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RAISING STATE PENSION AGE
ARE WE READY?

Raising State Pension Age: Are We Ready?

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Introduction

Many calls to raise what is usually referred to as 'retirement age' have been made recently[1]. Much analysis has focused on the falling labour force participation rate for the over 50s[2] or the need to save longer to build up adequate personal pension provision[3]. This study looks specifically at the age at which state pension becomes payable, and asks whether there is any justification for raising it. The process for such a policy change is also considered.

Why focus on State Pension Age?
Other countries are raising their State Pension Age (SPA). For example the USA is increasing SPA to 67, and Australia, Germany and Italy are among many other countries with plans to increase SPA.

In the UK, SPA is currently 65 for men and 60 for women, due to equalise to 65 for all by 2020. One could ask why have a State Pension Age at all - why not allow people a flexible age at which state pension can be taken? Further, is the age at which SPA is paid becoming increasingly irrelevant as the level of Basic State Pension (BSP) declines in earnings terms?

This paper assumes that there has to be a State Pension Age. Even if a flexible SPA were introduced, a central age would be required for ease of presentation, and from which to calculate adjustments. And SPA is used as a reference point for other state benefits besides state pension, as well as private and occupational pensions.

Further, it is assumed that there is a continuing role for the BSP. There is much debate about the appropriate role of state pensions. Should the state provide a low foundation income on top of which further private provision is expected, a guarantee of a modest standard of income, or a generous 'reward' for working? But, whatever one believes on this point, there has to be an age at which the state pension becomes payable, and the considerations around raising SPA remain.

State Pension Age is not 'retirement age'. There is no official retirement age. Many people retire when state pension becomes payable; many people do not. Since 1989, receiving state pension has not been dependent on giving up work, so that there does not have to be a direct link between receiving state pension and retiring. While retirement activity is related to the issue of SPA, and is considered later, this report aims to be clear-headed about reform of the State Pension Age.

[1] For example, IPPR (2002), ***Financial Times*** (March 2002)
[2] For example, Performance and Innovation Unit (PIU) (2000)
[3] For example, Pensions Policy Institute (2002), Axa Sun Life (2002)

Considering a change to SPA raises many questions about future situations that cannot be answered with certainty. Raising SPA is not a policy that can be implemented tomorrow. It would not be right to impose an increase in SPA on people near 65, and the SPA increase for women will not be complete until 2020. So, if SPA were to be raised, it is most likely to take effect after the year 2025. The oldest people likely to be affected by an SPA increase are currently around age 40. The potential work expectations and savings patterns of today's under-40s in thirty or more years time must be a different matter altogether than the characteristics of today's 50-65 year olds.[4] Any decision to raise SPA should not be made by extrapolation from today's situation.

About this paper

There are no policy recommendations in this paper. Its purpose is to gather the arguments from many perspectives in one place to encourage informed debate.

In Chapter 1, the reasons why raising SPA might be justified are explored. In Chapter 2, the best transition approach if SPA were to be raised is considered.

Appendix 2 on the financial implications of raising SPA was prepared by PricewaterhouseCoopers at the request of the PPI.

Feedback on this paper is welcomed. Please direct comments to Alison O'Connell at alison@pensionspolicyinstitute.org.uk

[4] See for example, Evandrou and Falkingham (2000) for a discussion of the issues in projecting forward the socio-economic characteristics of different age cohorts

Raising State Pension Age: Are We Ready? Conclusions

1. Raising State Pension Age is a legitimate - and timely - subject for debate.
   - There are enough valid reasons for raising SPA that the UK should be ready to consider it now.
   - The analysis and commentary in this paper are directed towards helping to build a fact-based consensus around a decision on whether or not to raise SPA.
   - This paper also suggests that the SPA issue should prompt debate with the aim of achieving long-term consensus on the role and level of the Basic State Pension (BSP).

2. Startling longevity improvements suggest a significant hike in SPA is overdue.
   - Many more people are living to collect their state pension: 90% compared to around 66% when the current social security system was set up around 1950.
   - People are living longer after collecting state pension: around 8 years longer than in 1950.
   - Benchmarking suggests a new SPA in the region of 72-75, so a catch-up in one step may not be practical. Further longevity improvements are forecast, so further increases in SPA may follow.

3. Raising SPA allows a higher Basic State Pension at higher ages, clarifying its role as insurance against living longer than expected.
   - It is hard to justify raising SPA for cost reasons alone. On current policy, state spending on pensions is projected to increase by only around 1 percentage point of GDP over the next 50 years.
   - But for no additional cost, the level of state pension benefit could be increased if SPA were raised. Raising SPA to 70 could free up resources to increase BSP by nearly 50% by 2030.
   - Alternatively, raising SPA allows the BSP to be increased by more at older ages: by up to 70% at ages 75 and over, at no extra cost.
   - Further increases could take older pensioners off means-tested benefits, for a small temporary extra cost. State pension resources would then be focused on giving a meaningful BSP to older pensioners, instead of a small amount to all.
   - Raising BSP at older ages clarifies the role of the BSP as a guaranteed insurance against poverty caused by living longer than expected. This role is increasingly relevant as longevity continues to improve.

4. Raising SPA should be a strong signal for today's younger workers to be prepared to work longer.
   - Raising SPA should only affect people today in their 40s or younger who should be able to adjust work and savings plans.
   - Raising SPA will reinforce other policies encouraging greater workforce participation at older ages in future. ***Not*** raising SPA appears to contradict these policies.
   - Raising SPA may prompt occupational schemes to increase normal pension age which would help relieve some of the current cost pressure on such schemes.

5. Raising SPA does not significantly alter the distribution of state pension money between income groups.
   - Life expectancy and health prospects are improving for all socio-economic groups, although lower-income people on average are unhealthier and die younger.
   - However, any relative financial disadvantage to lower-income groups on raising SPA is hard to quantify.
   - Inequalities have always been inherent in the pension system. The socio-economic disadvantage is no worse than men, who die younger on average, receiving fewer years of pension than women.
   - If other policies are in place to support those potentially vulnerable to any future increase in SPA, it would seem unreasonable ***not*** to raise SPA only because of redistributive concerns.

6. Any announcement of plans to raise SPA would need to be accompanied by activity to ensure other policies will be effective in time.
   - Communication of a decision to raise SPA is difficult because the issue tends to arouse immediate emotional responses. Clarity is important on who will be affected, when the change will take place and the reasons for the change.
   - Further research is necessary into the trends in those factors about which we know little, but are important for an increased SPA to be workable. These include the future health, caring and job prospects of people over 65.
   - The government needs to ensure that policies to help older people take suitable jobs, and to support those that cannot, are effective before any SPA change takes place.
   - The government will need to check that the private and occupational scheme sectors will be ready for a change in SPA.

Chapter 1: Is there any justification for raising State Pension Age?

This chapter considers possible justifications for raising State Pension Age (SPA). It concludes that there are powerful reasons for raising SPA to be a legitimate and timely issue for debate. The arguments for raising SPA and the difficulties with such a policy are complex. To disentangle the issues, four lines of thought are pursued:

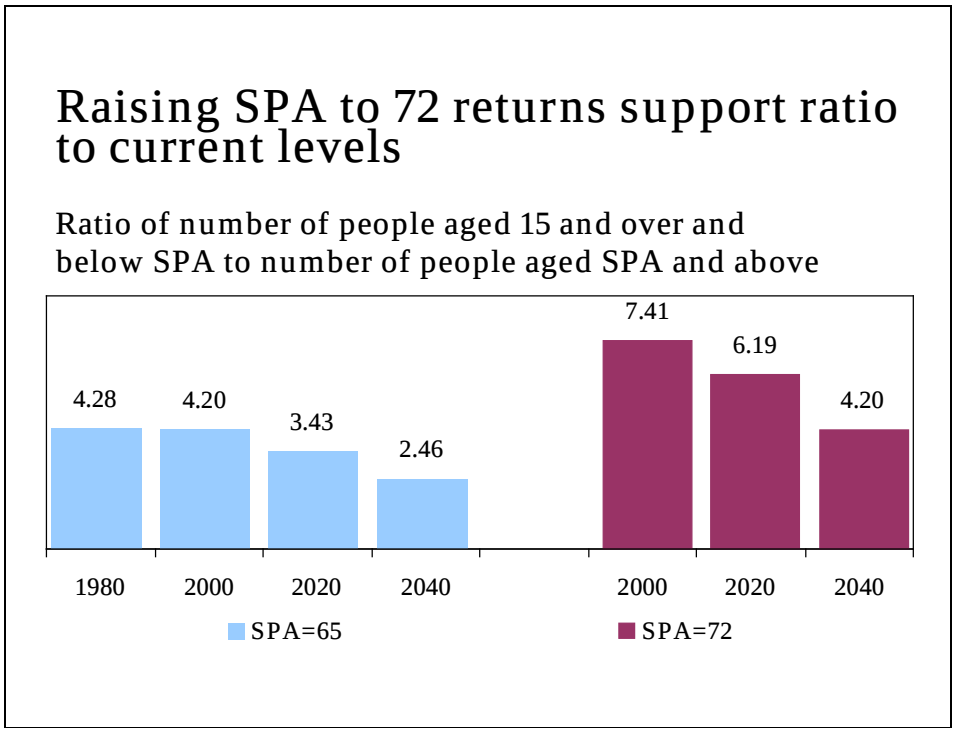
- The longevity logic: Startling longevity improvements suggest a significant hike in SPA is overdue
- The clarification argument: Raising SPA allows a higher Basic State Pension at higher ages, clarifying its role as insurance against living longer than expected
- The employment incentive: Raising SPA should be a strong signal for today's young workers to be prepared to work longer
- The distributional dilemma: Raising SPA does not significantly alter the distribution of state pension money between income groups

The longevity logic

Startling longevity improvements suggest a significant hike in SPA is overdue

The strains on state finances from an ageing population are often illustrated by the falling support ratio. For example, on one definition of this ratio, the SPA would have to increase to 72 to get the UK back to support ratio levels of the last quarter of the 20th century (Chart 1)[5].

Chart 1



Of course, this simplistic measure does not reflect the actual economic position. It does not take into account the different welfare costs for children, people of working age, or pensioners. It does not reflect the actual economic production or consumption by different age groups. But it does indicate the magnitude of demographic change on the age structure of the population as a whole.

[5] PPI analysis using Government Actuary's Department 2000-based population projections, available http://www.gad.gov.uk. See also Shaw (2001) for an earlier analysis

Part of the demographic change is the falling birthrate, which impacts how many people are available to pay for state pensions. The other demographic change is increasing longevity: people are living longer.

New data gives new insights on the extent of people living longer

Often, the increase in average life expectancies is used as a reason for considering an increase in SPA[6]. Further insights can now be obtained by using new 'cohort' mortality rates prepared by the Government Actuary's Department[7] (see Appendix 1 for further details).

For simplicity, we have concentrated on 5 cohorts, selected for the following reasons (Chart 2):

Chart 2

Explanation of cohorts used

Born in:	Age 65 in:	
1885	1950	New pensioners soon after current social security scheme set up
1915	1980	To see nature of past trends
1940	2005	Cohort reaching SPA about now – referred to as 'today's cohort'
1960	2025	Possible first cohort fully affected if legislation passed now for SPA to rise in future- the 'change cohort'
1980	2045	To see nature of possible future trends

More people are living to collect their state pension

The proportion of people who, having survived childhood to reach age 25, then live to collect their state pension has leapt up since the social security system was set up (Charts 3 and 4).

