# Sharing the burden - How the older generation should suffer its share of the cuts

IEA Discussion Paper No. 34

by

**Philip Booth** and **Corin Taylor**

**February 2011**

The Institute of Economic Affairs, 2 Lord North Street, London, SW1P 3LB; Tel 020 7799 8900; email iea@iea.org.uk

## About the authors

**Philip Booth** is Editorial and Programme Director at the Institute of Economic Affairs, and Professor of Insurance and Risk Management at Cass Business School.

**Corin Taylor** was formerly a Senior Policy Adviser at the Institute of Directors, covering economic policy, public sector pensions and public service reform issues.

**Institute of Economic Affairs**
**2 Lord North Street**
**London**
**SW1P 3LB**

**www.iea.org.uk**

# Contents


| | |
|---|---|
| Introduction | 4 |
| Abolition of non-cash benefits to pensioners | 5 |
| Abolition of married couples allowance for old people | 8 |
| Abolition of the age allowance | 9 |
| Not linking UK state pensions to earnings from 2011 | 11 |
| Raising state pension age to 66 in 2015 | 12 |
| Reduction in public sector pension contributions | 13 |
| Comprehensive pension reform | 14 |
| Conclusion | 18 |
| References | 19 |

# Introduction

The purpose of this paper is to examine non-means-tested government payments to older people. It includes an examination of the pension system and also other non-means-tested benefits provided to older people. There has been an enormous growth in government financial provision in old age in the last 13 years. Furthermore, increases above inflation in the basic state pension are planned in the near future. It is also the case that pensioners have received particularly favourable treatment in the tax system. They have a higher personal allowance than younger people and even have a marriage allowance.

This paper does not merely propose cutting back on government transfer payments to the elderly; it also proposes making the remaining transfers more economically coherent. We address the problems that pensioners receive income from approximately eight different sources (assuming only one private pension) and face about 12 different marginal tax and benefit withdrawal rates over the income spectrum (see Booth and Cooper, 2005). We also propose significant cuts in public sector pension provision and long-term reforms of the state pension and tax system for older people.

It is notable that the elderly have been identified for special treatment by the government in the 2010 Comprehensive Spending Review. They have been more or less exempt from spending cuts, despite the creation of many anomalous benefits for pensioners in recent years. Furthermore, the government proposes to increase pensions in line with general wage increases and also guarantee that increases in pensions will not be below 2.5% or the rate of inflation. At a time of apparent public spending stringency, this shows a remarkable degree of laxity, probably driven by the ageing of the electorate. The problems of reducing benefits to older people when electorates are ageing are discussed in Booth et al. (2008).

# Abolition of non-cash benefits to pensioners

We begin by proposing the abolition of three non-cash benefits that are provided to pensioners. This is the extent of the immediate direct reduction in income to older people from the state that we propose, though there will be other indirect changes to pensioners' income levels. These proposals for direct reductions in pensioners' income have been chosen because the relevant benefits give rise to economic distortions, involve significant costs of administration (which have not been included in the estimated savings) and/or involve significant time costs by individual claimants.

*Abolition of free bus travel*

It is extremely difficult to produce a rationale for providing free bus travel for pensioners.[1] As a means of transferring income to older people, it suffers from the following problems:

- It benefits only those pensioners who are fit enough to travel unaided.
- It benefits only those pensioners who live near reliable bus services.
- It benefits mainly those pensioners who choose to travel by bus rather than by car or cycle.
- It distorts economic decisions: pensioners who, facing all the costs and benefits of their decisions, would choose to travel by taxi, car, foot, by cycle or not to travel will be artificially encouraged to travel by bus as a result of the existence of free bus travel.
- It changes the dynamics of the bus market as it makes the providers of these subsidies to the elderly (local authorities, financed by the government) the customers of the bus companies rather than travellers themselves. As elderly people are a significant part of the market, this is not unimportant.
- It prevents bus companies from finding their own packages of price discrimination to help fill buses at less busy times.
- It reduces the incentives for dynamic innovation in taxibus and minibus services that can potentially compete with buses and provide a more personalised service.
- The taxes used to finance the benefit, themselves cause economic distortions.

