How much should the state spend on pensions?

Introduction

The PPI, the Government and the Pensions Commission have all recently published projections of future spending on state pensions. This Briefing Note compares the projections, and considers how much the state should spend on pensions.

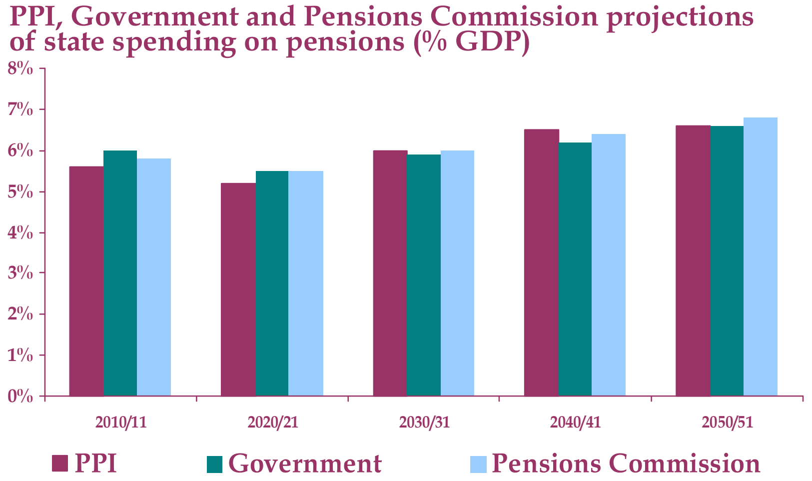
What is counted as state spending on pensions?

State spending on pensions includes expenditure on the Basic State Pension, SERPS / State Second Pension, Pension Credit and other pensioner benefits, such as Winter Fuel Payments[1].

The state partly 'pre-funds' future state pensions through contracting-out. As this reduces future state expenditure, the PPI includes it in current state spending. If it were not included, future liabilities could appear to reduce (e.g., if contracting-out increased) at no current cost.

Two different types of state spending are not included here. There is an annual 'cash-flow' cost of 1.8% of GDP[2] of paying tax relief on private pension contributions (after allowing for the tax paid on private pensions in payment[3]). And 1.5% of GDP (projected to rise to 2% by 2054) is spent each year on paying public sector pensions[4].

Chart 1: State spending on pensions will rise in future ...



How much will the current system cost?

Between 2010 and 2020 state spending on pensions is projected to fall slightly under the current system, as state pension age (SPA) for women rises from 60 to 65 (Chart 1[5]).

After 2020, state spending on pensions is projected to increase. It will rise above 6.5% of GDP by 2050 compared to less than 6% of GDP in 2010.

The PPI, Government and Pensions Commission projections have been made using different data and modelling techniques, but they all show a similar pattern of rising expenditure. However, within this apparent consensus there is still some uncertainty about the future costs of the current pension system.

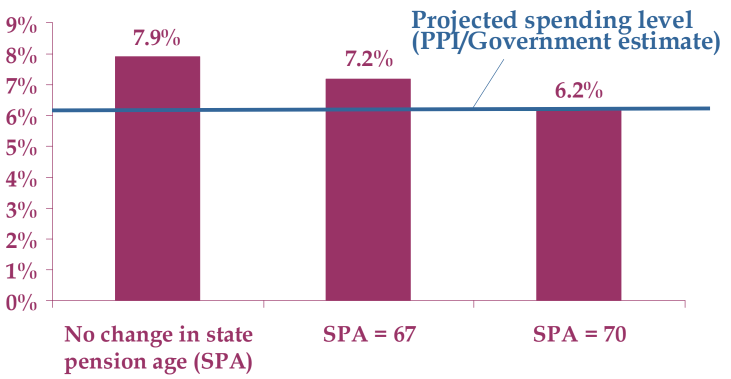
Much of this uncertainty is due to Pension Credit (PC), which will become a larger proportion of state pension spending[6]. PC expenditure is uncertain as it depends on how the income used to calculate entitlement to PC grows and on future take-up of PC; both of which factors are difficult to predict[7].

In the latest Government estimates, the assumption of how much other income future pensioners may have was revised, using detailed projections rather than simply assuming growth in line with average earnings. This increased projected future cost[8].

Further uncertainty surrounds the sustainability of current policy. If decisions are taken to increase PC more slowly than the indexing convention of current policy, then the less generous PC would cost less.

Chart 2: ...but will not keep pace with a growing pensioner population

Level of state spending on pensioners (i.e. excluding contracted-out rebates) required in 2050 (17.5m pensioners) for state spending per pensioner to be the same % GDP as in 2010 (12.2m pensioners)



What is affordable?

The expected fall in expenditure to 2020 suggests some scope for a more generous system to be introduced, while keeping short-term spending below 2010 levels. But resources would have to re-allocated from other areas, such as health and education, if the expected fall in pension costs has already been factored into spending plans.

Alternatively, existing pension resources could be shared differently between future and current pensions. For example, spending less on contracting-out (or tax relief) would free up current resources.

There has been little debate, and no consensus, on the balance of spending between current and future pensioners, or on the politically acceptable or affordable level of long-term spending.

One useful test for long-term acceptability is how state spending on pensioners[9] increases relative to the number of people over state pension age (Chart 2[10]). To keep pace to 2050 state spending would need to increase to almost 8% of GDP.

Increasing SPA would reduce the level of required spending. If SPA were 70 by 2050, which seems difficult to achieve, the projected spend on current policy would pay each pensioner roughly the same amount as they receive on average today.

Benchmarking to other countries suggests a worldwide expectation that spend should increase from current levels as the number of older people increases. So, it is unlikely to be acceptable to make up all the extra cost from demographic change by raising SPA[11].

The Pensions Commission suggested future state spend on pensioners should be in the range of 6.5% and 7.0% of GDP (on the basis used here[12]) assuming a rise in SPA to 67 or 69 by 2050. The Government's revised projections now reflect an expectation that state spending on pensions should increase (whereas previously the spend was projected to be level to 2050). But the increase is at the lower end of what seems politically acceptable (Chart 2).

Instead, the upper end of the range suggested by the Pensions Commission looks more appropriate (around 7% of GDP), provided that SPA can be increased to 67 or 68 by 2050.

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1 Other benefits, such as disability, housing and council tax benefits are not included here as they are for specific needs not general income
2 PPI Pension Facts, Table 25
3 Curry and O'Connell (2004) *Tax Relief and incentives for pension saving* PPI
4 HMT (2005) *Long-term public finance report: an analysis of fiscal sustainability* for PBR 2005
5 Steventon (2005) *What will pensions cost in future?* PPI, Pensions Commission (2005) *Second Report* and HMT (2005)
6 See Steventon (2005)
7 See Steventon (2005)
8 Projections made for Budget 2005 estimated total spending of 5.8% of GDP in 2050
9 As spending on contracting-out benefits future rather than current pensioners, it is excluded
10 PPI calculations based on HMT (2005) and GAD 2004-based population projections
11 See PPI Briefing Note Number 26 *Will spending on state pension remain level?*
12 Pensions Commission (2005) page 12, excluding housing and disability benefits