[6] For example, Daykin (1998), p 10

[7] Not yet published; used with permission and thanks

Chart 3

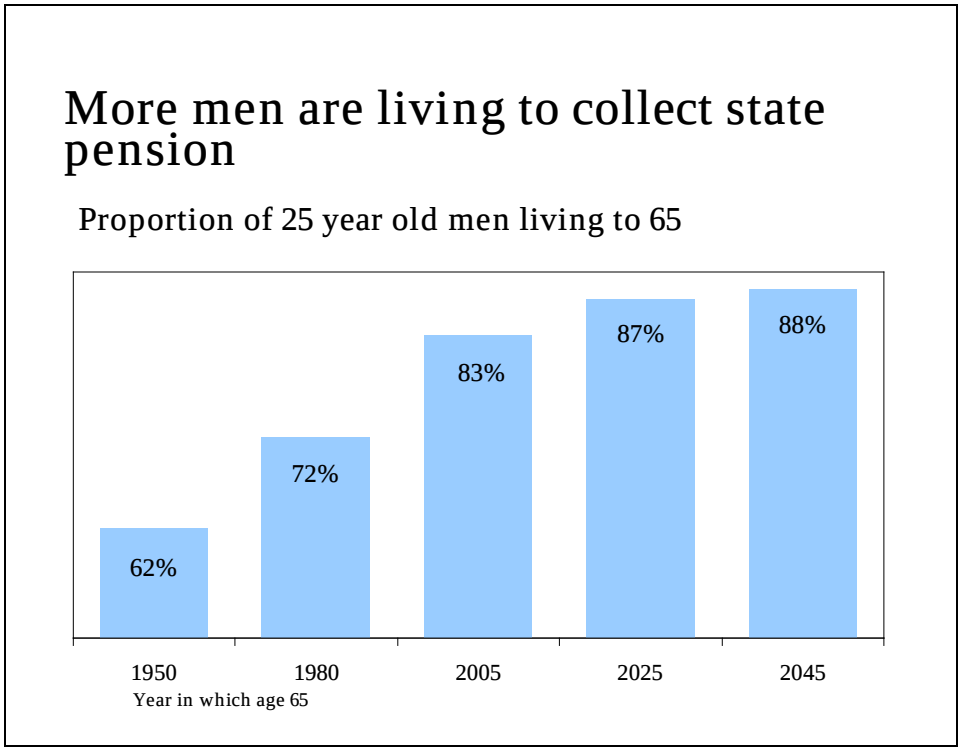
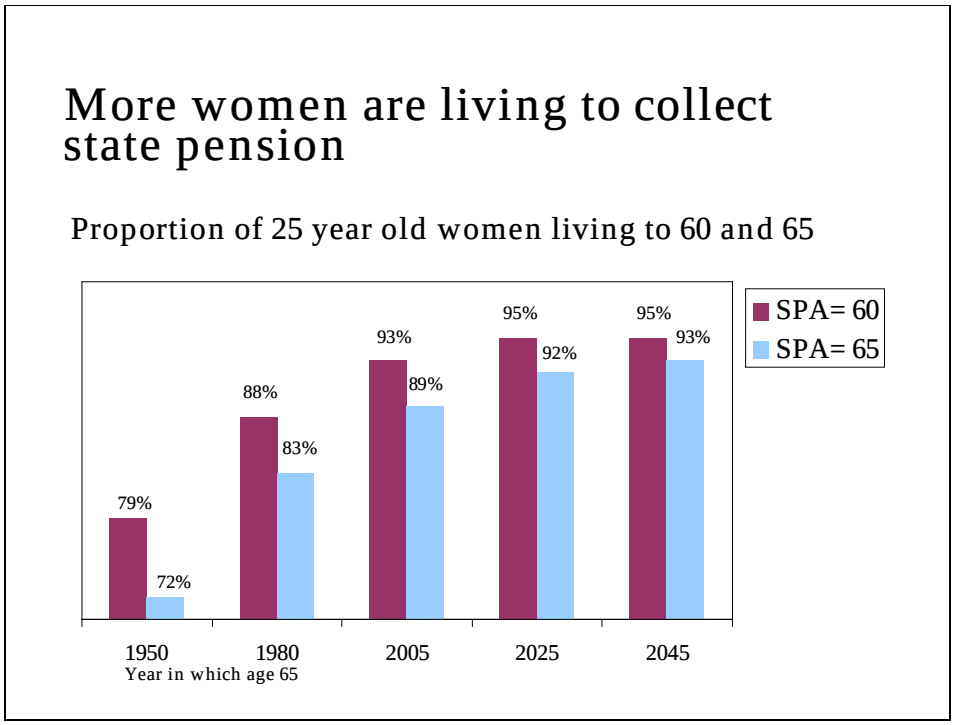


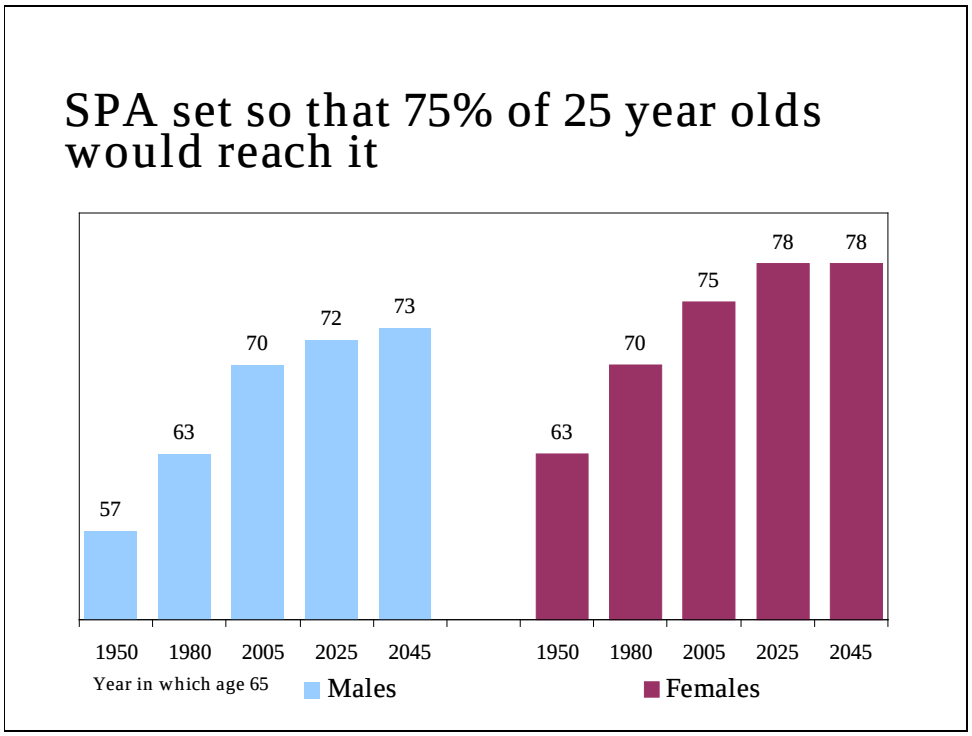
Chart 4



Considering the benchmark cohort reaching age 65 in 1950, 62% of men who had survived childhood to reach age 25 then lived to collect their state pension at age 65. Just over 70% of women in the same cohort reached 65. Today's cohort, and without a change in SPA tomorrow's cohorts too, will be 90% certain to reach their SPA.

There is no criterion set for what is the 'right' proportion of people that live to receive their state pension. If, say, a benchmark were set at 75% (not unreasonable as an average of previous expectations) then the SPA for the sample cohorts would need to be increased (Chart 5).

Chart 5



If this were an appropriate criterion, SPA would need to rise to age 72 for men and to age 78 for women in the change cohort – a significant hike.

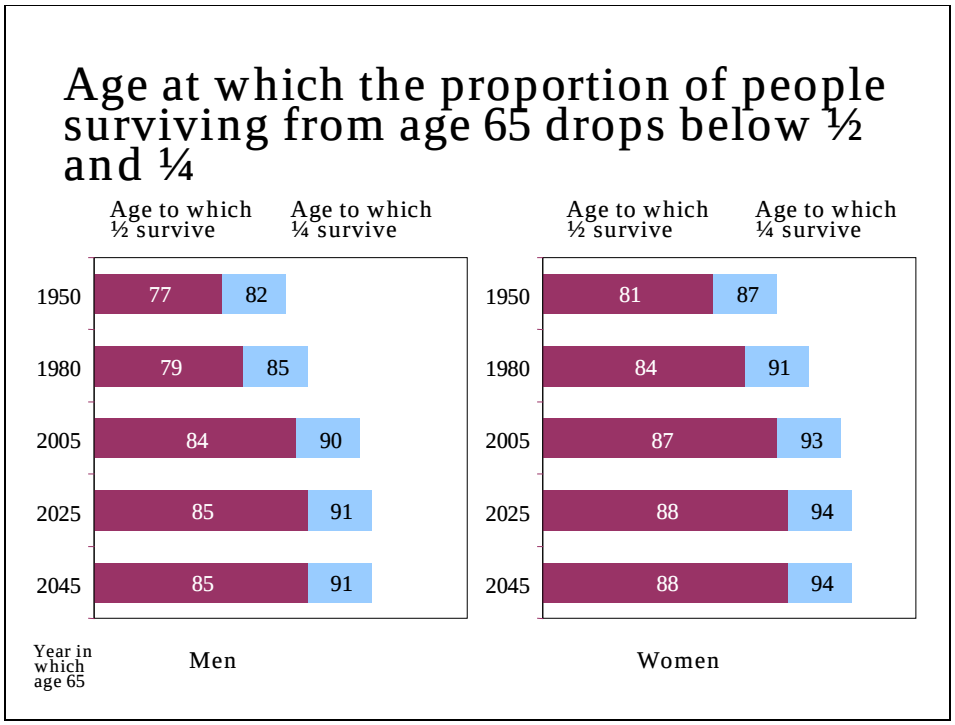
The data also shows that increases in the proportion reaching SPA have been larger during the lifetime of the social security system than are projected for future cohorts. Further improvements are expected, but at a slower pace.

People are living longer after collecting state pension

The previous section described one demographic pressure on the state pension. This section shows that the increased numbers of people living to SPA are also living longer after SPA.

For a cohort of people reaching age SPA it is useful to identify the ages at which the proportion surviving drops below half, and one quarter.

Chart 6



When the current pension system was put in place, a 65 year old man had a 50% chance of collecting it for at least 12 years, and a 25% chance of collecting it for at least 17 years. For a man in the change cohort, these payment periods are 8 and 9 years longer, respectively.

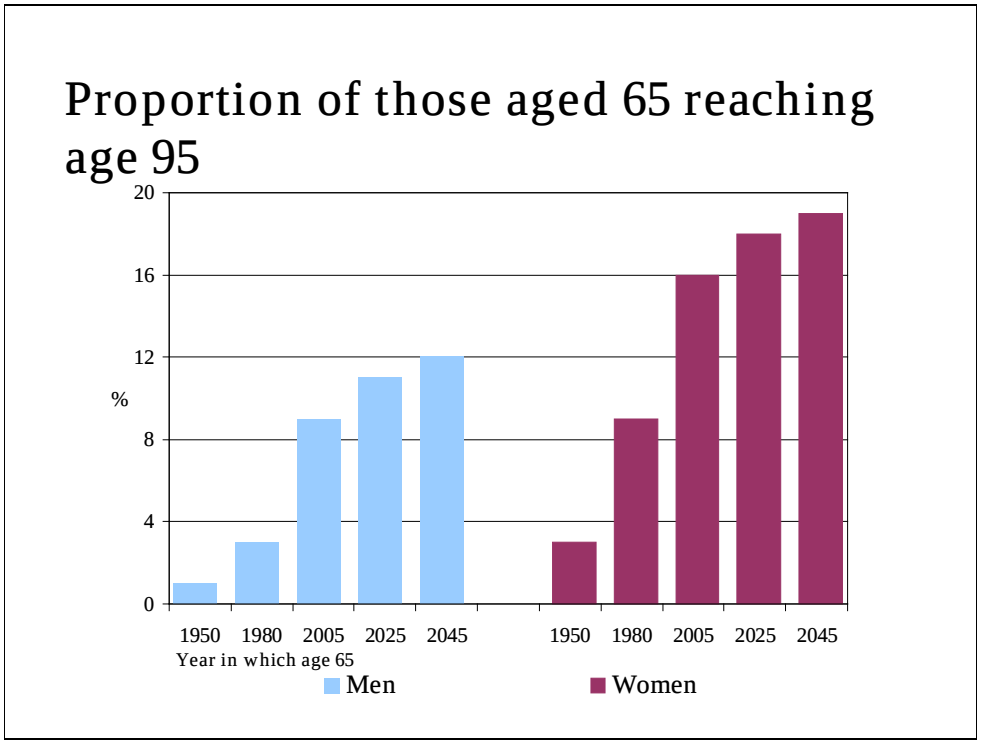
A woman of the benchmark cohort at 65 (having already had 5 years of pension) had a 50% chance of 16 or more years and a 25% chance of 22 more years. For a woman in the change cohort, these payment periods are both 7 years longer.

Again, there is no right answer for this. If the criteria were a 50% chance of collecting state pension for 15 years, and a 25% chance of collecting it for 20 years, then SPA would need to be set around age 72 for the change cohort.

Similarly to the analysis of proportion of survivors reaching SPA, a pattern of fast improvement while the current system has been in place, and a projected slower improvement for future cohorts can be seen.

What is also clear is that there will be more people, especially women, living to what we tend to think of as very old ages. Chart 7 shows the proportion of 65 year olds living to age 95.

Chart 7



This is consistent with projections of an increasing proportion of the 'oldest old' in future.[8].