It is suggested by some economists that providing free bus travel at off-peak times, with the costs being reimbursed to bus companies in the form of a subsidy, helps the industry cover average costs at a time of day when marginal costs are zero. As such, it is further argued that subsidisation in this way leads to a more efficient economic outcome. This ignores not just the arguments listed above but also the fact that bus companies themselves produce a range of innovative products that are designed to ensure that average costs are covered at times when marginal costs are low. Coach, rail and airline companies also handle this problem effectively.

It is difficult to obtain a precise estimate for the saving from abolition of free bus travel because of the changing rules for the benefit. However, its abolition would probably save approximately £1.3bn per annum by 2015/16.

1 In fact, at the moment, the free travel is for over 60s. The age will change with state pension age equalisation.

*Abolition of free TV licences*[2]

In many senses the rationale for not providing free television licences is the same as the rationale for not providing free bus passes. However, though it does distort how people spend their income to some extent, the demand for a television licence is likely to be highly price inelastic. As such, the economic distortions are not considerable. This may change with the increase in demand for and supply of internet, subscription and pay-per-view television.

Free television licences do, however, discriminate against those who do not wish to have their own television because they are poorly sighted or because they do not wish to watch television – they are receiving a benefit in kind which they do not value. The benefit also, rather bizarrely, is of value to young families who have a relative aged over 75 living with them.

There are also public choice arguments against providing free television licences. The television licence was generally regarded as a "user charge" until recently. It was a rather strangely constructed user charge because owners of televisions had to pay for a licence even if they did not watch the channels the fee was designed to finance. However, the move towards free television licences gives the licence fee, to an even greater extent, the features of a tax. The government requires a levy in the form of a television licence fee from households it deems *should* pay as well as making a contribution to the BBC itself on behalf of other householders who benefit from free licences. This strengthens the direct links between the government and the BBC.

The abolition of free television licences would save approximately £725m per year by 2015/2016.

*Abolition of winter fuel allowance*

The winter fuel allowance is marketed by the government as a contribution towards the cost of fuel. In fact, it is a tax-free cash payment made to all households in which there is an individual aged over 60.[3] It is generally paid at the rate of £250. The rate is increased to £400 if the household contains somebody aged 80 or over. The qualifying age will increase gradually as female state pension age increases.

It is very difficult to make any coherent argument in favour of this allowance. It is not related to fuel costs or how cold a particular winter happens to be (there is a separate payment made when weather is exceptionally cold): "winter fuel allowance" is a misnomer. The benefit is also an anomaly because the payment falls outside the standard tax and benefits system. The payment has to be claimed (with a special form) and is administered separately. There is simply no reason for this additional source of income to be provided to pensioners.

The abolition of the so-called winter fuel allowance would save £2.1bn per annum by 2015/16.

It is noteworthy that none of these benefits were cut in the coalition's recent spending review. Indeed, other forms of state finance for goods and services that have a stronger economic rationale (such as government provision for students[4]) were cut whilst benefits to pensioners remained untouched – indeed, provision for pensioners was actually expanded (see below). As has been noted,

2 We ignore, here, whether it is desirable to have what is effectively a state broadcasting service financed by a tax on televisions.
3 This will rise in line with female state pension age.
4 That is not to say that the authors support government finance for students but there is arguably a stronger rationale for such finance than there is, for example, for free television licences to households with a member aged 75 or over.

there is strong electoral pressure to retain benefits for the elderly.

## Abolition of married couples allowance for old people

It is not the intention of this paper, in general, to propose tax increases. All the measures proposed will lead to significant government spending reductions and thus facilitate tax reductions. But it is desired to make the tax system – as well as the provision of benefits – significantly more economically efficient. Lower taxes should also lead to simpler taxes, but achieving this involves the removal of certain tax exemptions.

It is very difficult to justify the existence of a married couples' tax allowance for older people. For younger people, the proposal for a transferable tax allowance has been justified by the bias in the benefits system against couples with children. However, the married couples allowance is not a transferable allowance to facilitate the using of unused tax allowances on a household basis and few pensioner couples have dependent children.

