

State pensions

Extract from the July 2017 Fiscal risks report

6.15 The state pension is the biggest component of welfare spending. In 2016-17, 12.9 million pensioners received an average £7,110 of state pension payments each. The ageing of the population is the most important underlying driver of spending on pensioner benefits, although policy choices are also important. These include changes to the state pension age (the SPA, which affect the numbers of people eligible) and to uprating policy (which affects the average amount that each eligible person receives).

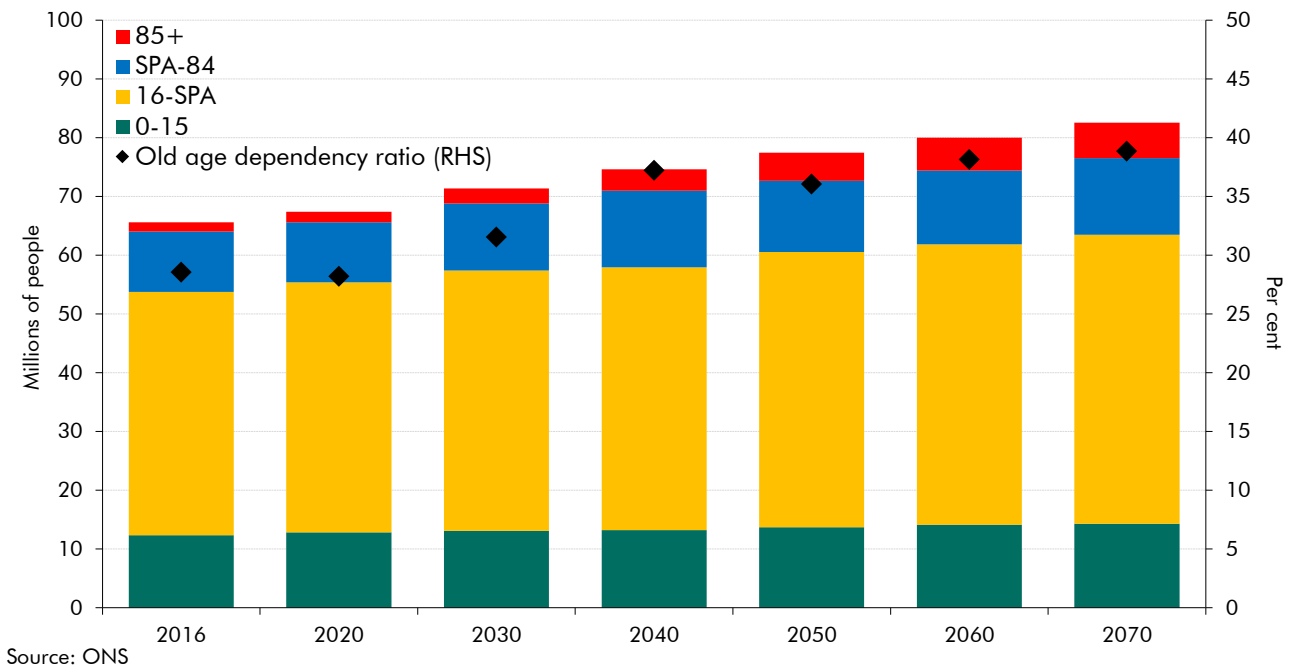
Drivers of pensions spending: population ageing

6.16 The size and age-structure of the population are important drivers of the public finances in general: the number of children helps drive education spending; the number of working-age adults helps drive tax receipts; and the number of older adults helps drive health, social care and pensions spending. Fiscally, the ageing of the population is the most important demographic factor over the medium- and longer term – specifically the number of elderly adults as a percentage of those of working-age (the ‘old-age dependency ratio’). This is the key driver of spending as a share of GDP and the most important demand-side driver of pensions spending (as well as on health and social care, as discussed in the next section).

6.17 Like many developed nations, the UK’s population is expected to age over the next few decades, with the old-age dependency ratio rising. This reflects increasing life expectancy, relatively low fertility rates, and the 1960s baby-boomer cohorts reaching retirement age. According to the latest ONS population projections (published in 2015), this is somewhat offset by net inward migration, which is concentrated among people of working age.