[8] For example, Thatcher (1999)

Even if SPA were now increased at the earliest possible date, further increases are likely later

An ever-increasing number of people are surviving the full period of a working life, contributing to the state pension. People are living to collect their pension longer after SPA. Therefore, it would seem only logical to increase SPA to keep pace with longevity trends.

On this basis, raising SPA appears overdue. And even if it were decided to increase SPA now (for implementation around 2025-30), later increases are likely to be called for. Longevity is projected to continue to improve (albeit at a slower pace), so the issue is not going to go away. Longevity has consistently broken through predicted limits[9].

The criteria used in this section point to an SPA of at least age 72 for the change cohort, perhaps even as high as 75. This is a huge change from the current SPA, illustrating the startling change in longevity since the middle of the twentieth century. The practical limits to change are discussed in Chapter 2.

[9] Oeppen and Vaupel (2002)

The clarification argument

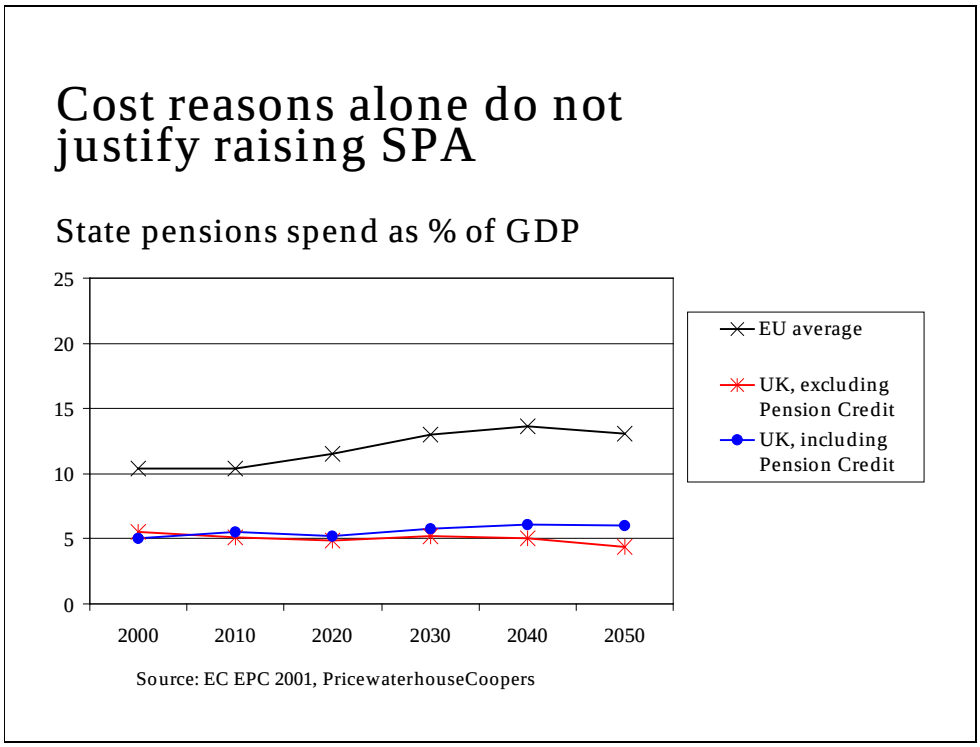
Raising SPA allows a higher BSP at higher ages, clarifying its role as insurance against living longer than expected

If SPA is raised, then for the same overall cost of state pensions, the level of the Basic State Pension (BSP) can be increased. If more is spent on state pensions temporarily, raising SPA could prompt an increase in BSP levels to above the level of means-tested benefits for older pensioners. In effect, this modernises the BSP, and clarifies its role. This becomes more important as longevity improves and more of us live to older ages.

It is hard to justify raising SPA for cost reasons alone

The long-term cost of state pensions in the UK is being constrained, compared with higher increases in other European countries. A rise in the UK's SPA is therefore not needed in order to rein back a spiralling cost (Chart 8)[10, 11].

Chart 8



[10] EPC (2001). Each country's government prepared these figures for the EC Economic Policy Committee (EPC). The UK figures include the basic state pension, SERPS/S2P, MIG and incapacity benefits at their levels before the faster than inflation rises of 2001

[11] Hawksworth (2002a). Hawksworth's figures update to 2002/3 levels. See also Hawksworth (2002b) for a reconciliation with government figures

The UK state spend on pensions and related benefits is currently around 5% of GDP. Without the introduction of Pension Credit, it falls slightly as a percentage of GDP in the long-term. The latest work by John Hawksworth at PricewaterhouseCoopers shows that including the effect of Pension Credit, the total cost of state pensions and their means-tested supplements is projected to increase over the next half-century by around 1 percentage point of GDP.

The EU average cost is currently around 10%, and expected to rise by just over 3 percentage points. Countries within the EU have very different patterns. Italy currently has the highest spend at nearly 14% of GDP, which is projected to rise to nearly 16%, before falling back to the current level. Germany is now just above the EU average, but is projected to rise sharply to nearly 17% of GDP by 2050.

The UK stands out as the lowest. This is partly linked to the greater scale of private pension provision in the UK compared to some other EU countries. The UK is also the only country where the percentage of GDP spent on state pensions is not predicted to rise significantly over the next half-century. This is despite the strains predicted from the falling birthrate and the trends in longevity.

Opinions may vary on whether the UK's level and increase in spending on pensions is too little (because we should be paying more on pensions as numbers of pensioners increase) or too much (because additional spending is needed in other areas, including health and long-term care). But it is hard to suggest that cost considerations alone provide a strong rationale for raising SPA.

But the level of state pension benefit could be increased if SPA were raised
The UK's constraint on pensions spending is the consequence of policy decisions to reduce future benefit per pensioner (relative to earnings) and eligibility for pensions. The two main drivers are the indexation of BSP to prices instead of earnings, and the increase in SPA for women from 60 to 65[12].

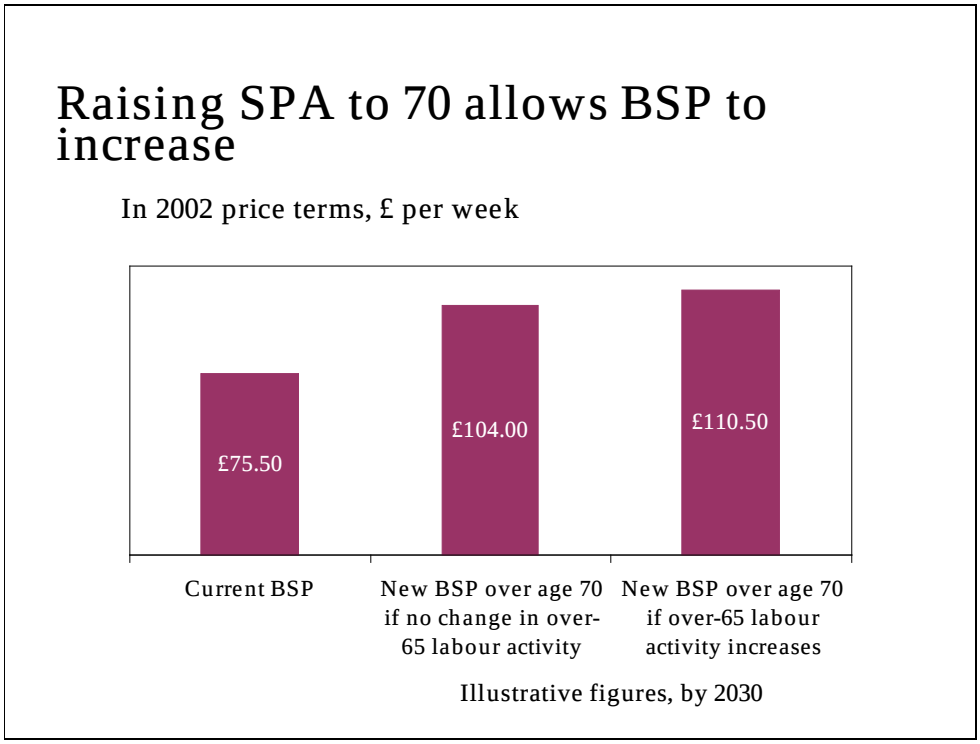
Tradeoffs are a constant theme in pensions policy making. For example, indexing the BSP in line with prices reduced the real value of the average pension relative to earnings, but kept eligibility constant. This implies that the BSP will decline to 'nugatory' levels: 7% of average earnings for men and 10% for women by 2050[13]. Current policy is to target spend on the poorest pensioners using means-tested benefits (MIG) and the Pension Credit. This favours paying higher amounts to an eligible sub-set of the population[14].

[12] Indexing BSP to prices was introduced in the 1981 Social Security Act and the increase in female SPA in the Pension Act 1995 (to be phased in between 2010 and 2020)
[13] Pension Provision Group (1998)
[14] See Glossary for details of each benefit

Raising SPA presents the opportunity for a different resolution of the tradeoffs. For example, a higher SPA could allow the National Insurance contributions that pay for pensions to be reduced. In isolation, this is hardly likely to be an acceptable policy at a time when, as now, everyone seems to agree that many people will not have enough pension. However, if a new, more generous, state pension system were to be introduced, raising SPA could mitigate any additional cost[15].

Alternatively, raising SPA can allow benefit amounts to be increased. If the SPA were raised then, for the same overall spend on pension benefits, the level of BSP could be increased. To illustrate, in today's money, the increase could be £28.50 to £35 (38% to 46%) per week by 2030 depending on the outcome of increased labour market activity over 65 (Chart 9)[16].

Chart 9



Note that these amounts are the minimum additions to the BSP made possible by a higher SPA. Under this policy some further savings on means-testing benefits would be made, which could be fed back into adjusting means-tested benefits or raising the BSP further. These further savings have not been costed here. Other work suggests these savings could be significant: around one-quarter of the cost of increasing BSP for all pensioners[17].

[15] For example, as the latest report from the Pensions Reform Group has suggested (August 2002)
[16] Hawksworth- see Appendix 2
[17] Hancock and Sutherland (1997)

Raising SPA could allow state pension benefits to be increased further at older ages

As shown in Chart 9, raising SPA allows a higher BSP for everyone above the new SPA while keeping costs neutral overall. Alternatively, it can allow a higher BSP at an even higher age, keeping the current BSP regime between the new SPA and that higher age. If SPA were raised to 70 then by 2030, the BSP for ages 75 and over could be increased by £43.50-£53 per week (58%-70%) in today's money[18].

In isolation this is not enough to take older pensioners off means-tested benefits, because BSP is currently below the level of means-tested benefits and will grow more slowly in future[19]. But it would be possible for an increase in SPA to prompt such an increase in BSP. Chart 10 shows the projected costs of a policy option to raise SPA to 70 and increase BSP to the level of the means-tested MIG for all pensioners over age 75.[20] The projected cost of this policy is equal to the projected cost of current policy in the longer term. The additional cost in 2010-20 is due to raising BSP as early as 2010; this could instead be phased in later coincident with raising SPA. By 2030, when the higher SPA is fully operational, costs are below those projected under current policy. Delay in raising SPA in reaction to longevity trends contributes to this shape of higher followed by lower costs.

Chart 10

Raising SPA allows BSP to rise above MIG level for older pensioners

UK state pensions spend as % of GDP

	2000	2010	2020	2030	2040	2050
Current policy with Pensions Credit	5.0	5.5	5.2	5.8	6.1	6.0
Current policy plus: - SPA to 70 by 2030 - BSP = earnings indexed MIG for 75+ - Current BSP + PC for <75	5.0	5.8	5.7	5.4	6.1	6.1

[18] Hawksworth- see Appendix 2

[19] Assuming means-tested benefits levels grow in line with earnings

[20] Table A2.1 in Appendix 2 and Hawksworth (2002b). Projection with changes to current policy assumes higher activity rates for over 65s and estimates savings in Pension Credit for over 75s

Raising BSP at older ages clarifies its role as insurance against old-age poverty

For individuals, the need for a state pension becomes more acute with increasing age. The significant minority forecast to live to age 95 in future (see Chart 7) are likely to have run down their resources – and what resources remain will be worth far less in earnings terms than those of younger pensioners. None of us know whether we will be in that group. We are not all likely to plan sufficient resources to meet the risk, especially as longevity is improving.

The state pension can provide an insurance scheme against the risks of longevity. The state can pool the risks of living longer than expected, in a wider pool than any other organisation could achieve. Therefore a state pension can ensure that those that do reach an older age have a guaranteed income when they cannot earn one.

