The state pension and the tax system – a briefing note from LCP

EXECUTIVE SUMMARY

The tax treatment of pensions and pensioners has become an issue of increasing focus in recent years. A combination of cuts to the real value of tax-free personal allowances and above-inflation increases in the value of the state pension has led to an increase of more than two thirds in the number of over 65s paying income tax since 2010. A continued freeze on personal allowances and the continuation of the generous 'triple lock' uprating of the state pension means that this trend is set to continue based on present policies[1].

In response to this, the Conservative manifesto contains a commitment to a 'triple lock plus' – a policy which would ensure that the personal allowance for income tax would rise in future in line with increases in the main rate of the new state pension.

As the standard rate of the new state pension (around £11,500 per year) is currently below the standard personal allowance (£12,750 per year), this would ensure that pensioners whose taxable income consisted exclusively of a new state pension, paid at the standard rate, would have no income tax liability.

The purpose of this paper is to provide background on the state pension system and its interaction with the income tax system in order to inform the debate on these issues.

Key points are:

- There are currently two separate state pension systems in operation in the UK; in 2023/24 there were 8.4m pensioners who reached state pension age before 6th April 2016 who come under the 'old' state pension system, and 3.2m who reached pension age after this date who come under the 'new' state pension;

- The old state pension system was highly complex, combining a basic state pension for those who met certain National Insurance contribution tests with a highly variable additional state pension (often called SERPS) which could range between zero and over £200 per week; some of the largest state pensions in the UK are paid to those who come under the old system and have large SERPS pensions;

- The new state pension system is designed around a standard rate, but a significant minority of new state pensioners may receive more than the standard

[1] The manifestos of both the Conservative and Labour parties contain commitments to continue with the 'triple lock' policy on uprating the state pension.

figure because of transitional protection of accrued rights built up prior to 2016; in simple terms, those who had built up a pension under the old rules bigger than the new flat rate as at 2016 were allowed to retain this higher entitlement even when the new rules were introduced;

- LCP analysis of DWP's figures on state pension receipt suggests that a significant number of pensioners have a sufficiently large state pension – mostly built up under the old system - that they are over the existing income tax personal allowance purely on the basis of their state pension; these people would, for the most part, still be taxpayers even if a 'triple lock plus' policy were to be introduced;

- To be more precise, we estimate that:

    - Around 2.5m pensioners or just over 1 in 5 of all pensioners resident in Great Britain have state pensions above the income tax threshold;

    - Of these, the large majority – 2.1m – are older pensioners on the 'old' state pension system; this group splits fairly evenly between men and women; the group of women on larger pensions will include a significant number of widows whose pension includes an inherited amount from a late husband;

    - In addition, around a third of a million pensioners on the new state pension are receiving pensions above the income tax allowance; these are overwhelmingly men;

- The 'triple lock plus' policy will, of course, deliver a lower tax bill for millions of pensioners than a policy of continuing to freeze personal allowances for pensioners. But our analysis shows that for around 1 in 5 pensioners it will not deliver the stated objective of ensuring that their state pension is completely free of income tax.

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1. Introduction

The state retirement pension, along with occupational and private pensions, is, in principle, subject to income tax. But for millions of people who only have a state pension (or a small private income on top) this fact is largely irrelevant. This is because most individuals enjoy a personal income tax allowance in excess of standard state pension rates. A pensioner who only has a state pension is therefore likely, in most cases, to pay no income tax.

The assumption that those who only have state pension income will generally pay no income tax has however been called into question in recent years. This is for a number of reasons:

- The additional tax allowances available to those aged 65+ have largely been abolished; in 2010/11, when the standard personal allowance was £6,475, those aged 65-74 had an enhanced personal allowance of £9,490, and those aged 75+ had an allowance of £9,640[2]; in the 2012 Budget it was announced that these enhanced allowances would gradually be phased out; this was done by freezing the cash value of allowances for pensioners whilst allowances for those of working age were gradually levelled up; equality was achieved in 2015/16 for those aged 65-74 and the following year for those aged 75+;

- Since 2010, the rate of the basic state pension and of the new state pension have been subject to the relatively generous 'triple lock' formula; this has resulted in annual increases being based on the highest of the growth in average earnings, the growth in prices and a floor of 2.5%;

- Since 2021/22 the main personal allowance (which now applies equally to pensioners and non-pensioners) has been frozen at £12,570; this freeze is set to continue until the end of 2027/28;

A combination of the abolition of age allowances, a freeze in the standard personal allowance and generous increases in the nominal value of the state pension has meant that growing numbers of pensioners are now paying income tax.

