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State spending on pensions: An update

Introduction

PPI Briefing Note Number 3 published in July 2003 outlined the projected future level of state spending on UK pension provision. New demographic projections and revised estimates of contributions to private pensions have changed these projections. This Briefing Note updates Briefing Note 3, shows that the government intends to spend more on pensions than previously thought, and questions how credible the new projections are.

State expenditure on pensions is predicted to rise

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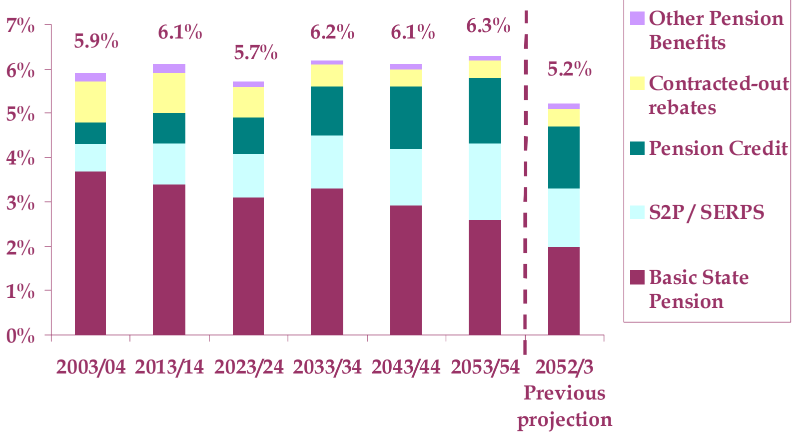
Projected proportion of GDP spent on pensions-related items



Government is now expecting to spend more on pensions

New demographic projections estimate that there will be 16.8 million people above state pension age (SPA) by 2051[1]—an increase of 1.8 million from earlier projections (and 54% higher than today's 10.9 million). Previously, the government projected spending on pension benefits and contracted-out rebates[2] in 2052 to be 5.2% of GDP. Now the government expects to spend 6.3% of GDP in 2053 - an increase of more than 20% (Chart 1)[3]. Current annual spending is 5.9% of GDP, or £65 billion.

The government also pays other state benefits to pensioners. Disability benefits, Housing Benefit and Council Tax Benefit paid to pensioners costs 1.1% of GDP today, and is projected to cost broadly the same in 2053[4]. This means that spending on pensions, contracted-out rebates and other benefits for pensioners is projected to rise from 7.0% today to 7.3% by 2053.

The government also forgoes tax and National Insurance revenue on private pension contributions and investment returns. After 'netting off' the tax paid back on current private pensions in payment, this revenue forgone represents a further 1.5% of GDP, or £16 billion today[5]. There are no projections of revenue forgone for future years.

Pension Credit costs have not changed significantly

Most of the difference between the projections is in estimates of spending on the Basic State Pension, with costs increasing by 0.6% of GDP in response to the higher estimate of the number of people over SPA. In contrast, estimates of the cost of Pension Credit (PC) have increased by 0.1% of GDP. This smaller increase than expected is due to a reduction in the assumed level of take-up of PC.

The latest projections assume that only 75% of people entitled to PC ever claim it, consistent with the target set for October 2004[6]. The previous estimate of the cost of PC assumed 80% of entitled people claim, while the first estimate assumed all entitled people claimed[7].

PC projections are uncertain

The fact that PC has to be claimed makes the projected cost uncertain. If, as in the initial cost projections, everyone who was entitled was assumed to claim PC the projected cost would increase by up to 0.5% of GDP by 2053[8].

PPI Briefing Notes clarify topical issues in pensions policy.

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There are other uncertainties in projecting the cost of PC. Entitlement is based on other income, including state pensions, private pensions, other savings and earnings. Current projections assume that income from all of these sources grows in line with average earnings[9]. But this seems a strong assumption.

