PENSIONS POLICY INSTITUTE
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Future Government spending on pensions

PPI Briefing Note Number 3

Introduction
Successive pension policy reforms over the last 20 years have reduced the average state pension benefit. Reforms since 1997 such as the introduction of State Second Pension (S2P) and Pension Credit (PC) have been designed to make targeted benefits more generous[1]. This is part of the current Government strategy to constrain state spending on pensions to around 5% of GDP, target spending on low income pensioners and encourage voluntary saving.

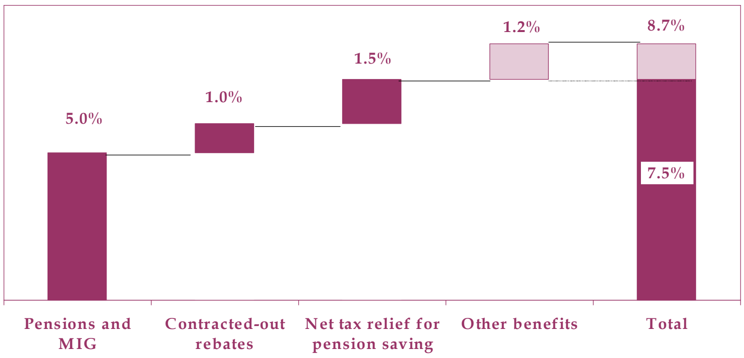
How much does the Government spend today?
State spending on pensions is usually measured as a proportion of Gross Domestic Product (GDP). This relates the amount spent on pensioners to the size of the economy.

In 2001, the Government spent 5% of GDP (£50 bn) on pension benefits—the Basic State Pension, SERPS and S2P, the Minimum Income Guarantee and the winter fuel payment[2].

Most other countries currently spend a higher proportion of GDP on pensions—**the average among EU countries is around 10%[3], and in OECD countries around 7.5%[4].** However, it is difficult to compare this directly with UK figures, as the structures of retirement provision are so different.

For example, in the UK **the economic cost of supporting private pensions is 2.4% of GDP[5].** 1% of GDP (£10 bn) is paid in contracted-out rebates, while around 1.5% (£15 bn) is spent on tax relief for private pension contributions. This increases the cost to government of pensions to 7.5% of GDP—£75 bn (Chart 1)[6].

Chart 1: The 'economic cost' of pensions and other benefits to the state as a percentage of GDP – 2001/2



On top of this, the Government pays **other benefits to those over state pension age (SPA), worth 1.2% of GDP (£12 bn) in 2001[7].** The most significant of these are Housing Benefit, Attendance Allowance, Disability Living Allowance and Council Tax Benefit.

How will this change in the future?
Over the next 40 years, the number of people aged SPA or older is expected to increase by 40%[8]. But **state expenditure on pension benefits is projected to stay relatively flat, at around 5% of GDP** throughout (Chart 2)[9].

This is achieved by reducing the value of the benefits paid per pensioner, relative to the size of the economy. **By 2040 each individual pensioner will receive on average a 40% smaller share of GDP than pensioners do today[10].**

In virtually all other countries, spending as a proportion of GDP is projected to increase further in future, as an increasing number of pensioners more than offsets planned reductions in state pensions[11].

The UK projections only cover expenditure on pension benefits. Projections of contracted-out rebates are made separately. There are no projections for tax relief on private pension saving.

PPI Briefing Notes clarify topical issues in pensions policy.

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It is important to consider both tax contracted-out rebates and tax relief as part of the long-term cost of pensions. The balance between state spending and state support for private saving has important consequences for future pensioners' incomes, and on the distribution of incomes. Lower income pensioners have received less in contracted-out rebates and tax relief.

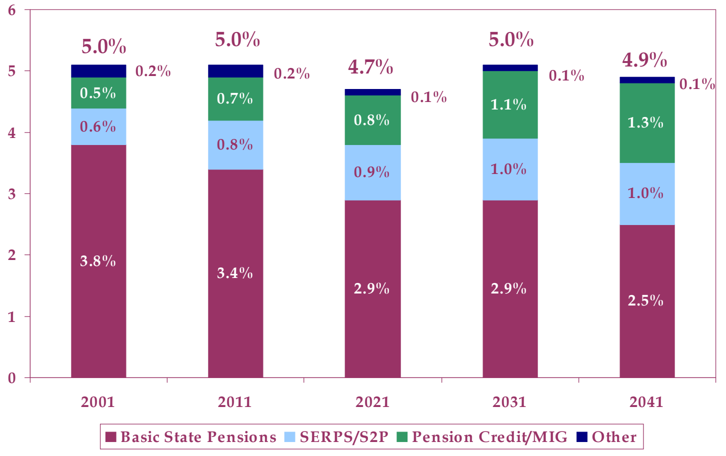
Some of the value of support for private pensions could be available to spend in other ways.

The system of contracted-out rebates means that other National insurance contribution levels are increased to cover current payments on state pensions. If contracted-out rebates were abolished, and the level of National Insurance contributions was not reduced to compensate , the money not spent on rebates could be used to pay higher state pensions[12].

Tax relief is really an economic cost rather than an actual cost. If tax relief were abolished, tax revenue would not increase by a full 1.4% of GDP, as people may switch to other forms of tax efficient saving, or spend the money instead. There would be some increase in tax revenue, but it is hard to say how much.

Changes in expenditure on other state benefits paid to pensioners are difficult to predict. For example, even though Housing Benefit may in future be available to higher income pensioners[13], the proportion of pensioners renting in future is likely to fall[14], so it is unclear what the overall impact might be.

Chart 2: Projected state pension expenditure as a percentage of GDP (components of first bar in Chart 1)



How certain are the projections?
There is always a large degree of uncertainty in projecting forward 30 or 40 years. For state pension projections in every country, expenditure is largely determined by what happens to life expectancy, and what happens in the labour market. For example, UK projections assume that average life expectancy will increase more slowly in future[15], and no change in labour market participation from 2007/8[16]. Different assumptions could change expenditure projections significantly.

In the UK there is additional uncertainty. For example, the amount paid in means-tested benefits depends on income received from other sources, including private pensions.

The current DWP projections assume that this private income increases in line with earnings growth. **If instead private income grows in line with prices, expenditure on state pensions would be around 2% of GDP higher by 2050**[17].

[1]See PPI (2003) *The Pensions Primer* for detail of policy reforms
[2]DWP (2003) *Simplicity, security and choice: Working and saving for retirement*
[3]European Commission (2003) *Joint report by the Commission and the Council on Adequate and Sustainable pensions*
[4]OECD (2002) *Economic Policy Committee, Working Paper 1 on Macroeconomic and structural policy analysis*
[5]This is revenue foregone, rather than actual expenditure
[6]PPI analysis of DWP and IR data, published in O'Connell (2003) *A Guide to State Pension Reform* PPI
[7]PPI analysis of DWP benefit expenditure figures
[8]GAD 2001-based population projections
[9]DWP (2003) - see footnote 2
[10]Curry C and O'Connell A (2003) *The Pensions Landscape* PPI
[11]See footnotes 3 and 4
[12]As suggested, for example, by the National Association of Pension Funds
[13]Qualifying income levels for HB are linked to qualifying incomes for the Guarantee Credit (part of the Pension Credit), which are assumed to increase in line with earnings
[14]Curry C and O'Connell A (2003) - see footnote 10
[15]GAD 2001-based population projections
[16]DWP (2003) - see footnote 2
[17]House of Commons Hansard, 3 June 2003, Column 390W

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