

The government rightly considers that analysis of long-term trends is essential: *Without this type of analysis there is a risk that unsustainable policies might be pursued, which require sharp corrective policy adjustments in future*¹. This is one reason why it has started to publish annual estimates of what the current pensions system will cost in future.

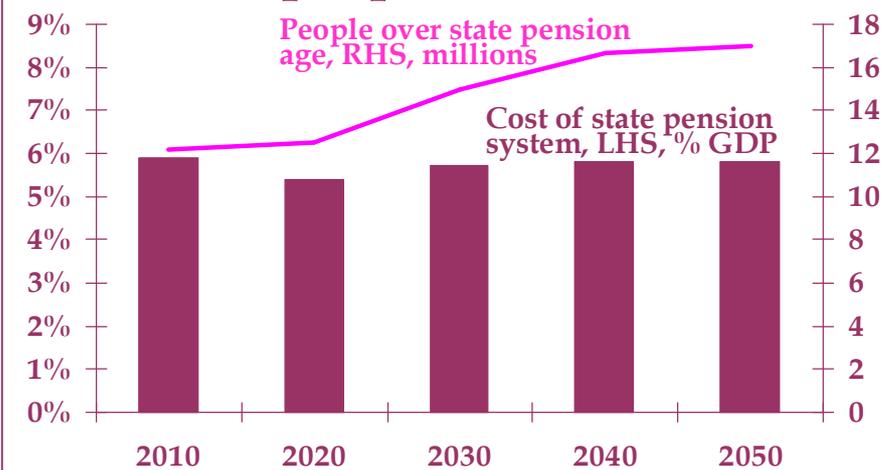
The 2004 estimates showed that spending will remain roughly level over the next 50 years. But are these particular estimates credible? This Briefing Note raises two doubts: first, political pressure may mean increasing pension benefits and second, the cost of Pension Credit is uncertain and is likely to be higher than anticipated.

The UK's spending in context

The government's estimates that state spending on pensions will remain roughly level should be seen in the light of the large increase in the population over State Pension Age (SPA) expected over the next 50 years (Chart 1)².

The UK forecasts are strikingly different to other countries around the world. Most countries are currently forecasting increases in spending on older people over the next 50 years, including some countries where spending is already higher than in the UK (Chart 2)³.

Chart 1: State spend on pensions falls below the number of people over SPA



State spending on pensions has traditionally been lower in the UK because of a stronger private pensions sector. But there are concerns that private pensions will not grow, and so there is doubt whether they will make up the increasing gap between what is required to maintain incomes and state spending.

Average contributions to private pensions have remained at around 8% of National Average Earnings since 1997⁴. Some commentators expect this to decline as Defined Benefit schemes continue to be replaced with typically less generous Defined Contribution schemes⁵.

Working longer would help fill the gap but it is unlikely to be enough on its own⁶.

Political pressure to increase benefits

Increasing spending by much less than the increase in the number of people over SPA means that the average amount older people receive from state pensions falls.

Continued economic growth would allow some of the increase in the number of people over SPA to be absorbed without a drop in average incomes.

But under current spending plans, average state spend on pension benefits per head would still fall by over one-fifth: from around 19% of National Average Earnings today to around 15% by 2050, the lowest level since the early 1970s⁷. If private income does not make up the gap, older people would be less well-off in future.

Will spending on state pensions remain level?

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Older people will make up a greater proportion of the electorate in future so if more of them find this reduction in state spending unacceptable, they might successfully lobby for increases.

The future cost of the current system is very uncertain

Financial sustainability appears to be well under control [in the UK], but depends to a larger extent than in other countries on the performance of private pension providers... If private provision produces significantly less than the anticipated coverage or level of pensions, future governments may face increased claims of means-tested benefits⁸.