This is shown in Table 1, based on figures provided by HMRC for those aged 65 or over.

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[2] Income Tax personal allowances and reliefs - GOV.UK (www.gov.uk). A minority of higher earning pensioners could however have these additional allowances tapered away if their income was above set levels.

Table 1. Number of individuals (thousands) aged 65 or over paying income tax 2010/11 to 2023/24

Year	Number paying tax (thousands)
2010/11	4,910
2011/12	5,090
2012/13	5,380
2013/14	5,970
2014/15	6,330
2015/16	6,490
2016/17	6,490
2017/18	6,460
2018/19	6,580
2019/20	6,500
2020/21	6,810
2021/22	7,310
2022/23	7,730
2023/24	8,500

Source: https://www.gov.uk/government/statistics/number-of-individual-income-taxpayers-by-marginal-rate-gender-and-age

As Table 1 shows, the number of people aged 65 or over who pay income tax has risen from 4.9m in 2010/11 to 8.5m last year. Since then the state pension has risen by a further 8.5% whilst personal allowances have been frozen. This suggests that there are currently probably in excess of 9m people aged 65 or over paying income tax.

In small part the increase in taxpaying pensioners since 2010 reflects the growth in the absolute size of this age group (as the 'baby boom' generation reaches pension age), but the main reason for the increase is the changes to allowances and state pension rates listed above.

Prior to the calling of the General Election, the government's policy was to continue with the state pension triple lock and to continue with the freeze on personal allowances. The Office for Budget Responsibility has published forecasts of the likely 'triple lock' state pension increases over the next few years as shown in Table 2.

Table 2. Expected 'triple lock' state pension increases in April of each year

	2025	2026	2027	2028	2029
Increase	3.7%	2.5%	2.5%	2.5%	2.6%

Source: Table A3, CP 1027 – Office for Budget Responsibility – Economic and fiscal outlook – March 2024 (obr.uk)

If we suppose that these forecasts are correct, we can look at the standard rates of the old 'basic' state pension and new state pension (both of which are covered by the triple lock promise) to see the likely levels of each over the coming years. This is shown in Table 3[3].

Table 3. Annual rates of basic and new state pension assuming triple lock uprating/2029

	Basic state pension	New state pension
2024/25	£8,814	£11,502
2025/26	£9,142	£11,928
2026/27	£9,370	£12,228
2027/28	£9,604	£12,534
2028/29	£9,846	£12,849
2029/30	£10,103	£13,185

Source: Benefit and pension rates 2024/2025 - GOV.UK (www.gov.uk) and author's calculations based on OBR assumptions

The government's current policy is for the personal allowance to remain at £12,570 until 2027/28 which would keep it just above the standard new state pension rate. Current OBR projections assume that the personal allowance would rise in line with inflation to £12,820 in 2028/29 and this is lower than the projected rate of new state pension of £12,849. The actual tax bill in that first year would be very small (£12,849 minus £12,820 times 20% or £6 for the year) though the figure would of course grow.

It is sometimes assumed that once someone has income above the tax threshold they have to fill in a tax return (if the tax is not collected through the PAYE system) but this is not the case. Instead, there is a process known as 'simple assessment' whereby HMRC uses the information which it already holds (including state pension income) to undertake a tax assessment and simply issues the taxpayer with a bill after the end of the tax year. Nonetheless, even without the need to fill in a tax return, receipt of such bills would obviously be unwelcome for those of relatively modest means.

[3] Note that we have assumed that the normal custom is adopted of rounding up weekly pension amounts to the next 5p following an uprating. Annual figures shown are simply 52 x the weekly rate. This is slightly different to the approach taken in the Conservative party press release which converts the weekly pension to a daily rate and then multiplies by 365, but the difference is not material.

2. The 'triple lock plus' policy

In response to concerns about the risk of those solely receiving the standard rate of the new state pension being drawn into the tax net, the Conservative party has included a new policy proposal in its recently published manifesto[4]. Under this policy, described as a 'triple lock plus', the Party pledges that, if re-elected, it will ensure that the personal allowance for pensioners is increased each year at the same rate as the increase in the standard rate of the new state pension. This should ensure that if someone currently receives just the new state pension at the standard rate (and is therefore below the tax threshold), they will remain below the tax threshold into the future.

