

PENSIONS POLICY INSTITUTE

PPI

The cost of alternative state pension reform options
A PPI paper for the TUC
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The cost of alternative state pension reform options

Summary

1. This document is provided to the TUC as an independent assessment of the costs of three different proposals for state pension reform:
 - A. A Universal Pension at the current level of the Basic State Pension (£82 per week or 16% of National Average Earnings)
 - B. A Universal Pension at the current level of the Guarantee Credit (£109 per week or 21% of National Average Earnings)
 - C. Increasing the Basic State Pension to the level of the Guarantee Credit
2. In all three alternative reform options considered:
 - The pension is uprated each year in line with average earnings growth
 - The State Second Pension (S2P) and contracting-out are retained
3. In this paper, 'state expenditure on pensions' means the annual cost to the public purse of paying Basic State Pension, Additional Pension (SERPS and State Second Pension), Pension Credit and contracted-out rebates. The government estimates of this future state expenditure are 5.9% of GDP in 2010 and 5.8% of GDP by 2050.
4. Under all of the reform options considered in this paper, state expenditure on pensions is projected to grow faster over time because the pension is uprated each year in line with average earnings growth.
5. The projections in this paper show that if the Universal Pension were introduced at the level of Basic State Pension, state expenditure on pensions would be around 6.3% of GDP (£90 billion) in 2010. This would grow to around 8.5% of GDP by 2050.
6. If instead the Universal Pension were introduced at the level of the Guarantee Credit, expenditure would be greater, at around 7.3% of GDP (£100 billion) in 2010. This is 1.0% of GDP (£10 billion) more than the cost of a Universal Pension at the level of the Basic State Pension. Again, expenditure would grow over time, from 7.3% of GDP to around 10.0% of GDP by 2050.

7. If the Basic State Pension were increased to the level of the Guarantee Credit, expenditure could be around 6.2% of GDP (£90 billion) in 2010. This is around 1.1% of GDP (£10 billion) less than the cost of a Universal Pension at the same level. By 2050, the higher Basic State Pension is not be expected to cost so much less than the Universal Pension at the same level.
8. The future cost of the current pensions system is uncertain and could be higher than expected. This means that the amount that would have to be found in 2050 to finance the reforms on top of the future cost of the current system is uncertain:
 - For the Universal Pension at the level of the Basic State Pension: between 1.2% and 2.9% of GDP
 - for the Universal Pension at the level of the Guarantee Credit: between 2.5% and 4.4% of GDP
 - for a Basic State Pension at the level of the Guarantee Credit: between 2.3% and 4.2% of GDP
9. Other reform options and transition paths to a Universal Pension or a higher Basic State Pension could cost less. For example, a Universal Pension replacing both Basic State Pension and State Second Pension could be more affordable. These different options and transition paths have different consequences for current and future generations over state pension age and for different income groups that are not discussed in this paper.

Introduction

10. The TUC has commissioned the PPI to provide an independent estimate of the potential costs of three alternative state pension reforms:
 - A. The introduction of a Universal Pension, payable to all residents over state pension age, at the level of the Basic State Pension (£82.05 per week or 16% of National Average Earnings)
 - B. The introduction of a Universal Pension at the level of the Pension Guarantee Credit (£109.45 per week or 21% of National Average Earnings)
 - C. Increasing the Basic State Pension to the level of the Pension Guarantee Credit (£109.45 per week or 21% of National Average Earnings), maintaining the current National Insurance contributory system as the criterion for eligibility

11. The Pensions Policy Institute (PPI) is independent and does not make policy recommendations, but exists to contribute facts and analysis to help all commentators and policy decision makers. The PPI has extensively analysed a 'Citizen's' or 'Universal' Pension.

12. This assessment:
 - Examines the potential costs of the alternative reform proposals
 - Compares these costs with the potential costs of the current state pension system to estimate how much would need to be found to finance reform

13. In all three alternative reform options considered:
 - The pension is uprated each year in line with average earnings growth
 - The State Second Pension (S2P) and contracting-out are retained
 - The pension is paid to individuals, so two partners in a couple receive the same as two single people
 - State pension age remains unchanged apart from the planned increase in state pension age for women from 60 to 65.Some or all of these features could be changed to reduce the costs of the reforms.

14. This paper assumes that the Universal Pension is introduced in 2010, the earliest possible date allowing for consultation and legislation. Introducing these reforms at an earlier date would not significantly alter their cost.

15. It has been assumed in this paper that the Universal Pension would not be payable to non-residents but any pension currently being received by non-residents would be protected. It has been assumed that under the option to increase the Basic State Pension to the level of the Guarantee Credit, pensions currently being received by non-residents as well as residents would be increased immediately in 2010.