The rules for the married couples allowance are bizarre in the extreme and have evolved from a series of decisions to limit the allowance and then to abolish it for younger people from April 2000. Older people were exempt from that latter decision for purely political reasons.

The rules for receiving the allowance are as follows:

- One person in a couple must be 75 or over.
- The amount of the allowance is £7,295.
- The rate at which the allowance can be claimed is 10%; it therefore reduces the marginal rate of tax for one person within a married couple by 10% over that band of income.
- If income is above £24,000 then the allowance is withdrawn at the rate of £1 for every £2 of income after the additional age-related personal allowance has been withdrawn until a minimum married couples' allowance of £2,800 is left.

Confused? It is not surprising. The net result is that pensioners have a marginal tax rate of 5% in addition to the standard rate of income tax on a band of income of about £8,000 starting at about £29,000. This is in addition to a marginal tax rate of 10% above the standard rate of income tax on a band of income of about £5,200 over approximately £24,000 because of the withdrawal of the age-related personal allowance (see below). The tax system should not be this complex and this tax relief has no economic rationale.

# Abolition of the age allowance

In addition to the married couples' allowance, pensioners receive an age-related personal allowance. This reduces the marginal rate of tax to zero on a tranche of income of £2,615 above the standard personal allowance of £7,475 (in 2011/2012). The age-related allowance is then withdrawn when income reaches £24,000 at a rate of £1 for every additional £2 of income. At the current basic rate of income tax this raises the marginal tax rate to 30% on a tranche of income of approximately £5,200 above £24,000. There is a small additional allowance for those over 75. The following table shows the marginal tax rates at specimen income points for an individual under age 65, an individual over age 75 and somebody who is married over age 75.

| Income level | Individual under age 65 | Individual over age 75 | Married person over age 75 |
|---|---|---|---|
| £5,000 | 0% | 0% | 0% |
| £7,500 | 20% | 0% | 0% |
| £10,000 | 20% | 20% | 10% |
| £17,500 | 20% | 20% | 20% |
| £25,000 | 20% | 30% | 30% |
| £30,000 | 20% | 20% | 25% |
| £39,000 | 20% | 20% | 20% |
| £50,000 | 40% | 40% | 40% |

It is very difficult to see a rationale for the age allowance and for the varying marginal tax rates to which this system leads. It increases incomes to pensioners in very particular circumstances. Married pensioners where one person in the couple has a high income and the other a low income might well not benefit from the age allowance whereas a married pensioner where one member of the couple was over 75 whose income was split evenly between the couple could obtain about £20,000 of tax-free income in addition to a tranche of income of over £7,000 on which tax of 10% was charged. The withdrawal of the two allowances is fiendishly complex. The whole system seems to be designed to reward effective tax planning.

We therefore propose to abolish the age-related personal allowance. This, together with the abolition of the married couples allowance would save £3.14bn.[5] There would be significant administrative savings both for government and individuals and significant savings in tax planning costs. This saving could be reduced in 2011/2012 when the personal allowance for all individuals is increased, but other factors before 2015/16 would lead to an increase in the cost of these two allowances. We have therefore assumed that the saving from their abolition would be £3bn per year.

Two groups on modest incomes would lose out from these proposals, and we might consider how to reduce taxes in a simple, transparent and economically coherent way using savings from cuts to other areas of government expenditure. The first group would be pensioner couples whose income was unevenly split so that one member of the couple did not make full use of their personal allowance. This group will become smaller as pension provision amongst women increases. The second group would be single pensioners on small incomes who will pay a maximum amount of additional

5 http://www.hmrc.gov.uk/stats/tax_expenditures/table1-5.pdf

tax of £520 a year. If it is wished to reduce taxes for the first group, then it should be done through a simple transferable tax allowance between members of a couple. The second group will gain from the general increase in the personal allowance that is already proposed and being implemented with effect from April 2011. Given the other proposals in this monograph, it should be possible to raise the basic personal allowance very significantly above the age allowance in any case.

The above two proposals would lead to nearly all pensioners paying a marginal rate of tax at either 0% or 20% on all their income. No tax returns would be necessary and the tax that would be due could be worked out by inserting three numbers into a pocket calculator.