6.18 As Chart 6.5 shows, the UK population is growing in size and the oldest groups are growing fastest. The adult population increased by about 13 per cent between 2001 and 2016, but the number of adults aged over 65 increased by 26 per cent and the number aged 85 or over by about 38 per cent. Those aged over the SPA increased by a smaller 15 per cent, thanks to rises in the SPA for women. As a result, the old-age dependency ratio – with the elderly defined as those aged above the SPA – increased only slightly from 29.8 to 30.5 per cent. The latest ONS projections assume that population ageing will continue, with the old-age dependency ratio reaching 38.9 per cent by 2070, despite future rises in the SPA. The proportion of the population aged 85 and over is projected to rise more rapidly – from 2.4 per cent in 2016 to 7.3 per cent in 2070 – a trend significant for spending on health and adult social care services and on disability benefits.

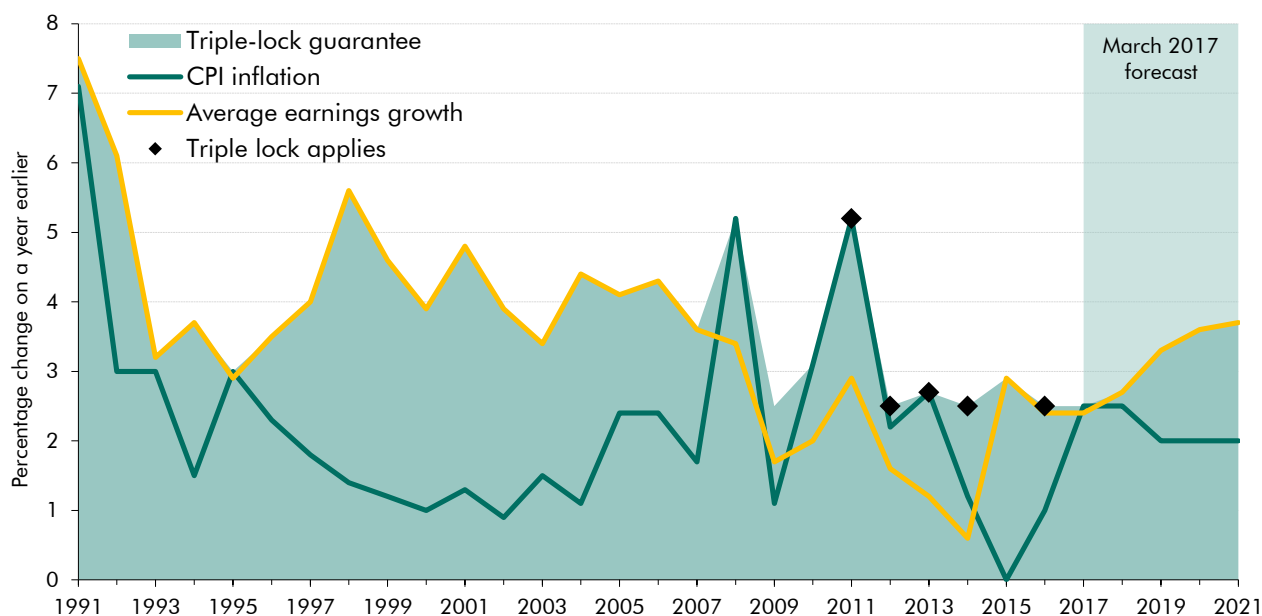
Chart 6.1: UK population structure



Drivers of pensions spending: unit costs and policy decisions

6.19 The annual increase in the value of the state pension is a policy choice that affects the average cost per pensioner over time. The current uplift is governed by the 'triple-lock', which raises its value by the highest of CPI inflation, earnings growth, or 2.5 per cent each year. This applies to the main rate of the new (flat-rate) state pension that new pensioners have been receiving since April 2016, and to the basic state pension that preceded it (which 81 per cent of pensioners will still be in receipt of in 2021-22 in our latest forecast). On average, the triple lock raises state pension awards faster than average earnings growth, which ratchets spending higher as a share of GDP. This is shown in Chart 6.6 where in five of the six years to 2015 the triple lock increased the state pension faster than average earnings. As a result, the basic state pension increased by 22 per cent between 2010-11 and 2016-17 while average weekly earnings increased by only 11 per cent.

Chart 6.2: Triple lock premium compared to earnings growth



Note: These figures are consistent with our 2017 FSR, including the data and November 2016 medium-term forecasts on which it was based. The figures are used to uprate state pensions in the following financial year.