16. Where the Universal Pension is introduced at the level of the Basic State Pension this paper assumes that the Universal Pension will be set at the current level of 16% of National Average Earnings (NAE) (around £102 per week in 2010). This means that the value of the pension relative to earnings is preserved between now and 2010. If instead the pension were increased in line with prices between now and 2010 in line with government policy, the Universal Pension would be lower, at around £93 per week in 2010. The cost of introducing the Universal Pension at this level would then be lower than the cost of option A shown in this paper.

Projections of the costs of the reform proposals

17. All three reforms involve an increase in state pension provision and therefore are projected to have an extra cost on top of the cost of the current system:
- Uprating in line with earnings has an increasing cost over time
 - A Universal Pension at the level of the Guarantee Credit costs more than one at the level of the Basic State Pension
 - A Universal Pension at the level of the Guarantee Credit costs more than the higher Basic State Pension in the short-term but not so much more in the long-term
18. In this paper, 'state expenditure on pensions' means the annual cost to the public purse of paying Basic State Pension, Additional Pension (SERPS and State Second Pension), Pension Credit and contracted-out rebates. The government estimates of this future state expenditure under the current system are 5.9% of GDP in 2010 and 5.8% by GDP in 2050.

Uprating in line with earnings has an increasing cost over time

19. Under all of the reform options, state expenditure on pensions is projected to grow over time because the pension is uprated each year in line with average earnings growth (Table 1).
20. For example, if the Universal Pension were introduced at the level of the Basic State Pension, pensions expenditure is projected to be around 6.3% of GDP (£90 billion) in 2010. The effect of uprating the pension in line with average earnings growth means expenditure is projected to grow to around 8.5% of GDP by 2050.

Table 1¹: Projected expenditure on pensions as a percentage of GDP and in £ billion in 2005/6 prices

	UP at the BSP level and uprating with earnings	UP at the GC level	Increasing BSP to GC level
2010	6.3%	7.3%	6.2%
2020	6.3%	7.4%	6.6%
2030	7.4%	8.8%	8.2%
2040	8.2%	9.7%	9.3%
2050	8.5%	10.0%	9.8%
2010	90	100	90
2020	110	140	120
2030	160	190	180
2040	210	250	240
2050	270	320	310

A Universal Pension at the level of the Guarantee Credit costs more than one at the level of the Basic State Pension

21. If the Universal Pension were introduced at the level of the Guarantee Credit, pension expenditure is projected to be around 7.3% of GDP (£100 billion) in 2010. This is 1.0% of GDP (£10 billion) more than the cost of a Universal Pension at the level of the Basic State Pension.

22. Over time, the cost of a Universal Pension at the level of the Guarantee Credit increases from 7.3% of GDP to around 10.0% of GDP in 2050. This is 1.5% of GDP more than the cost of a Universal Pension at the level of the Basic State Pension.

¹ PPI estimates using the Aggregate Model and Distributional Model (see the next Section and the Appendix for more details)

A Universal Pension at the level of the Guarantee Credit costs more than the higher Basic State Pension in the short-term but not so much more in the long-term

23. If the Basic State Pension were increased to the level of the Guarantee Credit, expenditure could be around 6.2% of GDP (£90 billion) in 2010. This is around 1.1% of GDP (£10 billion) less than the cost of a Universal Pension at the same level.
24. However, by 2050, the higher Basic State Pension is not expected to cost so much less than the Universal Pension at the same level, reflecting:
- The Universal Pension may not be paid to future generations of non-residents. The number of non-resident pensioners is projected to grow slightly over time.
 - Entitlements to the current contributory system are projected to improve slowly over time.

What is included in the projections

25. This section sets out important notes about what is and is not included in the projections. Further details can be found in the Appendix. The next section goes on to discuss the uncertainty in the amount that would have to be found to finance the reforms on top of the future cost of the current system.

26. The projections include:

- Basic State Pension / Universal Pension
- State Earnings Related Pension and State Second Pension
- Guarantee Credit (see paragraph 30)
- Savings Credit for the option with the Universal Pension set at the level of the Basic State Pension (see paragraph 31)
- An allowance for a reduction in Housing Benefit and Council Tax Benefit entitlements resulting from an improvement in state pension provision
- Savings through an increase in income tax paid by pensioners resulting from the more generous state pension. This saving is based on tax thresholds being uprated with average earnings from 2010. If instead current government policy of uprating with prices were continued into the long-term, the savings would be higher than shown (Table 2)².