## Not linking UK state pensions to earnings from 2011

The UK government has recently announced that the state pension will be linked to increases in earnings from 2011. Furthermore, the government will guarantee that the state pension will rise at the higher of the increase in the Retail Prices Index, national average earnings growth or 2.5%. It is difficult to justify this decision and it exposes the government to considerable risk if there were to be a period of sustained deflation, negative real earnings growth or high real earnings growth. Pensioners' real incomes will depend arbitrarily on the relationship between earnings growth, prices growth and 2.5% - as will the real cost of pensions to government. At a time when the population is ageing, a decision to raise the real level of pensions within a pay-as-you-go pension system financed by taxes of the working generation is imprudent.

In the long term, as discussed below, the government should develop a pensions system that maximises the scope for private pension provision. Meanwhile, the government should not expand the real level of spending within the current system. We propose that the basic state pension and all means-tested benefits through the pension credit system are frozen in real terms. Given the increase in means-tested benefit levels in recent years, as well as above-inflation rises to the basic state pension, this is an entirely reasonable approach. Indeed, it could be argued that real pensions should be reduced if real earnings fall in the current climate.

It is likely that real wage growth will be subdued over the next few years but, assuming wage growth of 2.5% per annum above inflation (which is about 0.5% per annum less than the government's GDP growth forecast), not increasing pensions in line with earnings will save about £5.6bn per year by 2015/16. Additionally, increasing the minimum income guarantee for pensioners in line with the rise in prices rather than the rise in earnings is likely to save about £0.8bn per annum.

## Raising state pension age to 66 in 2015

The government has already legislated for the state pension age to rise from 65 to 68. The rise to 68 will not take place until 2046. There is a strong case for a considerable rise in the state pension age very soon. In 1952, life expectancy for a male at age 65 was 11.7 years. By 2010, it was 21 years (see DWP, 2010). Indeed, even the rise in state pension age to 68 will not reduce the average number of years for which the state pension is received because, by 2046, life expectancy at age 65 is likely to have increased by at least a further five years.

The age at which people retire should be a matter of free choice. We propose below methods by which greater choice in this matter will be facilitated in the long term. However, as an interim measure, we propose a rise in the retirement age by half a year in 2014 and a further half year in 2015 for both men and women (for the latter this would be half a year each year above already planned increases). The savings from this would depend on the extent to which additional older people could be absorbed into the labour market and the relationship between pension payments and means-tested benefits. A conservative estimate of the savings would be about £5bn per annum.

## Reduction in public sector pension contributions

There has been much discussion in recent years about the level of pension provision given to public sector workers (see, for example, Record, 2006). This discussion culminated in the publication of a report by the Public Sector Pension Commission (Public Sector Pension Commission, 2010) and action by the government to set up its own commission.[6]

There is no particular need for the government to resolve this issue by designing new pension schemes for every group of public sector workers. Two reforms are important, however. Firstly, the full costs of all pension promises should be revealed and charged to public sector employers and employees as new pension accrues: the public sector should face the same discipline as the private sector. Secondly, public sector employees and employers should be free to negotiate pension arrangements: these arrangements may well be different in different areas of the public sector. Whatever pension arrangements they design, the full cost should be charged to employers and employees.

Currently, the cost of public sector provision is about 40% of the public sector salary bill – though it varies widely between different parts of the public sector (see Public Sector Pensions Commission, 2010). However, because of the way in which the government accounts for public sector pensions, only about half that figure appears in headline public spending numbers. We propose that all public sector budgets are adjusted so that they contain an allowance for current salaries plus an allowance of 20% of salary for pension provision. It would then be a matter for public sector employers (schools, hospitals or health authorities, the Ministry of Defence and so on) to agree pension arrangements with their employees. If pension arrangements cost more than 20% of salaries, cuts would have to be made elsewhere; if pension arrangements cost less, there would be scope for salary increases.[7]

This change to public sector pension arrangements would not change headline spending at all. The reason for this is that about half of public sector pension costs are currently hidden from government accounts. This policy change will, however, reduce underlying public spending on public sector pensions by £17bn to £18bn a year.