However, this role of the state pension is not fulfilled if, instead of 'living too long' being a risk that affects only ***some*** people, ***most*** people live to collect their pension. This is the case today. As shown earlier, 90% of people live to collect their state pension.

If the BSP is increased at older ages as longevity improves, then the role of the state pension is clarified as guaranteed insurance against poverty caused by living longer than expected. Means-tested benefits (MIG, PC and IS) can still be used as a support against poverty from other causes, below and above SPA. But, because the level of means-tested benefits can be changed without primary legislation, they are not guaranteed to the same extent as the BSP.

A higher BSP at older ages is consistent with the World Bank's proposed role of the state pension as (amongst others) ***protecting the old from risk by defining the benefits in advance.***[21] It is also consistent with the observed trend that older pensioners are poorer, for longevity-related reasons that are likely to persist[22].

After clarifying the role of the BSP, further policy options are more easily resolved. Current issues such as whether compulsion should be extended[23]; whether the State Second Pension should be scrapped[24]; how private provision can be made easier[25]; whether the BSP should be partly or totally funded[26] can all be considered more clearly once the SPA has caught up with the longevity trend and the role of the BSP is re-clarified.

[21] World Bank (1994) pp 15-16, pp.101-2
[22] See Dash and Webb (1999) for the reasoning, Pensioners' Income Series 2000/1 (DWP) for timeseries of the age gradient in incomes 1979-1996/7 and 1994/5-2000/1
[23] For example, TUC (2002)
[24] For example, Mercer (2002), IPPR (2002)
[25] For example, Pickering (2002)
[26] For example, Pensions Reform Group (2001), Centre for Policy Studies (2001)

One argument against maintaining the BSP as the foundation for guaranteed income is that it is not truly universal – it relies on a sufficient contribution history. Low coverage of the BSP among women especially has been a problem. But the situation has improved and is expected to continue to improve[27]. And raising SPA (to 70 say) and taking BSP above the MIG level at a higher age (say, 75) does not disturb the current policy of means-testing where necessary. Means-testing is never likely to disappear completely. However, raising BSP does offer some prospect of reducing or removing means-tested benefits for older pensioners for whom the process of obtaining means-tested benefits may be more difficult.

The other argument often used against increasing BSP is that it is not a redistributive policy – it uses state resources to give high-income pensioners a benefit they do not need. But raising SPA at the same time as raising the level of BSP can be cost-neutral over the long-term (as previous charts showed), so additional state pension resources should not be needed[28]. Essentially the point at issue is a preference for allocating pension benefits via means-testing (with potential complexity, high administrative cost and low take up problems, but with theoretically good targeting to pensioners in need), or via age (a simple approach with no take-up problems, but less well targeted).

It should also be pointed out that a policy to raise SPA and redefine BSP benefit levels cannot be a static one, for two reasons. First, a practical increase in SPA is unlikely to be fully robust against past longevity trends, let alone potential future improvements. Second, raising the level of BSP has to be set in the context of the level of means-tested benefits, and in particular how they have increased relative to prices and earnings.

In summary, raising SPA in response to trends of people living longer can prompt a clarification of the BSP which is particularly relevant as longevity improves.

[27] Pension Provision Group (1998) also point out that this problem is not totally within the ambit of pension policy to resolve: it depends on changing work patterns, and the availability of family care

[28] It should also be noted that these estimates do not take into account the gain from taxation where higher income pensioners receive a higher BSP

The employment incentive

Raising SPA should be a strong signal for today's younger workers to be prepared to work longer

There are numerous important issues currently in debate around the falling rate of workforce participation of workers over age 50. The government is supporting age diversity in employment and later retirement. It should be emphasised again that SPA is not 'retirement age'. SPA is the most common age at which people say they retired. However, nearly one-half of men currently retire before 65; one third of women retire before 60[29].

The economic inactivity rate for men aged 50-64 was 26.9% in 2001 (down from a peak of 28.5% in 1995). For women aged 50-59 the inactivity rate was 33.7% in 2001, down from 41.2% in 1984.[30] There are many reasons people give, apart from being retired, for being economically inactive, such as ill-health, looking after family or home, or not needing a job.

Raising SPA can only affect people today in their 40s or younger

Raising SPA is unlikely to contribute to raising the employment participation rate in the short-term, principally because of the long lead in-time required. However, it is a signal that longer working is expected. This signal is likely to operate more on people currently aged in their 40s and younger. These are the people who would find themselves actually facing a higher SPA, and would have time to adjust their work and savings plans. To illustrate, if SPA were raised from 65 to 70 between 2020 and 2030, then the oldest people that would be fully affected are aged 42 in 2002.

Raising SPA will reinforce other policies encouraging greater workforce participation at older ages

SPA is not the only lever likely to affect the employment patterns of current forty year olds at age 60 plus. There are many other drivers that are likely to make more of a difference over time. For example:

- The impact of demographic trends. The ageing population and falling birthrate are predicted to lead to a shift of 10% of the potential workforce to the over-50 category over the next 20 years[31]. This may mean that even in the absence of any policy change, employers seek out older workers more than they do at present.

[29] Disney et al (1997)
[30] Barham (2002)
[31] Barham (2002)

- The success of current and future policy initiatives outside the pensions sphere. There is a substantial effort going into encouraging age diversity in the workplace[32]. Many groups are lobbying for legislation to end age discrimination sooner than 2006, the deadline for compliance with the EU Employment Directive. There is a New Deal programme focused on getting over-50s back into the workplace. And there are tax incentives including higher personal tax allowances for people over 65. The effectiveness of these policies in achieving later retirement, and more flexible patterns of work in later life, remains to be seen.

  This makes it very difficult to predict what the expectations for working versus retirement of today's younger workers will be when they get closer to SPA. Research often shows that younger workers have unrealistic expectations of retiring early, but that for most people reality hits around age 50 when attention is turned seriously to pension planning[33]. Given that there are a number of initiatives encouraging later working in future, it is likely that expectations will change over time, as they seem to do anyway as people get older.

- The availability of money from occupational schemes or personal pensions to fund early withdrawal from work. Much early retirement has been funded by surpluses in occupational schemes. Money from occupational schemes has been one of the most important factors driving early retirement[34]. But as defined benefit schemes appear to be in decline, and are under economic pressure from falling investment returns and the cost of longevity, such money may not be available on such a scale in future. And this effect is not limited to those in defined benefit schemes. Workers in defined contribution schemes or with personal pensions face similar pressures from falling investment returns and the cost of longevity.

  The Pensions Policy Institute researched the impact of projected future investment returns and longevity on pension economics, using a model kindly supplied by Mercer. It found that, if today's thirty year olds want to reach a reasonable pension benefit level of two-thirds final salary, while paying contributions at the current average level, then they will need to keep saving for a pension until age 72[35]. Whether the schemes are defined benefit or defined contribution, working (and saving) longer will be necessary to support living for longer in retirement. In this environment it will be much less likely that pension monies are available to fund early withdrawal from work.

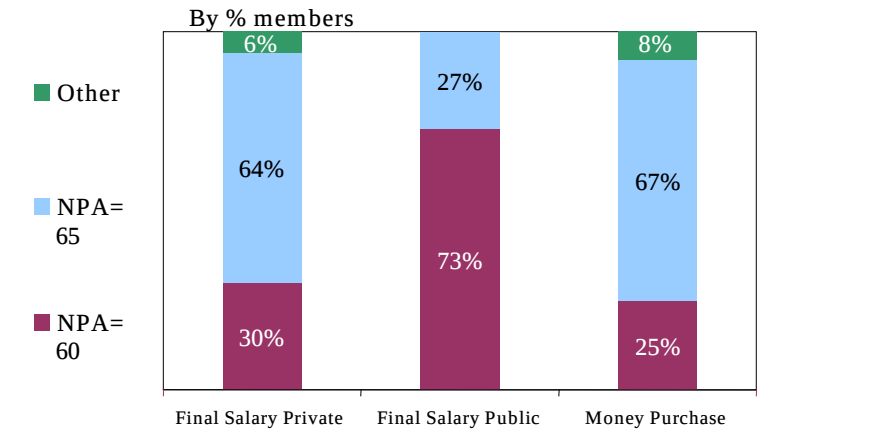
[32] See http://www.agepositive.gov.uk/
[33] For example, FSA (2002)
[34] Blundell et al (2002)
[35] PPI (2002)

Raising SPA is therefore both in line with the demographic trends and in support of other policies to encourage later working. ***Not*** raising SPA appears to contradict such policies.

Raising SPA may prompt occupational schemes to change their rules The Government's target for reversing the 60:40 ratio of the proportion of total pension income paid from state vs. private sources, suggests that SPA will be a less effective policy lever in future. The age at which private or occupational pensions become payable will become relatively more important. But raising SPA could operate through occupational schemes and/or employment conditions to encourage working to later ages.

Occupational pensions can become available for payment within a wide age band (typically 50 to 75, as set by Inland Revenue rules). Normal Pension Age (NPA - the age at which employers expect employees to retire and start receiving pension) is overwhelmingly either 60 or 65 (Charts 11 and 12). Many private sector schemes with an NPA of 65 allow an unreduced pension at ages 60-64 so in practice are quite similar to public sector schemes with NPAs mostly at age 60.

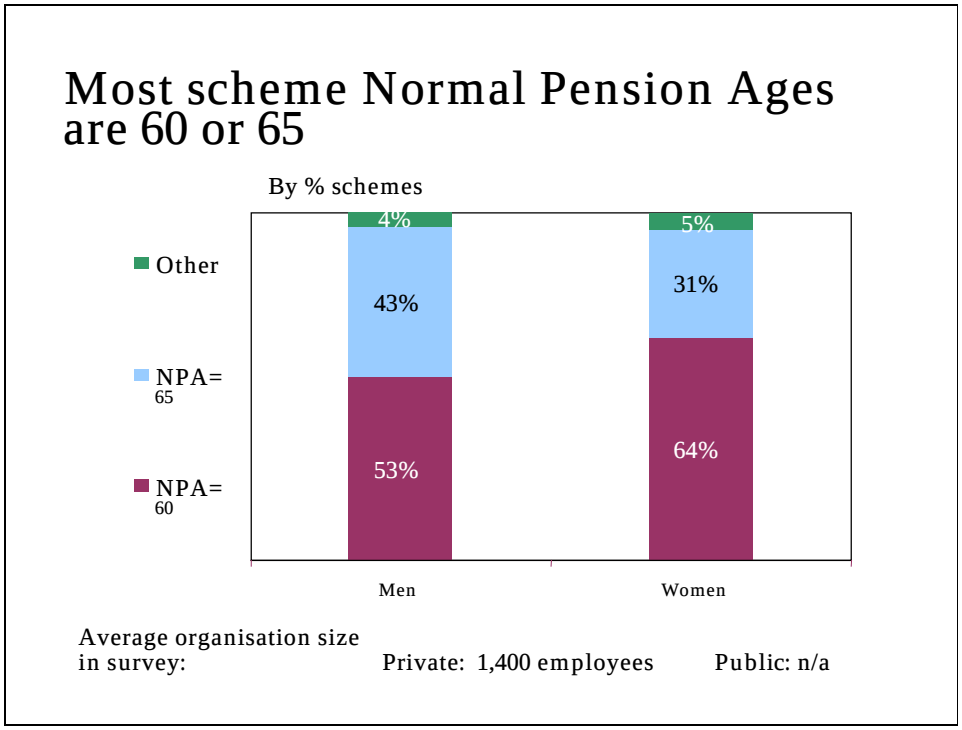
Chart 11[36]



Average organisation size in survey: Private: 7,250 employees Public: 22,750 employees

[36] NAPF (2001)

Chart 12[37]



There are a number of ways in which occupational schemes could be encouraged, or mandated, to raise their typical age at payment, which would be expected to have knock-on implications for work activity. For example, NPAs under an age closer to a new SPA, say 65, could be banned (although there will always be special occupations with lower NPAs). Or, the lower age limit for scheme Inland Revenue approval could be raised from 50 to, say, 55[38].

There are also ways in which employers could be encouraged or mandated to raise the age at which people leave work, which would then need to be reflected in occupational schemes where they exist. For example, the Government could ban Mandatory Retirement Ages (MRA), the age by which employees must leave their jobs even if they and the employer want to continue. MRAs are set by employers' employment terms. Whether MRAs should be banned altogether as part of the 2006 legislation is still under debate; they could be banned under a certain age.

[37] Smith and McKay (2002)
[38] As recommended in PIU (2000)

If SPA is raised, without any other action, there could be a gap between the new SPA and some NPAs or MRAs. Clearly, at the very least, raising SPA would encourage pension and retirement ages in the workplace to rise. Government could also mandate for MRAs to be at least the new SPA.