Table 2³: Possible increase in income tax paid by pensioners in 2050 as a percentage of GDP as a result of reforming the state pension system

	UP at the BSP level and uprating with earnings	UP at the GC level	Increasing BSP to GC level
Maximum likely saving - If tax thresholds continue to be increased with prices	1.1%	1.6%	1.8%
Savings allowed for in the projections - If tax thresholds are increased with earnings after 2010	0.2%	0.4%	0.6%

² The amount of savings is uncertain in how tax thresholds are uprated in the future. If the tax thresholds continue to be uprated in line with prices but pensions rise faster than prices, fiscal drag would mean that pensioners pay more tax.

³ PPI estimates using the Aggregate Model and Distributional Model (see the Appendix for more details)

27. The projections do not include:
- Winter Fuel Payments, the Christmas Bonus and the 25p per week addition for the over 80s after reform in 2010. Abolishing these benefits makes little difference to the projected cost⁴.
 - Graduated Retirement Scheme (GRAD). GRAD expenditure is relatively small (£1-2 billion in 2004⁵) and is expected to decrease rapidly.
28. The projections for the cost of the Universal Pension also include the cost of continuing to pay the pensions currently being received by the existing generation of non-residents. The projections assume that if a Universal Pension were introduced, the Universal Pension would not be paid to any non-residents in the future. In practice, there might be a transitional or special arrangement.
29. Guarantee Credit is assumed to be retained under all of the reforms. Although all residents would be entitled to the Universal Pension, Guarantee Credit would still be in payment for special categories of older people such as the severely disabled, even if the Universal Pension was set at the level of the Guarantee Credit.
30. Under the options of the Universal Pension set at the level of the Guarantee Credit and the higher Basic State Pension, Savings Credit is assumed to be abolished. To avoid cash losers in the transition, it may be necessary to protect all or some of the Savings Credit that is in payment when the reforms are introduced. This extra cost is not included in the projections.
31. Savings Credit is assumed to be retained under a Universal Pension at the level of the Basic State Pension. The projections assume that for this option the minimum income level for entitlement to the Savings Credit⁶ is uprated each year in line with average earnings growth, to maintain it at the level of the foundation pension.

⁴ The cost of these benefits is projected to decrease as a percentage of GDP because they are not automatically uprated. If these benefits were continued, they are projected to cost around 0.1% of GDP in 2050.

⁵ DWP (2005) *State Pension Summary of Statistics September 2004*

⁶ The Savings Credit Threshold

32. Note that under the current legislation, the Lower Earnings Limit (LEL) is calculated by reference to the level of the Basic State Pension. However, the projections in this paper assume that if the reforms were introduced, this link would be broken and the LEL would continue to be uprated in line with prices. If instead the LEL were increased to the level of the Guarantee Credit from 2010 onwards, there would be a reduction to the amount of S2P accruals and fewer people would qualify for BSP. In this case, the cost of the Universal Pension at the level of the Guarantee Credit and the higher Basic State Pension would be lower than shown in this paper.

Uncertainty in the future cost of the current system

33. The future cost of the current pensions system is uncertain and could be higher than expected. This means that the amount that would have to be found to finance the reforms on top of the future cost of the current system is uncertain.

34. Projections of Pension Credit expenditure are very sensitive to the amount of income older people have and to take-up levels. Current government projections make assumptions that may turn out to be too optimistic, resulting in an underestimate of future Pension Credit expenditure:

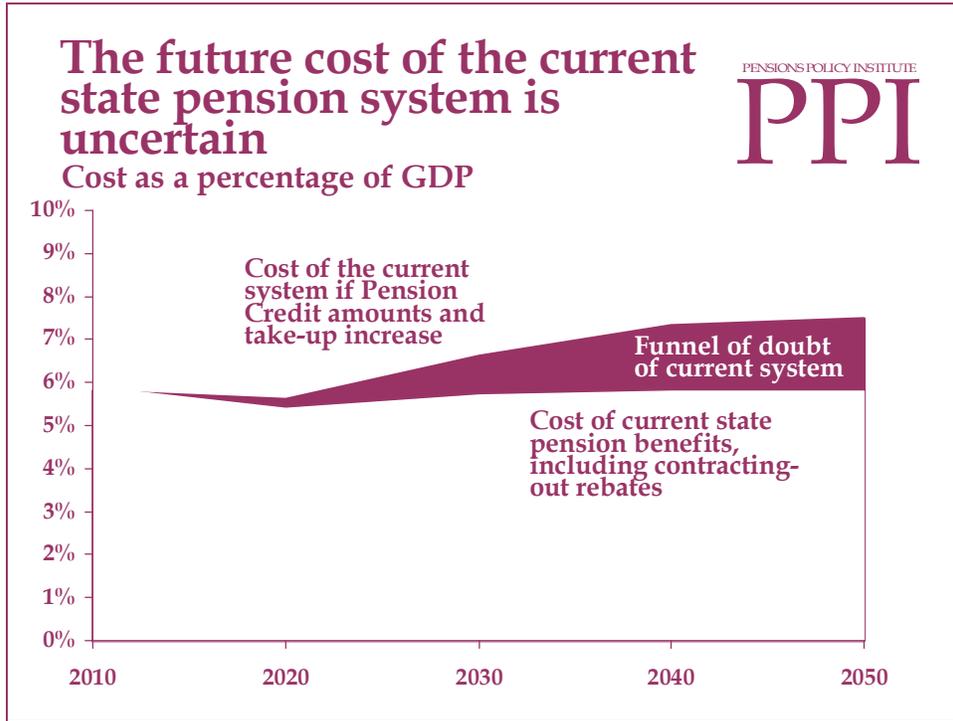
- Income taken into account in Pension Credit is assumed to increase in line with earnings⁷. This has been the case over the last 20 years. However, average state pension income is projected to increase slower than earnings in the future and average private pension income is expected to decline. There is uncertainty that non-pension saving and/ or earnings will be enough to make up the difference.
- Pension Credit take-up is assumed to remain at current levels⁸. An increase in take-up would increase the cost.

These uncertainties result in a funnel of doubt for the future cost of the current system (Chart 1 and Table 3).

⁷ DWP (2005) *Long-term projections of benefit expenditure: assumptions*
http://www.dwp.gov.uk/asd/asd4/explanatory_notes_long_term.asp

⁸ The current average take-up for Pension Credit as a whole is 75%. Take up of Guarantee Credit is higher, and for Savings Credit lower.

Chart 1⁹



⁹ PPI estimates using the Aggregate Model and Distributional Model (see the Appendix for more details) and latest government projections. The upper estimates are based on take-up increasing from 75% to 100% and assume that income from state pensions will increase in line with the other projections in this paper but that income from non-state sources will increase in line with prices. The upper bound illustrates the maximum possible cost, rather than the likely possible cost. It is theoretically possible for the cost to be lower than the minimum or higher than the maximum shown, but this is unlikely.

Table 3¹⁰: Projected expenditure on pensions under the current system as a percentage of GDP and in £ billion in 2005/6 prices

	Government projections	PPI base case scenario	PPI 'pessimistic' scenario
Growth in income	All income with average earnings	State and private pensions as expected (less than earnings), all other income with earnings	State pensions as expected (less than earnings), all other income with prices
Take-up	Remains at current levels	Small increase for Savings Credit	Increases to 100%
2010	5.9%	5.6%	5.8%
2020	5.4%	5.2%	5.6%
2030	5.7%	6.0%	6.6%
2040	5.8%	6.5%	7.3%
2050	5.8%	6.6%	7.5%
2010	80	80	80
2020	100	100	100
2030	120	130	140
2040	150	170	190
2050	180	210	240

35. If the future cost of the current pensions system turns out to be higher than expected, the extra amount that would have to be found in 2050 to finance the reforms could be less. Allowing for the uncertainty, the extra amount needed in 2050 could be (Table 4):

- for the Universal Pension at the level of the Basic State Pension: between 1.2% and 2.9% of GDP
- for the Universal Pension at the level of the Guarantee Credit: between 2.5% and 4.4% of GDP
- for a Basic State Pension at the level of the Guarantee Credit: between 2.3% and 4.2% of GDP

¹⁰ Government projections are those for the 2005 Budget. PPI projections are based on the Aggregate Model and the Distributional Model. Costs include Basic State Pension, SERPS / S2P, other state benefits (such as winter fuel allowances), Pension Credit and the cost of contracted-out rebates. PPI estimates are lower in the short-term because they assume less contracting-out. See Appendix for more details.

Table 4¹¹: Extra cost on top of the projected future cost of the current pensions system as a percentage of GDP

	UP at the BSP level and uprating with earnings	UP at the GC level	Increasing BSP to GC level
2010	0.7%	1.7%	0.7%
2050 – government assumptions on Pension Credit	2.9%	4.4%	4.2%
2050 – assumptions as for PPI base case scenario in Table 3	1.9%	3.4%	3.2%
2050 – assumptions as for the 'pessimistic' scenario in Table 3	1.2%	2.5%	2.3%

¹¹ PPI estimates using the Aggregate Model and Distributional Model (see the Appendix for more details)

Appendix: Assumptions and methodology used in the projections

The projections in this paper have been produced using the PPI Aggregate Model and Distributional Model. These models have been developed by the PPI to assess the impact of long-term policy options. The development of the models has been funded by the Nuffield Foundation.