A case could be made for going further. Pay increases in the public sector have outstripped those in the private sector in recent years. The Institute for Fiscal Studies (2011) estimates that the difference between private sector and public sector pay, after allowing for differences in skills and so on, is relatively small – about 7.5%. Employer pension provision in the private sector is funded, on average, at considerably less than 10% of salary.[8] The difference between the 40% of salary that pension benefits are currently worth in the public sector and the 10% of salary that represents a generous estimate of the average private sector employer contribution towards pensions is a reasonable estimate of the extent of the generosity of public sector pay packages relative to private sector packages – excluding the small amount by which headline rates of pay are higher in the public sector.

---

6 This commission is known as 'The Independent Public Service Pensions Commission', though unlike the 'Public Sector Pensions Commission' it is not independent as its only member is a public sector pensioner.

7 This 20% figure represents an average: it could be higher in some departments and lower in others. However, the authors believe that, even in areas such as police and defence, pension arrangements should be such that they do not treat early retirement generously. There is no reason why workers in those services cannot continue working, even if in less strenuous occupations.

8 See: http://www.statistics.gov.uk/cci/nugget.asp?id=1278

# Comprehensive pension reform

*The problems with government pensions*

The purpose of this paper is not simply to suggest short-term budget savings. We are also proposing long-term policies to radically improve the functioning of old-age provision. Comprehensive pension reform is therefore desirable.

Most Western countries have very high levels of explicit government debt. Though this is not unprecedented, previous situations where high levels of explicit debt existed were at times when government spending and taxation were at much lower levels than today – for example after the Napoleonic wars. In addition, the explicit debt is only the tip of an iceberg. For perhaps the first time in economic history, developed countries use the taxes of the working generation to provide income and healthcare to the retired for a long proportion of their total lifespan. As has been noted above, life expectation at age 65 has doubled in just 60 years. Currently, an individual who retires at age 60 can expect to be in retirement for a period equal to perhaps two thirds of his working life.

Where pensions are provided by the state, this leads to an implicit debt: that is it leads to an unfunded obligation on the younger generation to provide income and healthcare to the older generation. The explicit and implicit debt combined has been estimated to be around 550% of national income (see Hagist et al., 2009).

In the past, people provided for needs in old age through their extended families (older members being supported by younger members), through saving or through insurance (see Bartholomew, 2004 for more discussion). The portion of an individual's life for which provision of this type was made, of course, was much shorter than the period for which we expect to be in retirement today.

There are very good reasons to make a clean break from the post-war pension settlement. The most important is the burdens that pay-as-you-go pension systems place on future generations when the population is declining. When savings, insurance and family provision are the methods of providing for old age, there are automatic processes of adjustment to changing economic conditions. For example, when longevity improves and the working population shrinks, annuity prices increase and there will be upward pressure on wages. These effects increase the incentives for individuals to work longer and to defer retirement. The desirable outcome for the individual is also desirable for society as a whole.

The problem with the approach of using tax-financed pensions and healthcare – whereby taxes are levied on the young and those to whom promises are made make no funded provision themselves – is that the risks are inherently systemic and not self-correcting – indeed, they are self-reinforcing. When the working generation pays taxes to provide the pensions and healthcare of the older generation, the key variable that determines the burden is the number of children the older generation had when it was the working generation. However, there were no incentives whatsoever for today's retired generation to have sufficient children when they were the working generation in order to provide the means to pay for their pensions and healthcare. Furthermore, as the population ages, reform of state pension systems becomes more difficult because of the weight of older people amongst the electorate. The median age of an active voter in the UK is already over 50. In many continental European countries the median age of active voters is rising rapidly to the high 50s (see Booth et al., 2008). It is interesting that, in the recent Comprehensive Spending Review, there was very little downward adjustment made to the benefits of older people and state pensions are due to increase in real terms – possibly quite rapidly. No other group has been treated this way except the users of the health service who are also disproportionately older. A further problem is that, as the working generation shrinks relative to the retired generation, the taxes necessary to finance pay-as-you-go pension increase also. This can reduce the incentive to work and save, which then has a second-round effect on both tax revenues and the savings individuals themselves make for old age.