Source: ONS, OBR

6.20 Policy decisions also affect the proportion of the population eligible for state pensions. For example, the number of years of National Insurance contributions or credits required to qualify has increased with the introduction of the new state pension. This is expected to reduce the number of people eligible by around 35,000 by 2020 (around 2 per cent of the new state pension caseload by 2020).¹ As noted below, over the longer term the new state pension is expected to reduce spending, reflecting both caseload and average award effects. The bigger changes to eligibility relate to SPA changes. Previously legislated increases mean that the SPA will have completed its rise from 60 to 65 for women by November 2018. It then rises to 66 for both men and women by October 2020, and again to 67 between 2026 and 2028. Thereafter, the SPA will be subject to a 'longevity link', where increases are informed by projected changes in life expectancy, so that on average up to a third of adult life is spent over the SPA. The effect is discussed later in the section.

Medium-term pensioner spending risks

6.21 Between 2016-17 and 2021-22, we forecast that spending on state pensions will rise by about 16 per cent in cash terms, but fall by about 0.1 per cent of GDP. SPA rises reduce the caseload as a share of the population, which more than offsets the effect of awards rising faster than earnings at the start of the forecast due to the triple lock on uprating.²

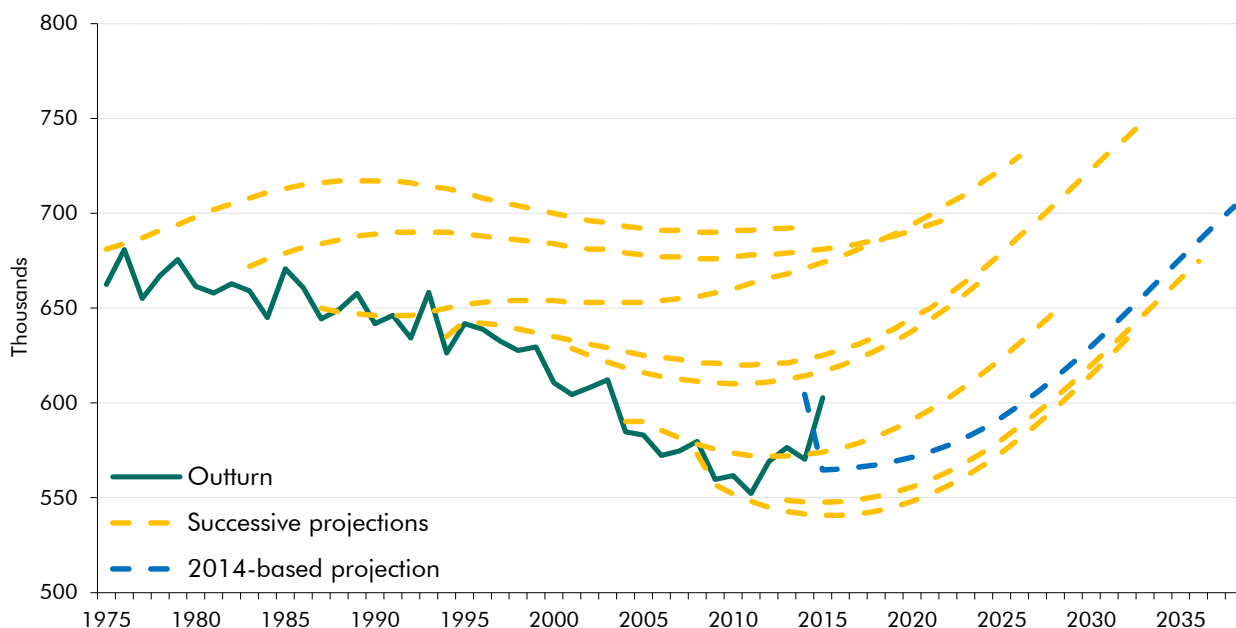
¹ DWP, *The single-tier pension: impact assessment*, Impact Assessment, May 2014.

² See Chart 4.8 and related discussion in our March 2017 *Economic and fiscal outlook*. Among the major items of welfare spending, only for state pensions spending is rising generosity a source of upward pressure on spending as a share of GDP over the forecast period.