The Aggregate Model has been used to project future expenditure on Basic State Pension, Universal Pension, State Earnings Related Pension, Second Pension and contracted-out rebates.

The projections of future expenditure are based on a projection of the UK labour market which assumes a constant rate of earnings growth and constant employment rates, after the state pension age for women has been increased to 65 in 2020. The projections allow for a continuation of current trends in contracting-out and entitlements to the Basic State Pension.

The Distributional Model has been used to project future expenditure on Pension Credit and also to assess the broad impact of the introduction of a Universal Pension on the amount of income tax paid by people over state pension age.

The projections of future Pension Credit expenditure are based on a projection of the distribution of pensioners' incomes. This underlying projection is based on the 2003/4 Pensioners' Income Series dataset but has been trued-up to the Aggregate Model results to allow consistent analysis.

All projections are ultimately driven by the data and assumptions they use and are subject to considerable uncertainty, even in the short-term. They are best interpreted as an illustration of the possible differences in cost between the different reform options considered, rather than what the cost would be under each individual option.

The assumptions adopted in this paper are broadly similar to the assumptions underlying the latest government projections of the future cost of the current system. The main difference is that the projections of the future cost of Pension Credit used in this paper are based on pension income increasing in line with the Aggregate Model projections, rather than with average earnings. This tends to increase the projected cost of Pension Credit.

Assumptions have been made on future pensions policy and on the UK economy as a whole.

The state pension system

Except for the reforms modelled, the central projections in this paper assume that the current state pension system continues, with the same uprating conventions as are used today¹²:

- The Basic State Pension and State Second Pension when in payment are assumed to be increased in line with prices. The Basic State Pension is assumed to remain the minimum level of entitlement to Savings Credit.
- The Guarantee Credit is assumed to be increased in line with earnings.
- The Lower and Upper earnings limits for State Second Pension are assumed to increase in line with prices. The Lower Earnings Threshold (the LET – the ‘flat-rate’ part of State Second Pension) is assumed to increase in line with earnings. The Upper Earnings Threshold is assumed to increase to reflect the changes in the LET, ensuring that higher earners receive the same in State Second Pension as they would have received in SERPS. However, when the Upper Earnings Threshold overtakes the Upper Earnings Limit, it is assumed to be uprated in line with prices.
- The baseline costings assume that Pension Credit take-up:
 - Remains at 85% for people who are entitled to both the Guarantee Credit and Savings Credit components.
 - Remains at 74% for people who are only entitled to the Guarantee Credit component.
 - Increases from the current level of 38% to around 60% for people who are only entitled to the Savings Credit component, as Savings Credit becomes a more significant part of older people’s income.

¹² For more details, see *The Pensions Primer*, www.pensionspolicyinstitute.org.uk

Private pension assumptions

The future cost of Pension Credit depends on future levels of income from private pensions, which are explicitly modelled in the PPI base case scenario:

- Current levels of private pension saving are based on revised ONS estimates of the amount of contributions that are currently being paid to funded pensions.
- The projections assume that there will be a shift from Defined Benefit to Defined Contribution pension provision. It is assumed that all members of Defined Benefit schemes begin to accrue in an alternative type of pension scheme when their scheme closes, at the current average level of DC contribution.
- The result of these assumptions is that contributions to funded private pension schemes are projected to total 3.0% of GDP in 2010 to 2.7% of GDP in 2050. These are similar to the Pensions Commission's central estimates (2.9% GDP).
- The projections assume phased retirement between age 55 and 72.
- All individuals take 25% of their pension fund as a tax-free lump sum.
- Most Defined Contribution and personal pensions are level and single-life.
- Annuity rates are calculated consistently with the assumed investment return and using mortality similar to that underlying current market annuity rates, adjusted to allow for future expected mortality improvements.

Macroeconomic assumptions

- Prices are assumed to grow by 2.5% each year
- Earnings are assumed to grow by 2.0% each year in excess of prices
- The age, sex and marital structure of the population is assumed to follow the Government Actuary's Department's 2003-based projections
- Employment rates are assumed to increase for women over age 50 as state pension age increases between 2010 and 2020 to be more in-line with today's employment rates for younger women
- Contracting-out in the private sector is assumed to halve between now and 2035 as defined benefit schemes are closed down but to remain at current levels in the public sector
- The assumptions used in setting contracted-out rebate rates are consistent with PPI macroeconomic assumptions in the long-term