Whether action is taken directly on pension arrangements, or on retirement practices, it is likely that the end result will be occupational pension schemes raising the age at which pension becomes payable. This may not be altogether unwelcome to occupational scheme managers. As discussed above, the longevity trends put economic pressure on occupational schemes too.

Therefore, younger workers in occupational schemes (or who join them later in their working life) are likely to receive a strong signal that working well into their sixties is expected. Even if for some people a higher SPA is a weak signal by itself, it is likely to be backed up by the stronger signal of a scheme pension age.

For people who go through their working life without occupational or private schemes, and will be more dependent on state pensions, the SPA will act as a more direct policy lever. Of employees aged 25 to 34, 42% are not in a private or occupational scheme; the proportion falls to 33% for employees aged 35 to 44[39]. People retiring without occupational or private pensions are more likely to have been lower earners in manual occupations. For such people, state pensions may add up to less than the means-testing income limit in future, so the relationship with means-testing benefits will become increasingly important[40]. These issues are considered further in the next section.

[39] Family Resources Survey, DWP, 2000-01

[40] See, for example, Mercer (2002)

The distributional dilemma

Raising SPA does not significantly alter the distribution of state pension money between income groups

A criticism that could be levelled at the policy to raise SPA is that it is not redistributive from the rich to the poor. Higher income groups tend to be healthier and live longer. People in high income groups are therefore more likely to receive more in age-related pension benefits than people in lower income groups.

There are two main strands to the argument that raising SPA is non-redistributive. First, raising the SPA to, say, 70 would change the income prospects of people aged 65 to 70. In particular, those unable to work, for example because of ill health or family caring commitments or unavailability of jobs matching available skills would be disadvantaged relative to those able to find work. Second, it would give more years of pension benefit to those who live longer (the rich) compared to those that have a lower life expectancy (the poor). In what follows, the evidence of these two arguments is presented, followed by a critique of whether this matters in the rationale for raising SPA.

It concludes that while the policy of raising SPA is not redistributive, it is not necessarily as disadvantageous to lower income groups as it appears at first sight. Further, the problems underlying the inequalities are, rightly, being addressed by other policy measures. Therefore, if it is decided that raising SPA is the right thing to do within pensions policy, other measures should be strengthened to deal with potential future distributional consequences.

Health prospects at 65+ are hard to discern, but seem to be improving

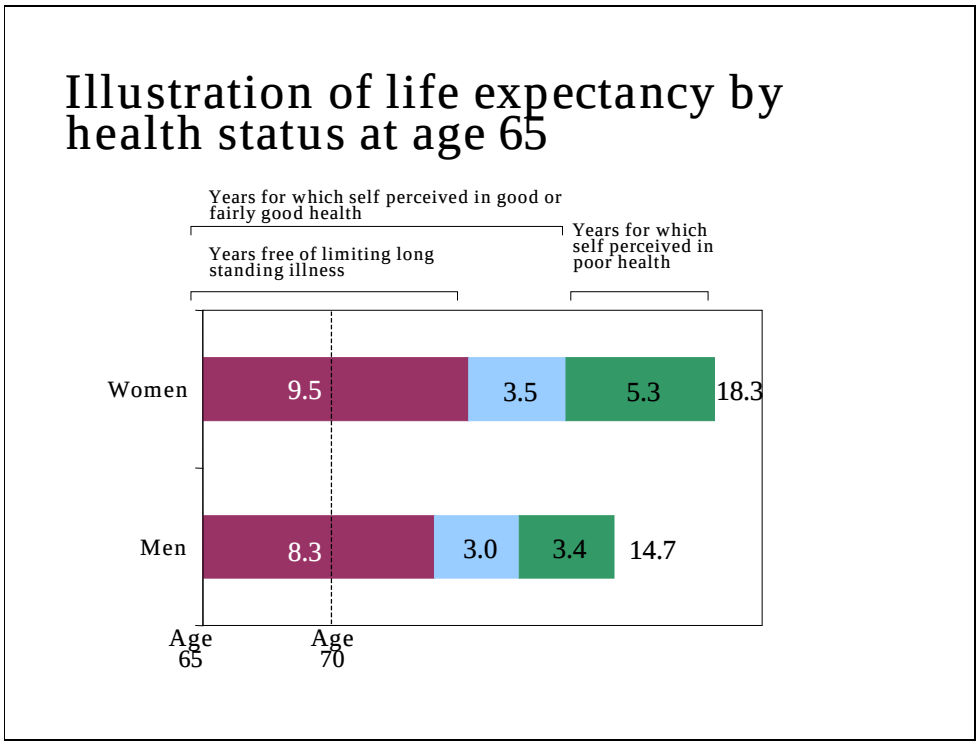
Raising SPA above age 65 assumes that people are able to work beyond this age. Poor health is one reason for being unable to work. The prospects for good health for those aged 65-70 are hard to discern. Currently 37% of people aged 65-74 report having a longstanding illness that limits their activities. This measure has remained fairly constant since the mid 1970s[41]. However, expectations of what should be good health may have changed over time, so self-reported health status alone is not necessarily an appropriate measure.

[41] Walker et al (2001) Table 7.1

It appears that healthy life expectancy at age 65 is increasing, although not by as much as total life expectancy. If this trend continues, a higher proportion of life over 65 will be spent with some form of illness or disability. It is suggested that the prevalence of moderate disability will rise, while that of severe disability may fall. While trends in smoking are favourable, cancer, obesity, high blood pressure and work-related stress are causes for concern, as are unknowns such as the effects of pollution and food technology.[42]

For the average 65 year old today, raising the SPA from age 65 to, say, age 70 would fall within a period of good health. For a woman aged 65, with on average 18.3 years of life remaining, 9.5 years would be free from limiting illness and in good or fairly good health. A man aged 65 can expect over 8 years in that state of health (Chart 13)[43]. Of course, the actual picture for any individual may well not be neatly sequential as shown, but it is worth pointing out that the ***average current*** situation would seem to allow some increase in SPA.

Chart 13



[42] Dunnell and Dix (2000); Evandrou and Falkingham (2000)
[43] Kelly et al (2002)

Trends in health also affect the need for caring for older relatives. A caring responsibility can also prevent people from working. Currently 24% of people aged 45-64 are carers, and 16% of people over 65 and over. Most carers are women caring for a parent or parent-in-law[44].

It is extremely difficult to predict whether the need for carers aged 65-70 from 2030 will increase (these are the people potentially impacted by a possible raising of SPA). Among the imponderables are: the age at which older people need care; the type of care needed as the mix of illnesses between acute and chronic changes; their preferences at the time they need care and ability to pay; the potential availability of kin to care as childlessness, divorce and separation have been increasing; competing responsibilities as, particularly the female labour participation rate increases; and, the impact of polices that may change the balance of family, community, in-home and institutional care.

Socio-economic health inequalities are expected to persist

There are socio-economic inequalities in health. 33% of men in non-manual groups aged 65 and over report a limiting longstanding illness, compared to 47% for manual groups. For women the figures are 38% and 44% respectively[45]. Healthy life expectancy at birth shows a north-south divide within England[46]. The prevalence rates of chronic sickness are higher for manual workers relative to non-manual, and healthy life expectancy lower[47]. Some of this difference can be explained by heavier smoking among manual workers, the impact of which is expected to persist into the future, so that the socio-economic gap in health inequality is not expected to close soon[48].

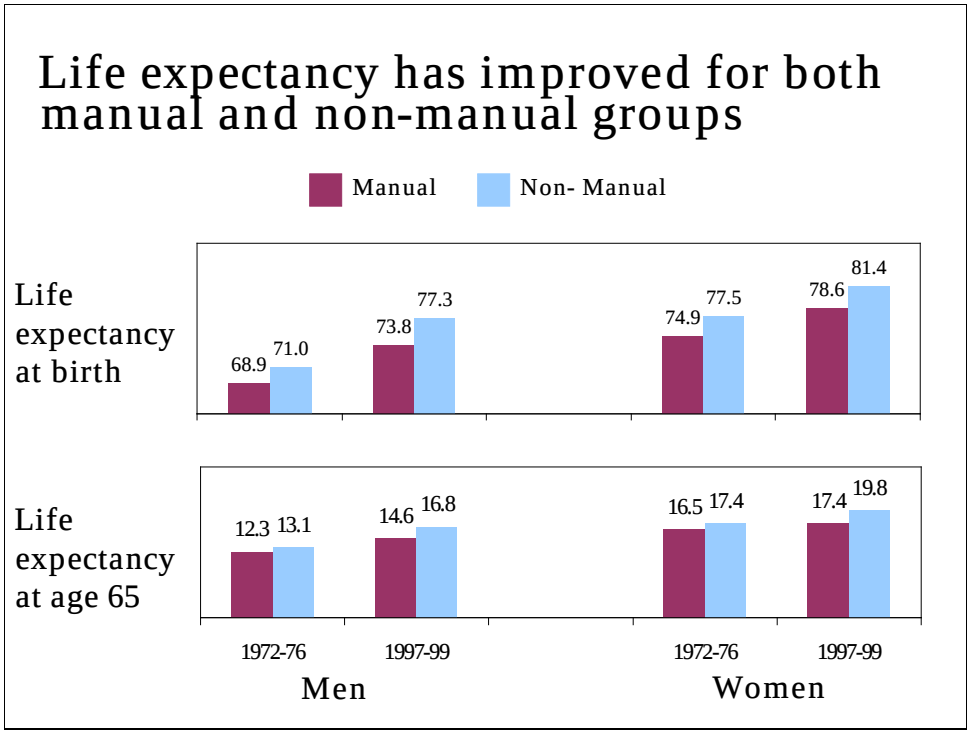
Life expectancy is improving for all socio-economic classes, but a gap persists

Life expectancy for all social classes has improved since the current social security system was set up. However, for many years there has been a social class gradient in life expectancy at birth and at age 65, for men and women[49].

The gap between life expectancy for non-manual workers and that for manual workers has been widening since the 1970s. Men aged 65 in the non-manual group can expect to live a further 16.8 years on average, as compared to men in the manual group who can expect to live 14.6 years. For women, the figures are 19.8 and 17.4 years, respectively (Chart 14)[50].

[44] Maher and Green (2002)
[45] Walker et al (2001) Table 7.5
[46] Bissett (2002)
[47] Dunnell and Dix (2000); Kelly et al. (2002)
[48] Evandrou and Falkingham (2002)
[49] Hattersley (1999)
[50] Donkin et al (2002)

Chart 14



Despite the widening gap, life expectancy for people in the manual group is now better than life expectancy was for people in the non-manual group in 1970s.

Any relative financial disadvantage on raising SPA is hard to quantify

The above sections used the language of relative disadvantage between socio-economic groups as a result of raising the SPA. However, the actual financial disadvantage is a slippery concept.

It is essential to emphasise that a policy of raising SPA is highly unlikely to be effected for those aged over 40 now. In trying to compare the relative effect of the policy on different groups, it must be remembered that these are sub-groups of the current under-40s as they will be in the year 2030 and beyond. This is necessarily subjective in that the characteristics of these sub-groups cannot be predicted. Also, any disadvantage relative to today's 65 year olds is somewhat hypothetical.

As an example, suppose the SPA is raised to age 70 by 2030. Low-income 65-70 year-olds in 2030 and subsequently will be disadvantaged relative to today's 65-70 year olds if they cannot work. But they will be eligible for Minimum Income Guarantee (MIG), which starts at age 60, and may receive an additional amount from the Savings Credit, which is planned to start at age 65[51]. But for people who would be reliant on means-tested benefits in any event, there would be no actual loss of income, provided the parameters of the benefits remain as they are today. Even if these parameters changed, for example so the age at which MIG became payable went up to age 70, Income Support (IS) would cover those below age 70. In that case, the disadvantage would be the gap between two means-tested benefits, neither of which are statutorily linked to an index but are set by the Government of the day with at most the 5-year time horizon of a Parliament.

This illustrates one advantage of current Government policy to include a large element of means-tested benefits. They can be changed relatively quickly to target specific groups. If raising the SPA did turn out to put unacceptable financial strain on certain groups of people, means-tested benefits provide the safety net.

Inequalities have always been inherent, and other policies can better realise redistribution

It is the case that a policy to raise SPA will mean fewer people reaching pension age and fewer years of pension being payable. This will fall disproportionately on people in lower-income groups. However, such differences have always existed. SPA has always been applied to all people, regardless of their actual health or life expectancy status. Gender has been a differentiator (and will be until 2020), but if a logical link to life expectancy were the only criterion, SPA for women would be ***higher*** than for men, not lower as it has been. The life expectancy gap between the manual and non-manual groups within genders has always been smaller than the life expectancy gap between genders[52]. So a policy to differentiate SPA by social class has no logical or historical precedent.

