Credit are automatically entitled to maximum Housing Benefit, maximum Council Tax Benefit, health benefits (including free prescriptions, dental treatment and sight tests) and certain Social Fund payments. Recipients of the Savings Credit may also be entitled to some Social Fund payments.

Savings Credit rewards those aged 65 or over who have saved for retirement. Only those with income from State Pensions and other private income sources that exceed the appropriate Savings Credit threshold (see Table 3.3) are eligible. Savings Credit effectively reduces the withdrawal rate for income above the Savings Credit threshold from 100% to 40% (i.e. whereas private income below the Savings Credit threshold reduces entitlement to Pension Credit pound-for-pound, each pound of income above the threshold reduces income by only 40 pence). The maximum amount of savings credit that can be received is therefore 60% of the difference between the Minimum Income Guarantee and the Savings Credit threshold, as shown by table 3.3 below.

Table A.3: Current rates of Savings Credit, £ per week

Savings credit thresholds:	Single person	111.80
	Couple	178.35
Maximum savings credit:	Single person	18.54
	Couple	23.73
Withdrawal rate		40%

Expenditure on Pension Credit is forecast to be £7.8 billion in 2012–13, of which £6.6 billion is forecast to be on the Guarantee Credit and £1.2 billion on the Savings Credit. Around 2.6 million pensioner families are claiming Pension Credit, of which 0.9 million are entitled to the Guarantee Credit only, 0.6 million are entitled to the Savings Credit only and 1.1 million are entitled to both.

The generosity of the Savings Credit component of Pension Credit is being reduced by the current government: the maximum amount of savings credit is being frozen in cash terms between 2010–11 and 2014–15. On top of this, it was announced in the Autumn Statement of November 2011 that the maximum amount of Savings Credit will be cut in 2012–13 to pay for a discretionary increase in the Guarantee Credit.

Summary

On their own, the state pension system and Pension Credit, together with the various benefits that are given to those of all ages to help with additional costs (specifically, the costs of bringing up children, rent and Council Tax),[39] would constitute a simple and coherent system for pensioners. However, there are other ways in which pensioners are favoured by the tax and benefit system for reasons that are unclear. In the next sub-section, we outline these in detail and examine whether this support could be provided in a more rational way through the BSP or Pension Credit.

Disability Living Allowance

Introduced on 1 April 1992, Disability Living Allowance (DLA) replaced, extended Attendance Allowance (see below) for claimants under 65, and Mobility Allowance. Its conditions are more generous so that people who could not have qualified for these benefits are now able to claim DLA. This leads to an anomaly in which those aged 65 and over are treated less generously than those under 65: there is no equivalent to the lower rate of Attendance Allowance in DLA (care), meaning that those who would be entitled to this benefit if they were aged under 65 do not receive anything, and there is no equivalent benefit to DLA (mobility) for those aged 65 and over. However, those who are claiming these benefits when aged below 65 can continue to claim them beyond the age of 65: it is only those whose disability develops after the age of 65 who are treated less generously.

DLA has two components, reflecting the benefits that it replaced: a care component and a mobility component.[40] Each element is available at different weekly rates depending upon the severity of the claimant's disability.

From 2013–14, both components of DLA for those of working age will be replaced by a new benefit called Personal Independence Payment (PIP). Between 2013 and 2016 all current DLA claimants aged between 16 and 64 will be reassessed to determine whether they are eligible for the new payment. This change would therefore not affect current pensioners and since Attendance Allowance (see below) is not changing, it would not

[39] For more on these benefits, see P. Levell, W. Jin and D. Phillips (2010), 'A survey of the benefit system', IFS Briefing Note 13, http://www.ifs.org.uk/bns/bn13.pdf.

[40] The individual only has to make one claim in order to be considered for both components of DLA.

affect future pensioners who would have been entitled to the middle or higher rates of DLA (care) either as they could claim Attendance Allowance instead once they reached the age of 65 if they were not entitled to PIP when of working age. However, those of working age who would have been entitled to DLA (mobility) or the lower rate of DLA (care) but are not entitled to PIP would continue to be affected by this change after the age of 65 since (as discussed above) there is no equivalent to these benefits for those aged 65 and over.

Disability Living Allowance Care Component

There are three rates of DLA (care):

For the lowest rate of DLA (care), the claimant must be 16 or over and so disabled that they cannot prepare a cooked main meal for themselves if given the ingredients. Alternatively, they must be so disabled that they require attention from another person for a significant part of each day in connection with bodily functions.