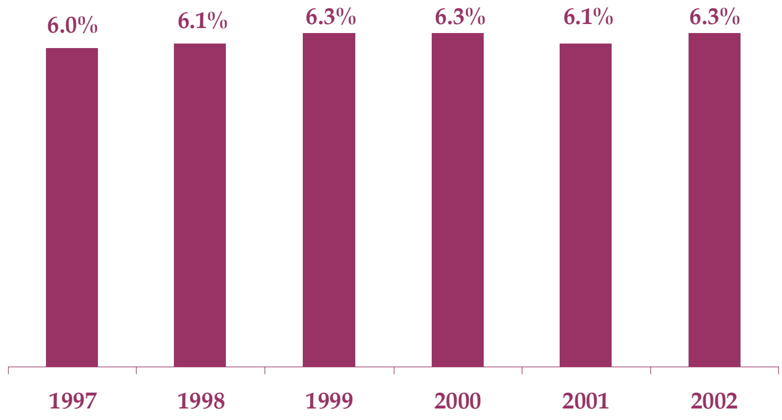
Expenditure on state pensions (other than PC) is fairly flat over the next 50 years, despite the number of pensioners increasing by 50%. This means that the average pensioner receives less in earnings terms from state pensions over time.

There are also indications that income from private pensions is likely to grow slower than earnings. The average contribution, after taking account of contributions that simply replace part of the state system, is only 6.3% of earnings, and has not risen in recent years (Chart 2)[10]. As longevity increases, so do the contributions needed to provide the same level of pension. So on current trends, average private pensions will also fall relative to earnings[11].

Currently, 80% of pensioners' incomes come from state and private pensions[12]. So, for all income used to calculate PC to increase at the rate assumed in the current projections, income from sources outside state and private pensions needs to grow much faster than earnings.

Contributions to private pensions have not risen

Average private pension contributions on top of contracted-out rebates, as a proportion of National Average Earnings



It is likely that more people over SPA will work in future, and so earnings will be an increasing part of pensioners' incomes[13]. It is also likely that more income will come from other forms of saving, such as housing[14]. But it is not clear how large these increases will have to be to offset the expected fall in pension income, and whether these increases are realistic.

Uncertainty in the future cost of PC is a problem

There is no indication of what the impact would be on the cost of PC if earnings and savings did not grow as expected. This uncertainty in the cost of the state pension system is important. Any reform option is automatically compared to the cost of the current system, to see if it is 'affordable'. A realistic range for the possible future cost of the current system is essential to allow proper comparisons to be made.

For more information on this topic, please contact

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[1] Figures from the GAD 2002-based population database, www.gad.gov.uk

[2] Pension benefits include the Basic State Pension, SERPS/S2P, Pension Credit, winter fuel payments, Christmas bonus and TV licences for the over 75s. Estimates of spending on contracted-out rebates have not been updated to take account of the latest demographic projections, but are the latest available.

[3] Benefit figures from DWP long-term projections (www.dwp.gov.uk/asd/asd4/long-term.asp), Contracted-out rebate figures from GAD (2003) *Quniquennial Review*

[4] DWP long-term projections

[5] Provisional PPI estimate based on Inland Revenue figures (www.inlandrevenue.gov.uk/stats/pensions/table7_9.xls) adjusted for new ONS private pension contribution estimates (July 2004). New IR figures are expected in September 2004.

[6] Department for Work and Pensions

[7] DWP (2002) *Simplicity, Security and Choice: Working and Saving for Retirement*, DWP (2001) *The Pension Credit: Long-term Projections*

[8] Assuming that non-claimants are entitled to similar amounts of PC to those who do claim

[9] Department for Work and Pensions

[10] PPI estimates based on ONS estimates of private pension contributions (July 2004) and Inland Revenue estimates of contracted-out rebates

[11] See Curry & O'Connell (2003) *The Pensions Landscape*

[12] PPI estimate based on DWP (2004) *The Pensioners' Incomes Series 2002/3*

[13] O'Connell (2003) *Raising State Pension Age: An Update*

[14] Curry (2004) *Property or Pensions?*