SPA has therefore never been a lever by which redistribution is achieved. It would seem unreasonable ***not*** to raise SPA (if thought to be appropriate for other reasons) because of redistributive concerns.

[51] See Glossary for further details of each benefit

[52] From Donkin et al (2002). It is also true that the life expectancy gap between the constituent countries of the UK is smaller than the gender gap, see Interim Life Tables at http://www.gad.gov.uk

However, raising SPA should be done only with effective policies in place to support those who will be unable to cope with the change when it happens. Many of these initiatives are set up. For example, the Government monitors improvement in healthy life expectancy at age 65 as part of its overall strategy to tackle poverty and social inclusion and to improve population health[53]. There are policies to support the financial position of carers, for example to credit them into the State Second Pension (S2P). From October 2002, Invalid Care Allowance can be claimed by carers aged 65 and over. New Deal programmes help people over 50 to learn new skills to return to the workplace. And anti-age discrimination measures are being pursued to encourage the availability of work for over-50s. These policies may need to be reconsidered and strengthened in order to ensure that they have enough impact by the time SPA can be increased.

As discussed elsewhere in this paper, there has to be a long lead-in time between deciding to raise SPA, and the change actually taking effect. Therefore it would be unrealistic to have all support mechanisms in place before deciding to raise SPA. It should also be pointed out that if raising SPA turns out to have caused more difficulties than acceptable, it can be reduced immediately.

Nevertheless, the perception that raising SPA is a class issue is a strong one, perhaps contributing to the difficulty in finding political will to act on such a policy. The details of the above arguments are not easy to explain in a short, positive phrase.

[53] Department of Social Security (1999)

Summary of Chapter 1: Is there any justification for raising State Pension Age?

Raising State Pension Age is a legitimate– and timely- subject for debate

This chapter has shown that there are enough valid reasons for the UK government to be now seriously considering whether or not to raise SPA.

For any pension system there is a trade off between benefit level and the age at which benefit becomes payable. This trade off comes into sharper focus in an era of improving longevity. The longevity trends in the fifty years since the current social security scheme was set up are significant.

The state pension is not immune from the impact of longevity. Although there is no need to raise SPA in order to reduce the overall projected cost of state pensions, the longevity trends suggest that the role of state pensions be revisited. Under current policy, without raising SPA, the state pension will become a tiny income paid at an age that will seem much younger than 'old age'.

This chapter has shown that raising SPA opens up options for a higher BSP. And if the level of BSP is stepped at a higher age, say 75, this could allow the role of the state pension to return to a guaranteed insurance against poverty caused by longevity. This would remove or reduce means-testing for the oldest pensioners.

The opening up of such options provides a powerful reason for raising SPA. It should not be done without support for the people likely to be adversely affected by the change, but many policies are already working towards that objective. And raising SPA signals a strong support for other policies working to encourage older people to stay or go back into the workforce. Raising SPA could be a constructive policy for the long-term, and the longevity trends suggest that it is already overdue.

Chapter 2: What are the practical transition issues in raising State Pension Age?

This chapter looks at, firstly, what decisions are linked to a change in SPA, and, secondly, what would need to be put in place before such a policy was implemented. This may not be exhaustive, but is intended to be a helpful checklist.

Further work is necessary to make the decisions linked to SPA

There are many decisions required that are linked to a decision to change SPA. Most of these will require more detailed work than presented in this paper. The main issues to consider include:

1. The new SPA
2. The date at which SPA could be raised
3. Flexibility in the new SPA
4. The role of the BSP
5. Adjustments to other age-related benefits
6. Adjustments to private and occupational pensions

1. The new SPA

This report stops deliberately short of recommending the new SPA. In making the decision there would need to be a balance between the theoretical and the practical.

A new SPA of at least 72 could be justified by the longevity argument in Chapter 1, but that is probably impractical to achieve in one step. The examples presented have been in terms of raising SPA to 70, for the convenience of a 5-year age band. Raising just 2 years to age 67 (the change currently underway in the US) seems insufficient given the extent of longevity improvements already experienced.

2. The date at which SPA could be raised

This paper has used the example of raising SPA to age 70 by phasing in from 2020 to 2030. This is consistent with the previous UK example of legislating in 1995 for a ten-year phasing in of the 5-year increase in women's SPA to be completed 25 years later. It would require legislation by 2005.

An option would be a shorter transition, between 2025 and 2030. This would put a clear break between the equalisation of women's SPA and further SPA change.

There is an argument, consistent with the finding that people tend not to start thinking seriously about their pension until age 50, that justifies an earlier transition, affecting people aged around 50. Those 50-year olds who find they have not got enough pension may welcome the chance to work longer to save harder for a later retirement.

Starting transition further into the future has an obvious appeal, as it is easier to communicate a difficult message when the impact will not be felt immediately. The US chose to take a very long time to make what seems to be a small change. The US legislation was passed in 1983 for a 25-year phasing in of a 2-year increase in SPA[54] (from 65 to 67) to be completed 44 years later[55].

The justification for raising SPA in the US was given partly in terms of the increased average life expectancy for the US population at age 65, compared to that when the Social Security system started in 1940[56]. At the time of the legislative change, 1983, life expectancy at age 65 has increased from the 1940 levels by just over 2 years for men and nearly 5 years for women. Latest statistics (for 1998) show that life expectancy has increased even further so that the improvement from 1940 levels is now nearly 4 years for men and nearly 6 years for women– even before the change in SPA has occurred[57]. Such a long transition time should anticipate longevity improvements ***during*** the transition phase.

On a similar basis to the US approach, average population life expectancy at age 65 in the UK has increased by just under 4 years for men and just over 4 years for women since the UK social security system was set up[58]. This gives as much justification as used in the US situation. But as discussed in Chapter 1, the average over time ignores the reality for specific future cohorts of people, which points to a larger increase required sooner than suggested by the US example.

[54] Usually referred to as the "normal retirement age", it is the minimum age for receiving full US Social Security retirement benefits

[55] This paper focuses on the US experience as other countries tend to be equalising female and male SPAs, which in the UK is already in train

[56] Background to the US SPA change is at http://www.ssa.gov/pubs/background.htm

[57] US National Vital Statistics System from Population Reference Bureau at http://www.prb.org/

[58] PPI analysis from English Life Tables for 1950-52 obtained from Government Actuary's Department. Note that the figures covers England and Wales only, but the trend will be indicative for the UK experience

3. Flexibility in the new SPA

Currently the only flexibility in the age at which state pension becomes payable is to defer it. The state pension can be deferred for up to 5 years, with an increment to the eventual income of one-seventh of 1% for every week deferred. The deferral option is not widely publicised or recommended as particularly advantageous[59]. From 2010, the option becomes more attractive, with the enhancement increased to one-fifth of 1% per week, and no limit on the length of deferral. Since receiving state pension is no bar to earning, there appears to be little point in deferring. Taking the pension and investing it would yield a more certain return[60].

An increase in SPA would prompt consideration of whether to change the deferral parameters. It could also open up the issue of whether more flexibility should be introduced to allow state pensions to be taken earlier than SPA.

Flexibility is often spoken of as desirable for retirement age, that is, people should be free to leave (or reduce) work on a date of their choice. But flexibility in SPA raises further issues.

If state pensions are available to be received at different ages, then some approximation to an actuarial factor has to be applied so that less pension is received per week if payment starts before SPA, or more if payments start after SPA. This adds complexity and cost.

Flexibility can lead to unintended problems. If someone on a reduced state pension because he or she chose to start payment before SPA subsequently had to claim means-tested benefits – should the claim to means-tested benefits be assessed relative to the actual pension received or the full pension that could have been received if the pensioner had not made the choice? This suggests that the role of the state pension, in providing some certainty of income in old age should not be made so flexible that the amount of final income becomes uncertain. Private and occupational pensions are perhaps better placed to deal with elective flexibility of this kind.

At the very least, changing SPA requires a reconsideration of the appropriate factors for deferral of receipt of state pension. The points raised above suggests that there is a case for considering further flexibility, but the likely real benefits must be balanced against the drawbacks of additional complexity and unintended adverse consequences.

[59] Ward (2001)

[60] Unless confident of living beyond age 84 (***Hansard***, 13 May 2002, Column WA24)

4. The role of the BSP

If SPA is changed, there are other BSP parameters to consider changing. To qualify for a full BSP, NI contributions need to have been paid for 44 qualifying years[61]. On raising SPA, the decision has to be taken to keep this parameter the same, or lengthen the contribution period required. Some modelling of the NI fund will be necessary to see the full tradeoffs between length of contributory period, level of contribution and level of BSP. At the same time, ways to increase the number of people with full contributions should be explored in order to continue improving coverage of BSP.

Other technical parameter changes may be necessary such as to increase the age at which people receive autocredits for NI contributions[62]. There are precedents for these changes from the equalisation of SPA for women.

Wider considerations on the role of the BSP are also made possible by an increase in SPA. This paper has illustrated that a new SPA could allow a higher level of BSP – either at the new SPA and/or a higher amount for pensioners above an age higher than the new SPA, with no increase in overall state pension spend.

Of course, options to increase the level of BSP are open to a government at any time, but making them coincident with raising SPA reduces the financial strain and, if a cost neutral option is chosen, avoids the need to increase NI contributions. It also allows a presentation of good news (a higher pension) to mitigate some bad news (raising SPA).

Therefore, before a decision to change SPA is taken, it is appropriate to consider whether the level of the BSP should be increased. This paper has suggested that there is a strong case to use a decision on SPA to prompt a review of the role of the BSP.

5. Adjustments to other age-related benefits

Many means-tested benefits have eligibility criteria linked to age, as outlined in Chapter 1 and the Glossary. The major decision is whether to keep the minimum ages for the elements in pension credit (PC) in step with an increase in SPA, that is, guarantee credit starts at SPA minus 5 years and savings credit starts at SPA. More detailed modelling will be required to understand the implications both in terms of overall cost and for people in different income situations.

[61] Currently 39 years for women, but will equalise by 2020

[62] Currently between 60 and 65 for men in specific circumstances, including not working. This will apply to women when SPA has equalised.

Other age related parameters include higher personal tax allowances at older ages. For the 2002-3 tax year, a single person's tax allowance is £4,615 up to the age of 64, then £6,100 at ages 65-74 and £6,370 at age 75 and above. The older age allowances are to be increased by more than inflation for 2003-4. If SPA were raised these allowances could be stepped at the new SPA, or, the current age parameters could be retained. The latter route may help the older age employment incentive, if the increased tax allowance were only allowed to be set against earned income.

6. Adjustments to private and occupational pensions

As discussed in Chapter 1, any increase in SPA is likely to be followed by occupational pension schemes, either directly or via changes in normal or mandatory retirement ages. Action on normal pension ages and retirement ages is outside the scope of direct government control, so would be very controversial to mandate. Therefore, there are few government decisions required in the field of private pensions as a result of a change in SPA, (ignoring the case of public occupational schemes where the government is the employer).

Exceptions to this are discussed in Chapter 1, specifically that the government could decide to outlaw mandatory retirement ages younger than the new SPA, and could also decide to increase the lower age limit for Inland Revenue approval of schemes (currently age 50).

If the SPA were to be raised, certain elements need to be put in place beforehand

Given that there may be years between announcement of a change to SPA and implementation, not everything has to be fully in place now, but should be set in motion.

The main issues to consider include:

1. Cross-party consensus
2. Communication of the change to SPA
3. Readiness of supporting policies
4. Readiness of the private sector
5. The next change to SPA

1. Cross-party consensus

Any change to the BSP – including a change to SPA - will affect all of us over a timescale that will see many Parliaments. Therefore, long-term stability in the role of the BSP and its parameters is desirable. To achieve stability, it would help to have cross-party consensus for the aims and implementation of any change.

This report has attempted to build a fact-based logic around raising SPA directed towards helping those considering and deciding on the outcome of the issue.

Raising SPA presents the opportunity of re-evaluating the role of the BSP. The analysis in this paper demonstrates that there is a strong argument for taking the opportunity to modernise the BSP at the same time, by increasing its level, particularly at older ages. It is, therefore, timely for such a debate to begin, with the aim of achieving long-term cross-party consensus on the role and level of the BSP.

2. Communication of the change to SPA

Communication of a decision to raise SPA is difficult because the issue tends to arouse immediate emotional responses. Clarity is important on who will be affected, when the change will take place and the reasons for the change.