The policy is described in the Conservative Manifesto in the following terms:

> *"Ensuring that from next year the tax-free personal allowance for pensioners also rises by the highest of prices, earnings or 2.5%, guaranteeing that the new State Pension is always below the tax-free threshold. From April 2025, we will increase the personal allowance for pensioners by introducing a new age-related personal allowance. This is a tax cut of around £100 for eight million pensioners next year – rising to £275 a year by the end of the Parliament"*
>
> *(p 15, Conservative Manifesto 2024).*

The vast majority of beneficiaries of this measure would be pensioners who already pay income tax. If the tax-free allowance were to rise by 3.7% from its current level of £12,570 it would be worth around £13,040 in 2025/26. A basic rate taxpayer would benefit to the tune of 20% of this increase or around £94 per year, whilst the minority of pensioners who pay tax at the higher rate would benefit by more. This suggests that the figure of 'around £100' is a reasonable estimate for the average gain next year.

The Conservative Party website[5] presents the policy as follows:

> *"So if you vote to stick with the plan, Rishi Sunak and the Conservatives will not only guarantee the Triple Lock — we'll introduce the Triple Lock Plus. This means the personal allowance for pensioners will rise every year — ensuring they NEVER pay tax on their state pension".*

In the next section we consider DWP data on state pension receipt to see if this claim is accurate.

[4] Conservative Manifesto 2024 (conservatives.com)
[5] Quadruple-Lock Your Pension | Conservatives

3. Does this policy mean that people who rely only on the state pension will not face income tax?

Having a policy to make sure that the standard personal allowance remains above the standard rate of the new state pension will ensure that pensioners on that rate will remain free of tax.

However, this is not the same as saying that pensioners who only have a state pension will be free of tax.

There are two groups[6] of pensioners who only have a state pension but would still be subject to income tax even if this policy were implemented:

a) Those on the 'old' state pension system (applicable to those who reached pension age before 6th April 2016) and who have a combined state pension income from 'basic' state pension and 'additional' state pension (also known as SERPS) in excess of the tax allowance;

b) Those on the 'new' (post April 2016) system who receive a pension in excess of the standard flat rate amount;

In this section we explain more about the characteristics of these two groups and provide an estimate of how many are in each group.

A. People with relatively large rates of 'old' state pension

The old state pension system had two main elements.

First, a basic state pension, worth up to £169.50 per week in 2024/25 for those with sufficient NI contributions. Most pensioners, and most male pensioners in particular, receive this full basic pension.

Second, since 1978, individuals have been able to build up an additional state pension under the state earnings-related pension scheme (SERPS)[7]. Unless they were 'contracted out' into a workplace or personal pension arrangement, individuals in work from 1978 onwards accrued further state pension, and this system continued until 2016. Those with long years in the new scheme and at relatively high earnings could

[6] In addition, in some cases someone could also have a large state pension because they had deferred taking their pension from pension age and were now being paid at a permanently higher rate, above the standard rate.

[7] A more modest earnings related 'Graduated Retirement Benefit' scheme operated between 1961 and 1975 and can also provide additional state pension.

build up a large SERPS pension, up to a maximum figure currently set at £218.39 per week, on top of their basic pension[8].

Because someone's SERPS pension depends in a complex way on the years they worked and how much they earned, as well as whether they spent periods in a contracted out pension arrangement instead, the exact amounts of state pension which individuals could receive under the old system vary hugely from individual/individual.

The weekly equivalent of the personal allowance is around £242 per week in 2024/25, so ideally we would use DWP data on pension receipt in 2024/25 to see how many people on the old system are above this figure. However, DWP's online statistics[9] only go up to May 2023.

As the basic state pension rose by 8.5% in April 2024 we can assume that someone on a pension of around £224 per week or more in 2023/24 would be over the tax threshold today[10]. We round this up to the nearest £5, and look at the characteristics of those on the old state pension with income in 2023/24 above and below £225 per week. This gives us a rough guide to how many people have state pensions which, on their own, would be enough to leave them in reach of the tax system.

Table 4 is based on pensioners resident in Great Britain in receipt of a pension under the old (pre April 2016) state pension system.