6.22 There are two main risks to our medium-term forecast:

- **Mortality rates:** spending on the state pension is sensitive to mortality rates among those receiving it. For some decades, falling mortality rates at old age have put upward pressure on spending, but they have risen unexpectedly in the past few years, putting downward pressure on spending (Chart 6.7).^{3,4}

Chart 6.3: The unanticipated rise in the numbers of deaths



Source: ONS

- **Triple-lock uprating:** the biggest source of uncertainty is real earnings growth. Any periods of falling real earnings will put upward pressure on state pensions spending as a share of GDP, as the inflation or 2.5 per cent elements of the lock kick in. As Chart 6.6 showed, it is the CPI element, rather than the 2.5 per cent floor, that has been the main source of this pressure. As regards the former, the biggest uncertainty in our medium-term forecast relates to our judgement that productivity (and therefore real earnings) growth will return close to historically more normal rates over the next five years. This means that earnings growth in our central forecast is higher than CPI inflation and 2.5 per cent beyond the near term. So a key risk would be a shock that raises inflation but not earnings growth (such as an oil price shock). There are few circumstances in which the triple lock would reduce spending materially as a share of

³ ONS, *Provisional analysis of death registrations: 2015*, April 2016.

⁴ Several explanations have been put forward to explain the higher mortality rates over the past five years, including above average deaths due to dementia (although this may be the result of changes to the way deaths are recorded rather than a true reflection of the cause of death), lifestyle diseases (obesity and diabetes), air pollution and cuts to health and social care – although no causal links have been identified. See Hiam, Dorling, Harrison and McKee, *What caused the spike in mortality in England and Wales in January 2015*, *Journal of the Royal society of Medicine* Vol 110(4), 2017 and 2020 Delivery, *Exploring the causes of increasing mortality*, 2017.

GDP⁵ – it is much more likely to have a ratchet effect that progressively raises spending as a share of GDP each time earnings growth falls short of the other parameters.

- 6.23 There is also uncertainty associated with the transition to the new state pension. In successive *Welfare trends reports (WTR)* we have shown how significant changes to the welfare system often come with unexpected fiscal consequences – from the introduction of tax credits in the 2000s to the recent and ongoing reforms to incapacity and disability benefits. We have not yet had reason to make significant changes to our forecast of the impact of the new state pension, but that will remain a possibility as the caseload rises and more information becomes available on its effects.
- 6.24 Between 2020 and 2026, the pressure from ageing will not be offset by changes to the SPA. This was discussed in our November 2016 *EFO*, where we noted that following a 2.6 per cent fall in caseloads in the five years to 2020, a 9.1 per cent increase was projected over the following five years. That would raise state pension spending by 0.3 per cent of GDP. This estimate would be sensitive to changes in mortality rates among older people (affecting spending) or to the working-age population (affecting GDP).

