Was Budget 2007 good for pensioners?

Introduction

Although Budget 2007 did not include any direct changes to the value of state pensions and benefits for pensioners (such as the Basic State Pension, Pension Credit and winter fuel payments) other than those already announced, the Budget will affect the income of current and future pensioners through:

- Changes to the income tax system, which alter the amount of tax paid by pensioners and the amount of tax relief on pension contributions
- An increase in the National Insurance Upper Earning Limit (UEL), which could change the future build-up of State Second Pension (S2P)

This Briefing Note examines who might gain or lose from these proposals, and the potential long-term implications for pension provision[1].

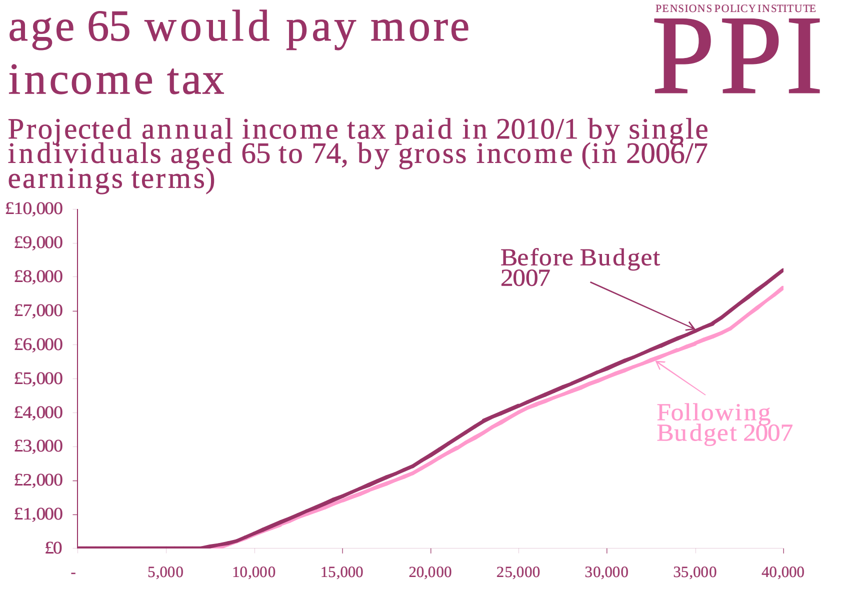
Current pensioners

A number of the changes announced to the income tax rates and allowances will change the income tax liabilities of current pensioners:

- The reduction in the basic rate from 22 to 20p will reduce the amount of tax paid by pensioners who pay at least part of their tax at the basic rate.
- The removal of the starting rate 10p income tax band will mean pensioners pay more tax on income in this band.

Chart 1: No individual over age 65 would pay more income tax

Projected annual income tax paid in 2010/1 by single individuals aged 65 to 74, by gross income (in 2006/7 earnings terms)



- The age-related personal allowances will be increased by an extra £1,180 a year. For people aged between 65 and 74, the allowance would be £8,730 a year, reducing the amount of tax paid by those with incomes between £7,550 and £27,910[2].

Together these changes will cost the Exchequer an estimated £500 million in reduced tax revenue from 2009[3].

When all these changes are considered together, the higher personal allowances more than offset the removal of the 10p starting rate of income tax, so that no individual would lose from the changes (Chart 1)[4] and some pensioners would no longer have to pay any income tax at all.

The gains from these tax changes are concentrated on the 4 million basic and higher rate pensioner taxpayers. Around 6 million pensioners do not have income high enough to pay tax[5], and they are not affected by these changes. The 1 million pensioners with total income currently in the 10p starting rate band of income tax see small gains as the higher personal allowances offset the loss of the 10p rate.

Future pensioners

The change in the basic rate of income tax will also change the value of tax relief given on pension contributions. With the current 22p rate, every 78p that an individual contributes to a private pension is topped up to £1 through tax relief. When the rate is reduced to 20p, individuals will need to contribute 80p to have the contribution topped up to £1.