Table 4. Number of pensioners in Great Britain on the 'old' state pension system receiving weekly pensions above/below £225 per week by gender, 2023/24

	Men	Women	All
Up to £225	2.35m	3.88m	6.22m
£225 or more	**1.11m**	**1.02m**	**2.13m**
All	3.46m	4.90m	8.36m

Source: Author's tabulations using DWP 'stat xplore' website. Note, row and column total may not sum exactly due to rounding.

Table 4 shows that in 2023/24 there were 8.36 million pensioners on the old state pension system and of these around 1 in 4 (2.13m) were receiving an amount which would have led them to being over the tax threshold in 2024/25. This total includes 1.11m men and 1.02m women. Many of these women with larger pensions will be older widows whose pension includes a significant amount of inherited state pension from a late husband.

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[8] A reformed version of SERPS – the State Second Pension – was introduced in 2002 and this also included provision to 'credit' certain people such as carers into the additional state pension system.
[9] Stat-Xplore - Log in (dwp.gov.uk)
[10] We calculate that someone in 2023/24 on an old basic pension of £156.20, increased by 8.5%, and a SERPS pension of £67.70, increased by inflation at 6.7%, would have a combined pension in 2024/25 of £241.71, up from £223.90 the year before.

B. People on the new state pension receiving in excess of the standard rate

When the new state pension was introduced in April 2016, the idea was that, over time, most people would receive the standard flat rate figure, currently £221.20 per week.

However, as at 2016, there was a group of people who had already built up state pension rights in excess of the flat rate figure. This was those who had a combination of basic state pension and SERPS pension which took them over the proposed flat rate figure.

On the basis that it would have been unfair to take these rights away, those who had already built up state pension rights in excess of the flat rate figure as at April 2016 were allowed to retain those rights (though not add to them through post 2016 contributions). Payments in excess of the standard flat rate figure are called 'protected payments'. Entitlements up to the full standard flat rate are subject to the 'triple lock' promise whilst the protected payment element is increased each year in line with CPI inflation.

As in the previous section, we can use the DWP's statistical tabulation tool to look at how many new state pensioners were on rates of £225 per week in 2023/24 or more and could thus be expected to be taken over the tax threshold in 2024/25 purely on the basis of their state pension. The results are shown in Table 5.

Table 5. Number of pensioners in Great Britain on the 'new' state pension system receiving weekly pensions above/below £225 per week by gender, 2023/24

	Men	Women	All
Up/£225	1.59m	1.28m	2.88m
£225 or more	**0.26m**	**0.07m**	**0.33m**
All	1.86m	1.36m	3.21m

Source: Author's tabulations using DWP 'stat xplore' website. Note, row and column total may not sum exactly due to rounding.

Because the new state pension has only been payable since April 2016, only 3.2m pensioners in Great Britain are on the new system. Of these around a third of a million were receiving amounts in 2023/24 which would put them above the tax threshold in 2024/25, and the large majority of these are men.

C. Combined picture

Combining the analysis in the last two sections, Table 6 shows the overall number of pensioners in Great Britain above and below the tax threshold purely based on their state pensions in 2023/24.

Table 6. Total number of pensioners in Great Britain receiving weekly pensions above/below £225 per week by gender, 2023/24

	Men	Women	All
Up/£225	3.94m	5.16m	9.10m
£225 or more	**1.37m**	**1.09m**	**2.46m**
All	5.32m	6.26m	11.57m

Source: Author's tabulations using DWP 'stat xplore' website. Note, row and column total may not sum exactly due to rounding.

Our key finding is that just under 2.5m pensioners are likely to be receiving a state pension in 2024/25 which, regardless of their other income, would be enough to make them taxpayers. The large majority of these people would therefore remain taxpayers in years to come purely on the basis of their state pension even if the 'triple lock plus' policy were to be implemented[11].