Long-term pensioner spending risks

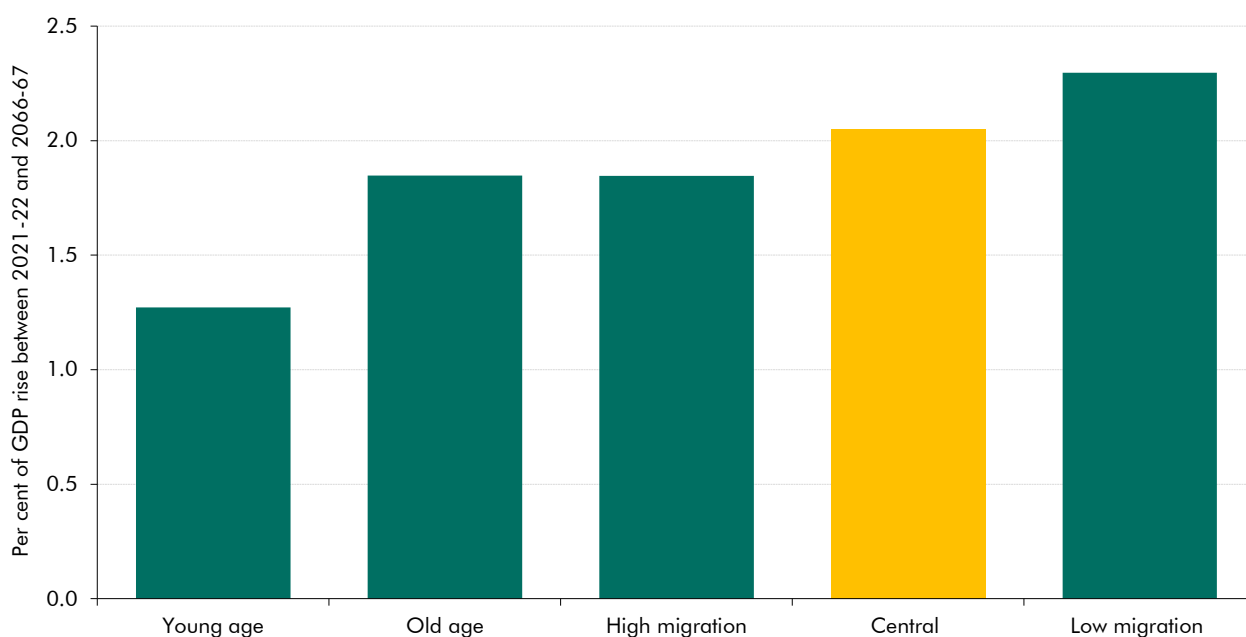
- 6.25 In our 2017 *FSR*, we projected that spending on state pensions and other pensioner benefits would rise from 5.0 per cent of GDP in 2021-22 to 7.1 per cent of GDP in 2066-67. The main upward pressures come from the ageing population and triple lock uprating, which we assume would add 0.34 percentage points a year on average to annual uprating over the long term. Partly offsetting these factors are the ‘longevity link’ (leading to further rises in the SPA), less generous pension entitlements under the new state pension,⁶ and the effect on GDP from higher employment rates among older workers.
- 6.26 Our long-term projections are sensitive to the assumptions we make about demographic factors, SPA changes and the triple lock. These are discussed below. There are also risks associated with the shift to the new state pension, as with any major changes to a benefit system that affect large numbers of people.
- 6.27 In terms of sensitivity to **demographic assumptions**, Chart 6.8 shows the projected increase in spending between 2021-22 and 2066-67 under different variants presented in our 2017 *FSR*, and how they compare with our central projection of a 2.1 per cent of GDP rise. The variants are affected by differences in the old-age dependency ratio (raising spending and reducing the share of the population that is of working age), by the direct effect of SPA rises on eligibility (reducing spending) and by the indirect effect of SPA changes on employment rates (where we assume, in line with recent evidence, that raising the SPA increases employment rates among those in the age groups affected, which boosts GDP). The employment effect at older ages is sufficient in the old-age scenario (which combines lower

⁵ One type of shock that could leave state pensions spending lower as a share of GDP despite the triple lock would be a negative shock to the labour share of income, whereby earnings growth would be slower than growth in nominal GDP per head.

⁶ In our 2014 *FSR*, we estimated that while there would be little impact on spending until the 2040s, by 2063-64 it would deliver savings of 0.4 per cent of GDP.

fertility, higher life expectancy and lower migration) to reduce spending as a share of GDP relative to the central projection. Only the low migration variant has a higher increase in state pension spending than the central case, because it includes a smaller working-age population, but does not include higher life expectancy that would feed through to SPA changes and the employment rate among older people. But even the young-age scenario sees spending rise as a share of GDP in the long term due to ageing and the triple lock.

Chart 6.4: Change in pension spending under different demographic variants



Source: OBR

6.28 In terms of **assumptions about future changes to the SPA**, there are uncertainties around how the longevity link will be applied and the effects of SPA changes on employment among older people. The SPA changes underpinning the projections in Chart 6.8 above were based on our calculations of how the longevity link would apply. Since our 2017 *FSR*, the first independent report into the state pension age (required by Pensions Act 2014) has been published. It recommended that the SPA should rise to 68 between 2037 and 2039, but that it should not increase by more than one year in any 10-year period.⁷ At the same time, as required by the same legislation, the Government Actuary's Department (GAD) reported its analysis of the implications of specifying the 'up to one third of adult life' principle as either 32 or 33.3 per cent of adult life from age 20. GAD found that under the 32 per cent scenario the SPA could rise to 68 between 2028 and 2030 and to 69 between 2040 and 2042. Under the 33.3 per cent scenario these dates move back to 2039 to 2041 and 2053 to 2055.⁸ These timetables differ from those assumed in our 2017 *FSR*.