In 2005/6 it is estimated that almost £10bn of personal contributions were made that would have attracted tax relief at the basic rate. Paying this at 20p instead of 22p could cut the cost of tax relief to the Exchequer by around £250 m[6].

Balanced against this, individuals would pay less tax on private pensions when they come into payment[7], depending on the tax rates and allowances in place in future. The overall impact on incentives to save is therefore ambiguous, but is likely to be small for most individuals.

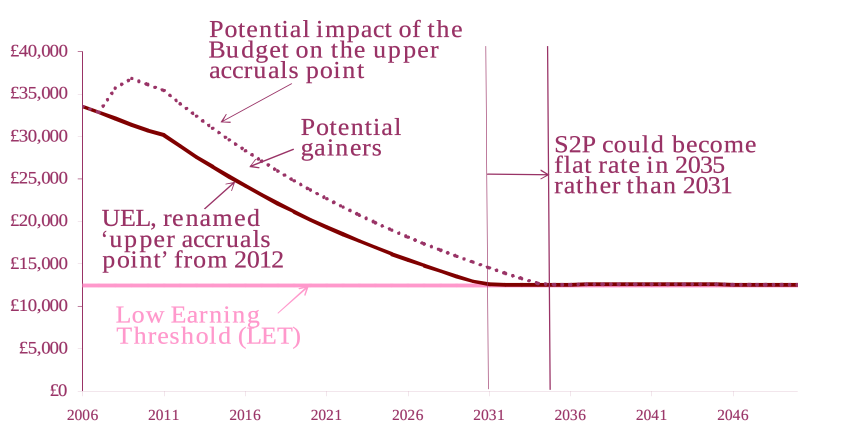
Individuals receiving tax relief at the higher rate of tax will not see any change in the rate of tax relief. The proportion of total tax relief that goes to higher rate taxpayers is therefore likely to increase from the current level of 55%[8].

The alignment of the UEL for National Insurance (NI) Contributions with the higher rate tax band will increase the revenue collected in the NI fund.

S2P is currently paid on all earnings between the lower and upper earnings limit. So, unless the link between S2P and NI contributions is broken before 2012, it will also increase the annual build-up of S2P for people earning above the old UEL of £34,840. Those earning above the new UEL of £40,625 will build up a pension of £2.83 a week in 2009 compared to £2.38 without the Budget changes[9].

Chart 2: The changes to the UEL may mean S2P does not become flat rate until 2035

Projected S2P thresholds, in 2006/7 earnings



The increase in the value of S2P built up by higher earners runs counter to the direction of reform of state pensions, which aims to gradually reduce the difference between the S2P received by low and high earners. The new increase for high earners will mean that low and high earners will not receive the same S2P each year until 2035, compared to 2031 in the current system (Chart 2)[10].

Conclusions

The changes announced in the budget will:

- Help middle and higher income pensioners by reducing the amount of tax they pay, costing the Exchequer £500 million.
- Reduce the value of tax relief at the basic rate on pension contributions. This could save the Exchequer around £250 million a year, and further skew the proportion of tax relief towards higher rate taxpayers. The impact on incentives to save though is ambiguous as less tax may be paid when pensions come into payment.
- The increase in the UEL for NI contributions could increase S2P for higher earners, and delay the flattening of S2P by up to 4 years.

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[1] The Budget also extended the Financial Assistance Scheme (FAS) for individuals who lost all or part of their occupational pensions as a result of employers going bankrupt before the introduction of the Pension Protection Fund in 2005. This will be the subject of a separate PPI Briefing Note.
[2] Age allowances for people 75 and over will also increase. See PPI (2007) The Pensions Primer for a full description of how the age-related tax allowances operate
[3] IFS figure. April 2009 is the first year all policies are in place. This estimate also includes changes to tax credits that could affect a minority of pensioners.
[4] PPI calculations
[5] Estimates based on figures from the Survey of Personal Incomes supplied by Her Majesty's Revenue and Customs (HMRC)
[6] PPI estimate based on HMRC estimates of tax relief for 2005/6
[7] Including from past pension contributions
[8] PPI Pension Facts Table 26
[9] PPI calculations
[10] PPI calculations

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