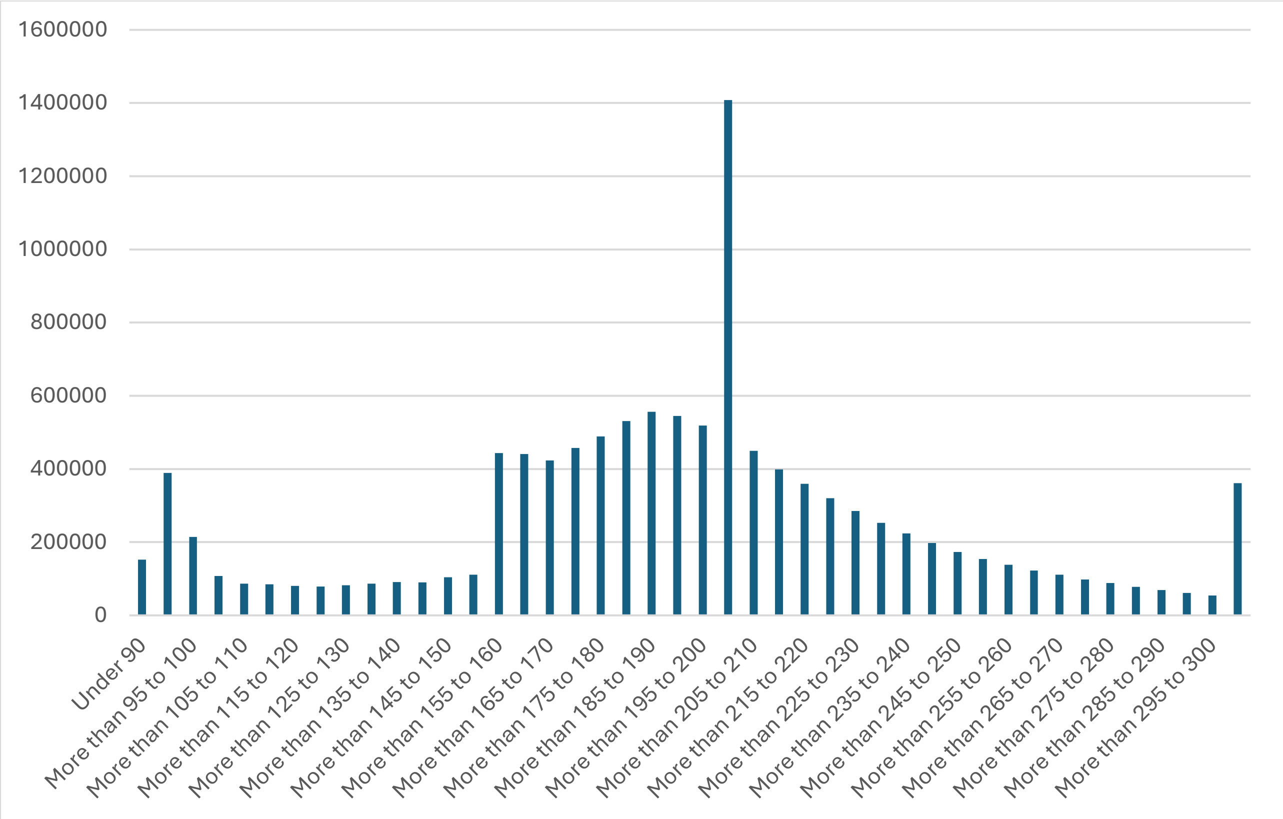
It is worth noting that the majority of pensioners have taxable income from occupational and private pensions, earnings, rental income or other sources which mean that they could be taxpayers even if their state pension was below the threshold of £225 per week. This would remain the case for most pensioners even with a faster increase in the tax allowance. But focusing purely on the state pension, just under 2.5m pensioners will face tax bills *regardless of their other income*, even if this new policy were to be implemented.

[11] The main exception to this would be those who are only slightly above the tax threshold in 2024/25 and who do not get the 'triple lock' increase on the whole of their state pension income. In this case the cash increase on the tax allowance would be larger than the cash increase on their state pension and this could take a relatively small number out of tax (assuming they had no other taxable income).

APPENDIX

In the main body of this paper we look purely at the number of pensioners above or below a set threshold. But it is instructive to look at the whole distribution of state pension payments, combining old and new systems, in order to see the full diversity of state pension payments. Such a distribution is shown in Figure 1.

Figure 1. Pensioners living in Great Britain, numbers receiving different amounts of weekly state pension in 2023/24



The large peak in the chart at between £200 and £205 reflects the fact that the standard rate of the new state pension was £203.85 per week in 2023/24, and at this point nearly half of all those on the new state pension received this exact figure. The much wider variation elsewhere in the chart shows in particular the highly variable outcomes from basic and additional state pension under the old state pension system, and the fact that most pensioners in Britain today are still on that old system.

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