Of course, it should be stressed that savings, insurance and family provision are not risk-free methods of transferring income across time and for making long-term income provision in old age, as the last few years have shown us. However, those risks can be managed and, as has been noted, savers can respond to price signals as they approach retirement when real wages and annuity prices change. It is also often contended that, when people use private forms of pension provision, their retirement incomes can be inadequate. Here we should bear in mind two points. The first is that, if government provision of income, goods and services were less, people's net incomes would be greater from which saving could take place. Secondly, the only way in which government pension schemes have provided large pensions without huge contributions throughout working life is by the government throwing the burden onto generations as yet unborn.[9] It is, indeed, expensive to save throughout a thirty-five year working life to provide a pension for 25 years – brushing the cost under the carpet does not make it cheaper.

*Proposed reform*

The current UK state pension schemes are extremely complicated and their existence and interaction with the social security system substantially reduce – or even eliminate – incentives for most people to save.[10] We propose a very simple system which would provide a small but adequate system from which people would be able to contract out and make their own private provision. Individuals would be able to finance whatever retirement period they wished over whatever period they wished to supplement a small state pension that would be received from age 70, with that age being adjusted upwards as life expectancy increased. The system would be designed so that rights would be accrued within this system in such a way that they could not be increased arbitrarily.

In line with the general practice of pension reform, we propose leaving accrued rights in existing systems unchanged. With regard to future state pension accrual, we propose a new approach, but one that is based on the contributory principle. The principles of a new, sustainable, state pension system are enunciated below. The details can, of course, be changed without changing the underlying logic and sustainable nature of the system.

We suggest that, for each year of work in which an individual earns income above the lower earnings limit in the National Insurance system,[11] he would accrue a right to a pension equal to 1/45$^{th}$ of a full state pension. The new model could be implemented immediately, though it would be many years before the old model was completely phased out – transition arrangements would be needed for those who had accrued pension under both the new and existing state pension schemes.[12] The

9 As has been noted above, Record (2006) and Pensions Commission (2010) show that contributions of 40% of salary would be necessary to provide an income in retirement equal to that received by most public sector workers. To the extent that the contributions that are made are smaller and not invested, future generations are bearing the burdens through implicit debt that is accumulating.

10 See Field (2002) – the situation has not improved since this time.

11 This is currently just over £5,000 per annum and is designed to be at a level that makes the notion of a contributory system relevant.

12 It might be possible to phase out the old systems quickly if transition arrangements allowed rights in older systems to be transformed into rights in the new system of equal actuarial value.

full state pension would be set at a level of around £140. This level is close to the current pension credit minimum income guarantee and somewhat below the level of the current combined Basic State Pension and Second State Pension. The pension would be financed by national insurance contributions levied, as now, separately from the income tax system.

Other features of this pension regime would be as follows

- The accrued pension would be indexed to median wages before retirement as would the basic level of pension which determined how much pension was accrued each year.
- Once in payment the pension would be linked to increases in the Retail Prices Index.
- All individuals could contract out of the system on simple and actuarially neutral terms so that they would receive a rebate of National Insurance contributions to invest in a private pension scheme. Full privatisation of pension provision would therefore be possible on a voluntary basis.
- Some accrual of pension would be given for those who were not paying National Insurance contributions in certain circumstances as is the case now.
- State pension age would be adjusted every five years so that life expectation at pension age would remain the same as life expectation at age 70 today.
- The number of years that it would be necessary to work to receive a full pension would rise in line with the state pension age.
- Once a full pension was accrued, no further state pension could be accrued but no further National Insurance contributions in respect of the state pension would be payable.
- After a phasing in period, no special level of means-tested benefits will be given to older people: those who had not contributed to the system would not be treated any differently above state pension age than they are below state pension age.