For the middle rate of DLA (care), the claimant must require frequent attention from another person throughout the day *or* night in connection with bodily functions, or continual daily *or* prolonged nightly supervision to avoid substantial danger to themselves or others.

For the highest rate of DLA (care), the claimant must be so severely disabled that they require constant supervision or attention throughout the day *and* night with respect to bodily functions, or to prevent danger to themselves or others.

For each rate, the individual must have satisfied the conditions throughout the three months prior to claiming, and they must be likely to continue to satisfy these conditions for at least six months after the claim has been made. Children under the age of 16 must satisfy an additional disability test in order for DLA (care) to be awarded (unless they are terminally ill – see below).

Once DLA (care) has been awarded, there is no upper age limit on continued payment; however, no new claims can be made after the age of 65, except where the individual is already in receipt of DLA (mobility) and their condition worsens sufficiently to be eligible for the middle or higher rates of DLA (care).

Terminally ill claimants with a life expectancy of six months or less are automatically entitled to the highest rate of DLA (care) and do not have to satisfy the qualifying period.

Table A.4: Current rates of Disability Living Allowance (care), £ per week

Highest rate	77.45
Middle rate	51.85
Lowest rate	20.55

Disability Living Allowance Mobility Component

To qualify for DLA (mobility), claimants must be aged between 5 and 65 (3 and 65 for the higher rate) when making the claim, and must show that they would benefit from taking outdoor journeys. Further, they must satisfy the relevant disability conditions (outlined below). Children under the age of 16 applying for lower-rate DLA (mobility) must also satisfy an additional disability test. There are two rates of DLA (mobility):

To claim lower-rate DLA (mobility), the claimant must show that they cannot walk outside without substantial supervision or guidance.

To claim higher-rate DLA (mobility), the claimant must be (virtually) unable to walk because of their disability, or be deaf and blind, or be severely mentally impaired with severe behavioural problems and qualify for the highest rate of DLA (care).

For both rates of DLA (mobility), the claimant must have satisfied the same three-month qualifying condition and the forward test as for DLA (care). Terminally ill claimants with a life expectancy of six months or less are not guaranteed to receive DLA (mobility), but if they are entitled to it, they do not have to satisfy any qualifying period.

Table A.5: Current rates of disability living allowance (mobility), £ per week

Higher rate	54.05
Lower rate	20.55

Both components of DLA are not payable to people in hospital. The care component is not payable once the claimant has been a resident in a care home for 28 days.

In November 2011, over 3 million people were receiving DLA. Of these, 416,070 people received only the care component, 466,260 received only the mobility component and 2,344,460 people received both components. Table 3.5.6 shows the combinations of care and mobility components received by DLA claimants. DLA payments are estimated to have cost the exchequer approximately £11.9 billion in 2010–11.

Table A.6: Cases in payment of Disability Living Allowance, as at November 2011

		Mobility rate			
		None	*Higher*	*Lower*	***Total***
Care rate	None	-	363,990	102,270	416,070
	Highest	44,970	525,850	195,150	765,960
	Middle	115,090	474,520	501,440	1,091,040
	Lowest	256,010	425,610	221,900	903,520
	Total	466,260	1,789,970	1,020,750	3,226,790

Source: Department for Work and Pensions, *Disability Living Allowance tabulation tool*, available at http://83.244.183.180/100pc/dla/tabtool_dla.html.

Attendance Allowance

Attendance Allowance (AA) is a benefit paid to individuals over the age of 65 with care or supervision needs. To qualify for AA, the claimant must satisfy the relevant disability conditions for a period of six months before the award.

AA is paid at two rates: the lower rate is paid if the disability conditions for the middle rate of DLA (care) are met (i.e. the claimant has day *or* night needs) and the higher rate is paid if the conditions for the highest rate of DLA (care) are met (i.e. the claimant has day *and* night needs). Neither AA nor DLA is counted as income when calculating entitlements to means-tested benefits such as IS, income-based JSA, income-related ESA, HB, CTB, and PC.

People with a terminal illness and/or those with a life expectancy of less than six months are automatically eligible for the higher rate of AA and do not have to satisfy the six-month qualifying period.

In November 2011, approximately 1.8 million people were entitled to AA at an estimated cost of just over £5.2 billion in 2010–11.

Table A.7: Current rates of Attendance Allowance, £ per week

Higher rate	77.45
Lower rate	51.85