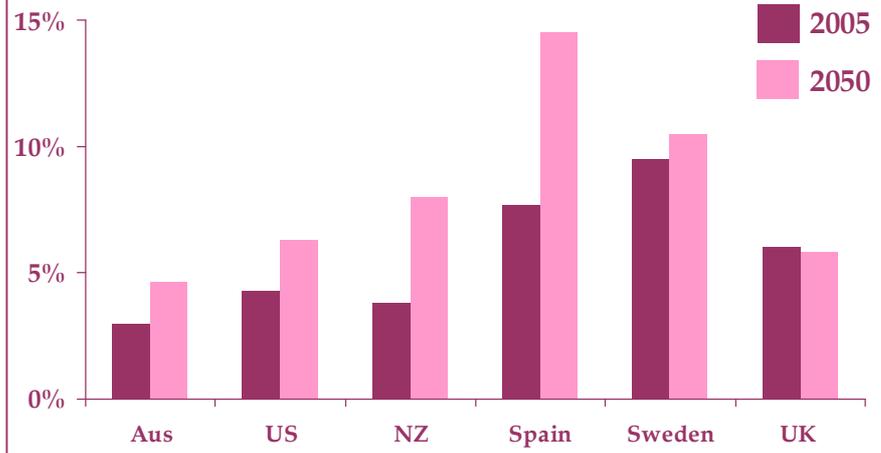
Government estimates of what Pension Credit will cost in future assume the income people have taken into account in the calculation for their eligibility grows with average earnings⁹. But if average state pension falls as expected, and private pension income at best stays level, this would not be achieved.

Current spending plans also assume that take-up of Pension Credit remains at around 75%¹⁰. But if take-up improves, as could happen as Pension Credit becomes a more important part of older people's income, then the cost would be higher than expected.

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Chart 2: The UK's spending on state pensions looks different

Illustrative government spending on state pensions as a percentage of GDP



In a pessimistic scenario, if private income increases only in line with prices rather than average earnings, while state pension income increases as planned and take-up increases to 100%, then spending could be 1.7% of GDP higher than expected by 2050¹¹ (an increase of one-third on government estimates).

In a more realistic scenario, that private income grows faster than prices, but not as fast as average earnings, and take-up improves modestly, spending could be 0.8% of GDP higher by 2050. This is still a significant increase, of almost one-sixth.

So while many countries have an issue with credibility in that spending may not be able to increase as planned, the UK has

the reverse problem. Whether it comes from political pressure to increase state benefits, or from the uncertain future cost of Pension Credit, spending on pensions could turn out to be higher than expected.

Recognising the risk of higher than expected spending is critical to developing a more sustainable pensions system.

¹ HM Treasury (2004) *Long-term public finance report: an analysis of fiscal sustainability*

² Costs include BSP, SERPS/S2P, Pension Credit, other pension benefits such as Winter Fuel Allowances and contracted-out rebates. Costs of pension benefits from the 2005 Budget and contracted-out rebates from GAD (2004) *Update of the Government Actuary's Quinquennial Review of the National Insurance Fund as at April 2000*. Population estimates are from GAD (2004) *2003-based principal population projections*.

³ UK figures are as for Chart 1. Other countries from national sources. Comparisons between countries may not be like-for-like because countries use different definitions of pensions spending, but trends over time should be comparable.

⁴ PPI analysis based on Penneck and Tily (2005) *Private pension estimates and the National Accounts in Economic Trends* 622. Includes contracted-out rebates. Average contributions have increased over the last two years, mainly because of special contributions, but this may not be a sustained trend.

⁵ For example, see *Pensions Commission (2004) Pensions: Challenges and Choices* Page 102

⁶ See PPI (2005) *Why are incentives to work and save important?*

⁷ PPI analysis based on DWP expenditure figures and ONS population estimates. Excludes contracted-out SERPS/S2P.

⁸ An analysis of national pension strategies in EC (2003) *Adequate and sustainable pensions* Page 161

⁹ DWP (2005) *Long-term projections of benefit expenditure: assumptions* www.dwp.gov.uk

¹⁰ The assumption varies by type of entitlement

¹¹ PPI (2005) *What will pensions cost in future?*