Such a system would bring significant economic advantages over the current state pensions system. These advantages would include the following:

- Two complex – indeed incomprehensible - schemes with completely separate rules would be replaced by one simple scheme.
- The currently incoherent National Insurance system would be radically simplified.
- The proposed scheme would considerably limit the extent of pay-as-you-go pension provision and fix the level of that provision in advance.
- Individuals could opt out of the scheme if they so wished thus facilitating full privatisation of pensions on a voluntary basis and a further reduction in state pay-as-you-go pension liabilities.
- Costs for National Insurance payers would be reduced significantly but it would be possible, at limited cost, for an individual to save to pay for extra benefits either to facilitate longer retirement or to facilitate a higher retirement pension. This additional saving could be through either formal pension schemes or more flexible savings products.

There would be significant long-term savings arising from the increase in the state pension age and a reduction in the total extent of the state pension scheme. Contracting out would lead to further long-term savings.

In many ways, this would take us back to Beveridge's original intention for the social insurance system. Beveridge (1942, paragraph 9) suggested:

> 'The state organising security should not stifle incentive, opportunity, responsibility; in establishing a national minimum, it should leave room and encouragement for voluntary action by each individual to provide more than that minimum for himself and his family.'

We go further, however, and allow that 'national minimum' to be provided by private means. This proposal would extend one of the most successful aspects of UK pension policy – that of contracting out. In recent years, contracting out has been undermined as a result of the government reducing National Insurance contribution rebates below fair actuarial value; the government is now in the process of removing the ability of most workers to contract out.[13]

13 There would be a practical problem with contracting out that could be resolved in various ways. Currently, percentage rate National Insurance contributions are paid for a flat-rate pension. This leads to significant redistribution within the scheme. Either National Insurance contributions would have to return to being flat rate (together with reductions in other taxes paid by the less well off in order to compensate) or the rebates would have to be larger than the National Insurance contributions actually paid for those workers who are less well paid. Neither approach creates any particular practical difficulties and the best approach would depend on the shape of the tax system after taking into account all the tax reductions that would be possible across government.

## Conclusion

We propose that many of the benefits currently given to old people are abolished, that older people do not get special treatment in the tax system, and that we have a long-term sustainable settlement for the state pension system which allows people to make alternative private provision if they wish to do so. Other short-term adjustments are proposed to the state pension system such as raising the state pension age. The total savings from these proposals are approximately: £15.5bn per annum. In addition tax revenues of an additional £3.0bn would arise from removing special allowances for older people. Furthermore, underlying public spending would be cut by £17bn though this would not affect headline public spending because of the way in which public sector pension costs are currently incorporated in government accounts. More importantly than the short-term savings, would be significant benefits from a more coherent tax and benefits system and from long-term reforms to the state pension system.

The cuts suggested here, though radical in terms of the current political debate, generally only remove benefits that have been granted in the last 15 years. However, the proposed reform of the state pension system would have radical implications for spending in the long term.

## References

Bartholomew, J. (2004), *The Welfare State We're In*, London: Politicos.

Beveridge, W. (1942), *Social Insurance and Allied Services*, London: His Majesty's Stationery Office.

Booth, P. M. and Cooper, D. R. (2005), *The Way Out of the Pensions Quagmire*, Research Monograph 60, London: Institute of Economic Affairs.

Booth, P. M., Juurikkala, O. and Silver, N., (2008), *Pension Provision: Government Failure Around the World*, Readings 63, London: Institute of Economic Affairs.

DWP (2010), *When should the state pension age increase to 66? A call for evidence*, London: Department for Work and Pensions.

Deacon, A. (ed), (2002), *Debating Pensions: self-interest, citizenship and the common good*, London: Civitas.

Hagist, C., Moog, S., Raffelhuschen, B. and Vatter, J., (2009) *Public Debt and Demography: an international comparison using generation accounting*, Germany: CESifo, DICE Report.

Institute for Fiscal Studies (2011) *The IFS Green Budget, February 2011*, London: IFS.

Pensions Commission (2010), *Reforming Public Sector Pensions – solutions to a growing problem*, London: Institute of Directors.

Record N. (2006), *Sir Humphrey's Legacy*, Hobart Paper 156, London: Institute of Economic Affairs.

Institute of Economic Affairs
2 Lord North Street
London
SW1P 3LB

www.iea.org.uk