Some of the facts and rationale in this document may be helpful as a basis for wider communication. The US example has been discussed. On the website explaining the US legislation can be found:

Congress cited improvements in the health of older people and increases in average life expectancy as primary reasons for increasing the normal retirement age.[63]

As discussed above, similar justification exists in the UK for a larger increase in SPA.

Any good news to go with the bad news may also help. As discussed above, this could include decisions to increase the level of BSP. It could also include information on policies in place to support those potentially negatively affected by the change, as discussed next.

3. Readiness of supporting policies

Related policies to tackle issues such as encouraging and helping older people to stay in work, and to support those particularly vulnerable to an increase in SPA, are important. While they need not be fully implemented before any increase in SPA is announced, the government would want to be sure that the right policies would be effective in time for such a change.

Such policies were discussed in more detail in Chapter 1. They include policies to encourage:

- Age diversity in the workplace and new skills learning
- Better health for older people
- Better support for carers

[63] http://www.ssa.gov/history/1983amend.html

The US example suggests an approach to ensure the effectiveness of such policies. The 1983 Act legislating for the increase in SPA also required the relevant department to:

…. conduct a comprehensive study and analysis of the implications of the changes in retirement age for those individuals affected by the provision for increasing full retirement age who, because they are engaging in physically demanding employment or because they are unable to extend their working careers for health reasons, may not find their work lifetimes are increased as a result of general improvements in longevity[64].

Similarly, the UK government could instigate further research into the trends in those factors about which we know relatively little, but are important for an increased SPA to be workable. While some future trends will always remain unknowable, better knowledge should help better planning in case the trends worsen. This report has highlighted that further research would be useful on: the health of older people, the likely increase in the number of older carers, the likely demand and supply of suitable jobs for older workers and the resulting likely scenarios for future economic activity above age 65.

4. Readiness of the private sector

The government will need to check that the private and occupational scheme sectors are ready for a change in SPA. Consultation would be expected to understand the likely response of occupational schemes, particularly whether normal pension age will be raised in line.

Some occupational schemes may be able to help those for whom a later SPA would be particularly hard. Some high-stress occupations, for example paramedics, could find working beyond 65 especially difficult. Such designated occupational groups could retain normal retirement ages that are lower than average, with appropriate financial support from their occupational pension schemes.

There may be other technical issues. For instance, where an occupational scheme defines its pension benefit as a proportion of final salary less the state pension, this may need to be redefined. And, if an occupational scheme offers payment of the state pension amount from early retirement to SPA, such a bridging payment may be need to be extended to the new SPA.

The private sector may be keen to provide annuity products to bridge the gap between actual retirement and SPA[65]. And it seems appropriate that the government should consider revising the age of compulsory annuity purchase (currently 75) if SPA were increased.

[64] http://www.ssa.gov/history/1983amend.html

[65] For example, Legal and General (2002)

5. The next change to SPA

Further changes to SPA are likely in future. Longevity is forecast to keep improving. And if a policy of increasing BSP as SPA is increased is pursued, then SPA will need to continue to rise in order to keep the integrity of the role of the BSP. Therefore, communication of any rise in SPA should refer to likelihood of a future uplift if longevity continues to improve.

It is also worth considering whether a later change in SPA could be announced at the same time. For example, changes to SPA to age 70 for those under 40 and to age 72 for those under age 25 could be announced together.

The Swedish system is sometimes referred to as an example of a pension that is "future-proofed" against improvements in longevity. The pension level for a new cohort reaching 65 is set according to their expected life expectancy at that time. If the average lifetime is expected to be higher than previous, then the annual pension is reduced for the whole cohort. If the cohort then lives longer than expected, there is a survivor bonus. There is also a complex balancing mechanism that ensures the funds are sufficient to pay promised pensions even if there are any further changes in longevity not taken into account by the cohort adjustments, or any unexpected changes in investment performance[66].

These mechanisms operate in the pay-as-you–go part of the Swedish old-age pension. The Swedish pay-as–you-go system is based on each individual being credited with a notional account in which his or her individual pension rights accumulate according to lifetime earnings. In the UK, the pay-as-you-go system is more basic. There are no such individual accounts, but everyone shares in the pooled fortunes of the UK's National Insurance fund for the same level of BSP, according to contributions paid.

However, there appears to be nothing in theory to stop the UK system adopting a similar approach of setting the BSP level every year for each cohort. In practice, it would be very complex. Also, it would require a long-term consensus to develop and maintain the approach. Consensus has, so far, been a feature of the Swedish reforms. They took more than 15 years to develop; the balancing mechanism being the most time-consuming part.

[66] Hörngren (2001)

A less complex solution is to undertake periodic reviews to see if conditions have changed enough to justify a change in SPA. The reviews should, at a minimum, address the following questions:

- How has longevity changed, and what longevity trends are expected in future? What is the impact of the trends on, for example, the proportion of 25-year-olds living to SPA and the expected length of life after SPA? Trends in average longevity and inequalities should be considered.
- Is the level of BSP still appropriate given its agreed role? For example, how does it compare with means-tested benefit levels?
- Is the total cost of state pensions at the right level? What changes in SPA and BSP level could be afforded?

There has been at least one call for an independent State Pension Age Committee, similar to the Bank of England's Monetary Policy Committee[67]. The aim of such a committee would be for any decision about SPA to be taken out of politics. The committee would make such periodic reviews independently and make recommendations about SPA to government.

Whether there is a working party within government, a group of independent experts set up to advise government on an ad hoc basis, or a fully independent, permanent decision-making committee, the issues to be considered are the same.

Raising SPA is now a legitimate and timely subject for debate. It is hoped that this paper has contributed to a careful consideration of the appropriate issues. Feedback on the analysis and commentary in this paper is welcomed.

[67] Actuarial Profession (2002)

Appendix 1: Explanation of mortality rates used in Chapter 1 longevity analysis

This report has used new 'cohort' mortality rates prepared by the Government Actuary's Department. These are not yet published, and are used with permission, and thanks.

Most other studies have used 'period mortality rates'. These generalise from the mortality experience of all ages in a certain time period. But they fail to take into account that mortality improvements over time have happened faster for some cohorts of people, in particular the cohort centred around birth year 1931. In the 1960s, mortality improved fastest for people in their thirties, in the 1970s for people in their forties, and so on[68]. It is therefore technically better to use cohort mortality rates.

The new GAD cohort rates are exceptionally useful because they estimate the longevity experience for people born each year over a long period, hence the ability to pick the 5 birth cohorts used in the Chapter 1 analysis.

The data is available for England and Wales only. In generalising the trends to the UK, the higher mortality in Scotland and N. Ireland should be noted. The overall life expectancy at birth for the UK is around one quarter of a year lower than the England and Wales average. The gap in life expectancy at age 65 is less than 0.15 of a year. For example, for females in England & Wales the latest life expectancy at age 65, is 18.85 years, for the UK as a whole it is 18.71 years.[69]

[68] Willets (1999)

[69] Government Actuary's Department Interim Life Tables 1998-2000. Available at http://www.gad.gov.uk

Appendix 2: Financial implications of raising the State Pension Age

Appendix 2 was prepared by John Hawksworth at PricewaterhouseCoopers

PricewaterhouseCoopers (PwC) has been asked by the Pensions Policy Institute (PPI) to prepare a short paper looking at the implications for public spending of raising the state pension age (SPA). We have also considered the options that this would create for raising the Basic State Pension (BSP) and/or other state pension spending. This work uses a model of UK state pension spending originally developed by PwC in 2000 and subsequently used in a study for the IPPR[70].

The paper is organised as follows:

1. Baseline definition: spending projections under current government policy
2. Higher SPA: base case with rise to 70 from 2030 and no employment effects
3. Impact of higher employment rate for older workers due to increased SPA
4. Other sensitivity tests
5. Summary and conclusions

1. Baseline definition: spending projections under current government policy

As in the IPPR work, we define the baseline spending profile as a projection of current government policy in which:

- the BSP is assumed to rise in line with inflation (assumed to be 2.5% per annum)
- the guaranteed element in the pension credit rises with average earnings growth[71] (assumed to be 2% per annum in real terms, in line with trend productivity growth); between 2010 and 2020 the age at which this is paid rises from 60 to 65 in line with rising female SPA; thereafter it remains in line with the SPA at 65
- the savings credit lower income threshold remains equal to the BSP (ie price-indexed)[72]; the savings credit is payable from 65 throughout;

[70] See Hawksworth (2002b) and IPPR (2002) for further details of the model and the results.

[71] The government has committed to this for the current Parliament and it seems most natural to assume this would continue in the long run. Price-indexation of the guaranteed credit would lead to a significant reduction in state pensions spending (by as much as 2% of GDP by 2050) since most pensioner incomes would rise above the means-tested income support level in the long run in this case.

[72] If instead the savings credit lower threshold was earnings-indexed, then the cost of the savings credit would be significantly lower in the long run (by around 0.8% of GDP by 2050). But this would mean that an ever increasing slice of savings income above the BSP would be subject to 100% 'clawback' rates via the pension credit, which would be contrary to the original intention of the policy to avoid such high withdrawal rates.

- in line with the government's own assumptions in long-term projections, we assume full take-up of the pension credit from 2010 onwards (this may overstate long run spending by around 0.2% of GDP by 2040 if the take-up rate was only 80%);
- labour force participation rates are constant over time, except for a rise for women aged 60-64 between 2010 and 2020; this takes the average participation rate for men and women in this age group to just under 50% by 2020.

State second pension (S2P) costs are treated as exogenous, based on earlier GAD projections. The impact of S2P in boosting the relative incomes of less well-off pensioners is taken into account in the assumptions made on the evolution of pensioner incomes relative to average earnings over time. The model does not include interactions with other benefits (housing benefit, council tax benefit, incapacity benefit etc) or with the tax system.

Using GAD population projections, the model produces the baseline projections for state pension spending and related benefits shown in Table A2.1 below and in Chart 9 of Chapter 1.

Table A2.1 – Projected total public spending on state pensions and related Benefits

% of GDP	2000	2010	2020	2030	2040	2050
Basic pension	3.6	3.5	2.9	2.9	2.7	2.2
SERPS/S2P	0.5	0.8	0.9	1.0	1.1	1.2
MIG only	0.4	0.4	0.5	0.7	0.8	0.9
Other*	0.5	0.5	0.5	0.5	0.5	0.5
Total spending (without PC)	5.0	5.2	4.8	5.1	5.1	4.8
Cost of pensions credit**	0	0.3	0.4	0.7	1.0	1.2
Total spending (with PC)	5.0	5.5	5.2	5.8	6.1	6.0

* Includes winter fuel allowances, concessionary TV licences, widows' benefits, war pensions and the Christmas bonus. Assumed constant at 0.5% of GDP throughout.
**Additional cost of the pension credit (PC), over and above the cost of the existing MIG. For comparable indexation assumptions, these projections are similar to those published by DWP in January 2002.
Source: PwC estimates based on data from DWP and GAD (for financial years starting in year shown)

Overall, on the assumptions outlined above, spending is projected to rise from around 5% of GDP in 2000 to around 6% of GDP by 2040 and then to remain at around that level up to 2050. In itself[73], this does not seem unaffordable, particularly relative to other large EU countries where state pension spending is typically already over 10% of GDP and tending to rise by around 3-5% of GDP over the next 50 years[74]. A rise of around a fifth in the share of GDP spent on state pensioners would also be significantly less than the estimated rise of over 40% in the number of state pensioners between 2000 and 2040 (according to GAD projections).

On the basis of these projections, there would not appear to be a pressing need to raise the SPA in order to curb future state pension spending in the UK, in contrast perhaps to some other EU countries where this argument might appear stronger. On the other hand, as discussed in the main text of this PPI report, there are other arguments for raising the SPA such as: increased longevity; a desire to encourage later retirement; and, in particular, as a means to fund higher state pension payments to older (and, on average, poorer) pensioners. We focus on this latter motivation in this paper.

Higher SPA: base case

We assume that the SPA rises from 65 to 70 between 2020 and 2030 for both men and women. This new SPA is assumed to apply both to the BSP and to the pension credit. We focus on these two elements in state pension spending, since our model does not cover the S2P or other benefits paid to state pensioners, although clearly these may also be affected to some degree[75].

In the base case, we assume no change in economic activity rates as a result of the increase in the SPA. We also assume that 30% of 65-69 year olds qualify for (non-pensioner) income support in this case, at an average of 60% of the MIG level. These assumptions seem plausible enough but are somewhat arbitrary. We consider the implications of alternative assumptions in our sensitivity tests below.

The implications of a higher SPA for total spending on the BSP and income support (through the pension credit and non-pensioner income support for 65-69 year olds) are summarised in Table A2.2 below. Results are shown only for 2030 and 2040, since the results for 2050 are very similar to those for 2040.

[73] Public spending on health and long-term care will also be subject to significant upward pressures over time, as discussed in detail in the Wanless report on NHS spending (2002) and in Hawksworth (2002a). This does not have direct implications for pensions policy, spending on which should be determined primarily on its own merits, although at some point there could be perceived to be macroeconomic or political limits on total public spending and tax levels as a share of GDP.

[74] See EPC (2001) for details of these projections for other EU countries. Note that the UK projections in that study are somewhat out of date (being based on the policy regime in mid-2000) and exclude the costs of the pension credit.

[75] In the case of the S2P, a higher SPA could have offsetting effects since payments of S2P may be deferred but contracting-out rebates may need to be paid for a longer period. The net effect would probably be to reduce public spending, but we have not been able to quantify this effect.

Table A2.2 – Implications for state pensions spending of raising SPA to 70 (base case)

% of GDP	2030			2040		
	SPA = 65	SPA = 70	Change	SPA = 65	SPA = 70	Change
BSP	2.9	2.1	-0.8	2.7	2.2	-0.5
PC/IS	1.4	1.3	-0.1	1.8	1.6	-0.2
Total	4.3	3.4	-0.9	4.5	3.8	-0.7

Source: PwC projections

The cost savings are somewhat lower in 2040 than in 2030 since, with a price-indexed BSP, the value of this (relative to GDP) falls over time. The number of people aged 65-69 is also somewhat lower in 2040 than in 2030 (although the total number over 65 is higher, these are older on average in 2040 than in 2030 due to the effect of the baby boomers cohort).

In both years, however, savings are significant. Focusing on the figures for 2030, 0.9% of GDP in that year would, at constant 2002 prices, be equivalent to around £15.7 billion on our estimates. Given that there would be around 10.5 million pensioners aged 70 or above in 2030 on GAD projections, this would translate to around £1,490 per annum or around £28.50 per week extra per pensioner aged 70 or above (at 2002 prices). If the extra state pension payments were focused on those aged 75 or above, of which there might be around 7 million in 2030, the average increase per person would increase to around £43.50 per week. These would be significant sums for less well-off pensioners[76].

[76] Note, however, that if these are paid directly via the Basic State Pension then the poorest pensioners would see at least 40% of this clawed back through the pension credit (and possibly more if you took into account housing benefit and council tax benefit). These amounts should therefore be seen as hypothetical average lump sum payments per pensioner made possible by a higher SPA.

For 2040, the amounts would be lower since the total savings from raising the SPA are lower and there would be more people aged 70 or over to share the money between. We estimate that the extra payment per person aged 70 and over would average around £23.50 per week in 2040, while the extra payment if made only to those aged 75 and over would be around £34 per week (all figures are at 2002 prices). This illustrates the point that, as time goes on and longevity continues to increase, the 'pay-offs' from a given increase in the SPA would tend to decrease.

Higher economic activity variant

The above calculation does not take any account of the possible influence of a higher SPA on effective retirement ages. As discussed in the main text of the PPI report, it is plausible to argue that there would be some such effect[77], although it is difficult to quantify this with any precision. For the sake of illustrating the possible order of magnitude of this effect, however, we have assumed that the average labour force participation rate for 65-69 year olds rises gradually from 15% to 40% between 2020 and 2035 (ie to somewhat below the c.50% rate for 60-64 year old men now). This mirrors the assumption we made in the IPPR work.

In this case, we assume that, following the rise in the SPA, only 20% of 65-69 year olds qualify for (non-pensioner) income support at 60% of the MIG, since more of this age group would be working and so would be less likely to need income support.

The results for this case are summarised in Table A2.3 below[78]. We can see that the cost savings from increasing the BSP are higher by around 0.2% of GDP in both 2030 and 2040. This arises primarily from employment, and thus GDP, being higher and, secondarily, from lower income support payments to 65-69 year olds in this variant.

[77] As evidenced, for example, by the fact that female participation rates for the 60-64 age group are currently much lower for women than for men. It is hard to explain this without reference to the 'social norms' of the current differential SPAs for men and women.

[78] The results for the higher activity rate case are analogous to those reported in our work for the IPPR, but there the estimated savings from raising the SPA to 70 were higher at around 1.5% of GDP in 2030 since the BSP is significantly higher in the IPPR's 'gold-plated' option. For details see Hawksworth (2002b).

Table A2.3: Impact of higher activity rate as a result of raising SPA to 70

Cost savings from higher SPA (% of GDP)	2030			2040		
	Same activity rates	Higher activity rates	Change	Same activity rates	Higher activity rates	Change
BSP	0.8	0.9	0.1	0.5	0.6	0.1
PC/IS	0.1	0.2	0.1	0.2	0.3	0.1
Total	0.9	1.1	0.2	0.7	0.9	0.2

Source: PwC projections

The potential additional payments to older pensioners would rise accordingly by around 22% in 2030 and around 29% in 2040 in this case. The table below summarises these results in terms of extra payments per week (at constant 2002 prices).

Table A2.4: Potential extra payments to older pensioners from raising SPA to 70

Average payment per pensioner (£ per week at 2002 prices)	2030		2040	
	Same activity rates	Higher activity rates	Same activity rates	Higher activity rates
Paid to 70+ group	28.50	35.00	23.50	29.50
Paid to 75+ only	43.50	53.00	34.00	43.50

Source: PwC projections (rounded to nearest 50p per week)

It is worth emphasising again that these amounts should be interpreted as the (net) additional average payment per pensioner that would be possible in a cost-neutral package (within the scope of this model). This is not the same as the possible increase in the Basic State Pension, which would generally be higher due to potential offsets from lower pension credit and other benefit payments.

Other sensitivity tests

The key parameters of our model that can be easily changed are:

- the real earnings growth rate (e.g. 1.5% rather than 2%)
- the indexation rate for BSP (savings credit threshold would adjust in the same way as the two are linked together in our model)
- the indexation of the guaranteed element in the pension credit (i.e. the old MIG)
- the savings credit rate (60% in base case)
- the % of 65-69 year olds qualifying for income support if SPA is raised to 70
- the level of this income support (as a % of MIG)

The first four of these parameters influence the baseline spending projections as well as the potential cost savings from a higher SPA. A full discussion of these sensitivity tests is beyond the scope of this short paper, but the general points that emerge are that:

- the results are not critically dependent on whether real earnings growth is assumed to be 2% (as in this paper) or 1.5% (as is typically assumed by the GAD);
- if the BSP is indexed to earnings rather than prices, then total state pension spending increases significantly relative to the baseline (by around 2.5% of GDP in 2050 after allowing for offsets from lower pension
- credit payments); as such, the savings from a higher SPA would also be significantly greater in this case;
- if the guaranteed element in the pension credit (the old MIG) is only indexed to prices rather than earnings, then spending on the pension credit would tend to dwindle away towards zero in the long run (as a % of GDP); the cost savings from a higher SPA would therefore come through only in the form of lower BSP payments and so would be somewhat smaller; and
- a higher savings credit rate would increase pension credit payments to 65-69 year olds and so, other things being equal, would increase the potential cost savings from a higher SPA; for plausible changes in the savings credit rate, however, the impact would be relatively small (i.e. less than 0.05% of GDP).

The changes to assumptions on income support levels for 65-69 year olds are more directly relevant to the question in hand, but we find that, for plausible variations in the assumptions, the effects are generally no more than around 0.1-0.2% of GDP. As such, the results appear reasonably robust to these admittedly somewhat arbitrary assumptions.

Alternative SPAs of, say, 68 or 72 cannot be modelled directly since the model uses data in five year age bands, but simple 'pro rata' estimates should be give a reasonable indication of the magnitude of the impact of such changes (i.e. cost savings should be around 60% of the base case estimates for an SPA rise to 68, or around 140% of base case estimates for a rise to 72). It would be possible to model an SPA of 75, but we have not attempted this in the present paper due to the short time available for the exercise and the fact that, at present, such a large increase in the SPA would not appear to be a realistic political option, even if it might eventually become one in the very long run if longevity continues to increase as, or more than, expected.

5. Summary and conclusions

Our modelling work suggests that, even on comparatively generous indexation assumptions, current government policy only implies a relatively small increase in UK state pension spending from around 5% to around 6% of GDP over the next 40-50 years. It would therefore be difficult to argue that a higher SPA was needed on cost grounds alone.

On the other hand, our analysis indicates that raising the SPA to 70 would allow significant additional payments to be made to older pensioners. Even assuming no change in employment rates for 65-69 year olds as a result of a higher SPA, the increases (at constant 2002 prices) could be of the order of £28.50 per week for the 70+ age group in 2030, or around £43.50 per week if extra payments were restricted to those aged 75 and over. Payments could be up to around 20-30% higher than this if there were also plausible increases in economic activity rates for older workers as a result of a higher SPA. On the other hand, our modelling shows that these effects tend to reduce over time for a given rise in the SPA, given continued longevity increases.

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PricewaterhouseCoopers
August 2002

Glossary

State Pension Age (SPA)
State pension age is the age from which state pensions are normally payable. This is currently 65 for men, and 60 for women. SPA for women will increase from 60 to 65 between 2010 and 2020.

Basic State Pension (BSP)
Basic state pension is the flat rate (not earnings-related) state pension paid to all people who have met the necessary National Insurance (NI) contribution conditions. It is payable from state pension age, although claims can be delayed in return for an increased level of benefit. The amount of BSP for those with a sufficient NI contribution record is £75.50 per week for a single person as at April 2002. For a married couple, based on husband's contributions, the rate is £120.70 per week.

State Earnings Related Pension Scheme (SERPS)
SERPS is a state earnings related pension. Benefit is calculated from the earnings-related contributions paid between April 1978 and April 2002. It is paid in addition to the basic state pension, and is payable from state pension age.

State Second Pension (S2P)
S2P replaced SERPS as an addition to the basic state pension for earnings from 6 April 2002. Compared to SERPS, S2P will pay enhanced benefits to those with earnings below £24,600, with the largest enhancements directed at those earning less than £10,800, those caring for the disabled or young children, and those with a long-term illness or disability. It is payable from state pension age.

Income Support (IS)
Income support is a means-tested benefit payable to those with low incomes. As at April 2002, the basic rate for a single person aged 25 or over is £53.95 a week, with supplements available for partners, lone parents, disability, and for children. For those over 60, IS is replaced by the minimum income guarantee, which is paid at a higher rate.

Minimum Income Guarantee (MIG)
Minimum income guarantee is a higher level of income support, payable to those aged 60 and above. From April 2002, amounts payable are £98.15 per week for a single person, and £149.80 per week for a couple. From April 2003, MIG will rise to at least £100 per week for a single person, and £154 for a married couple. The state pension actually receivable by a person is taken into account (along with other income) in calculating the income support under the MIG.

Pension Credit (PC)

Pension credit is a new means-tested benefit to be introduced in 2003. PC combines a guarantee credit for those aged 60 and above (which is the minimum income guarantee renamed), with a new savings credit for those 65 and above. The savings credit will top-up the MIG by an amount related to how much other income is being received on top of the full amount of BSP. The maximum top-up is expected to be £13.80 per week for a single person and £18.60 for a married couple.

Job Seekers Allowance (JSA)

Job seekers allowance is a social security benefit of at least £53.95 per week, as at April 2002. It is payable to someone below state pension age if they are actively seeking work, but currently not working or working less than 16 hours a week. It is in effect replaced at age 60 by the minimum income guarantee.

Incapacity Benefit (IB)

Incapacity benefit is a social security benefit for people who are incapable of work because they are sick. It may be paid to those who are unemployed, self-employed, or employed and no longer eligible for statutory sick pay (which may run out after 4 days of illness), as long as sufficient National Insurance contributions have been paid. As at April 2002, IB rates vary from £53.50 per week to £70.95 per week, depending on the duration of sickness.

Housing Benefit (HB), Council Tax Benefit (CTB)

People on low incomes may be eligible for some or all of their rent and council tax to be paid by means of housing benefit and council tax benefit. People on income support or minimum income guarantee automatically receive the full amounts of HB and CTB.

Invalid Care Allowance (ICA)

From October 2002, carers aged 65 or over will be able to claim ICA for the first time. Those without a retirement (state) pension, or on a reduced amount will be able to increase their income by up to £42.45 per week. Carers receiving MIG could receive a carer's premium of £24.80 per week. From April 2003, ICA will be known as Carer's Allowance.

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