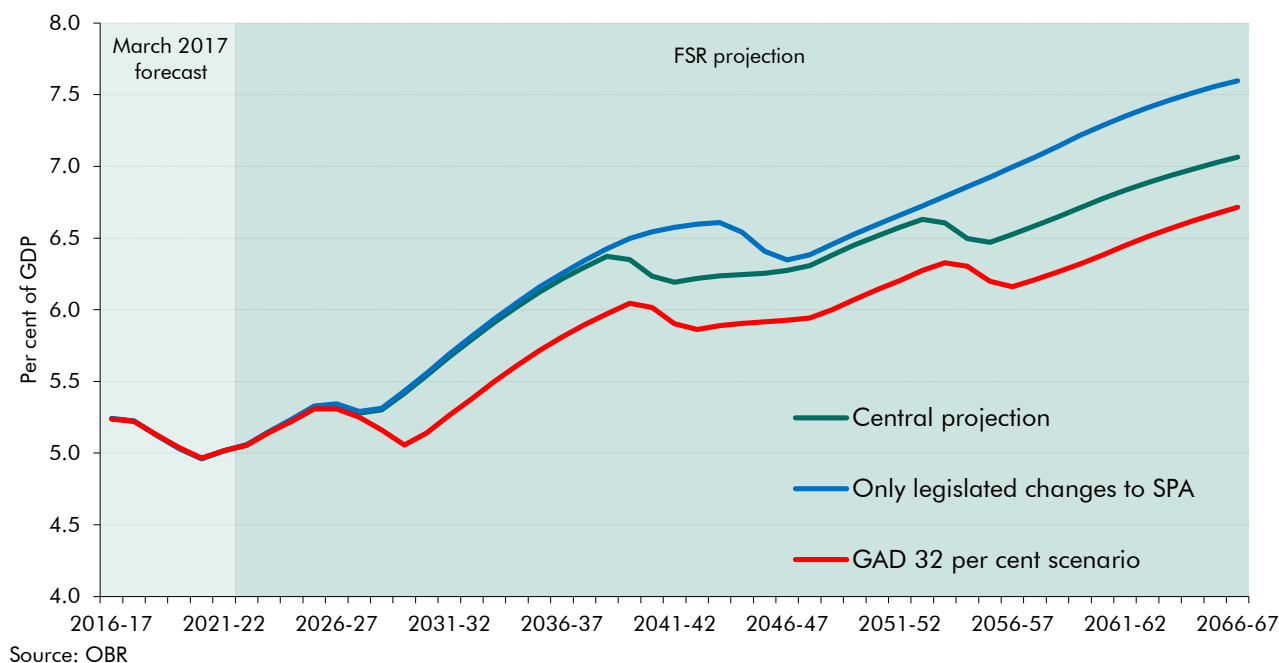
6.29 Chart 6.9 illustrates the sensitivity of spending to different assumptions about the number and timing of future SPA changes. On the basis of only currently legislated changes to the SPA, spending in 2066-67 would be 0.5 per cent of GDP higher than our central projection.

⁷ Cridland, *State Pension age independent review: final report*, 2017.

⁸ GAD, *State Pension age periodic review: report by the Government Actuary*, 2017.

On the basis of the GAD '32 per cent' timetable, spending in 2066-67 would be 0.4 per cent of GDP lower than our central projection.

Chart 6.5: State pension spending projections under different SPA paths



6.30 In terms of our **assumptions about the long-term cost of the triple lock**, there are uncertainties associated both with the policy and its assumed effects. We define 'unchanged policy' over the long term as applying the triple lock. This could of course change. The 2017 Conservative Party manifesto stated that "we will keep our promise to maintain the Triple Lock until 2020, and when it expires we will introduce a new Double Lock, meaning that pensions will rise in line with the earnings that pay for them, or in line with inflation – whichever is highest." This commitment was superseded by the party's subsequent 'confidence and supply' agreement with the Democratic Unionist Party, which states that "there will be no change to the Pensions Triple Lock". Looking further ahead David Gauke, Secretary of State for Work and Pensions, said on 21 June 2017: "Do I think that in 10, 20, 30 years' time, we will still have a triple lock? I cannot see in all honesty how we can."⁹

6.31 The long-term effect of the triple lock is factored into our projections as a premium relative to earnings growth.¹⁰ Chart 6.10 shows the long-term effect of triple lock uprating on state pensions spending as a share of GDP. Against a baseline of earnings uprating, where spending rises by 1.1 per cent of GDP, the triple lock adds a further 0.9 per cent of GDP in our central projection. Basing the triple lock premium on experience over the past five years would add a further 0.3 per cent of GDP to the rise in spending. If productivity and real

⁹ The Telegraph, 'Triple lock' is unsustainable, says new Pensions Secretary David Gauke, 22 June 2017.

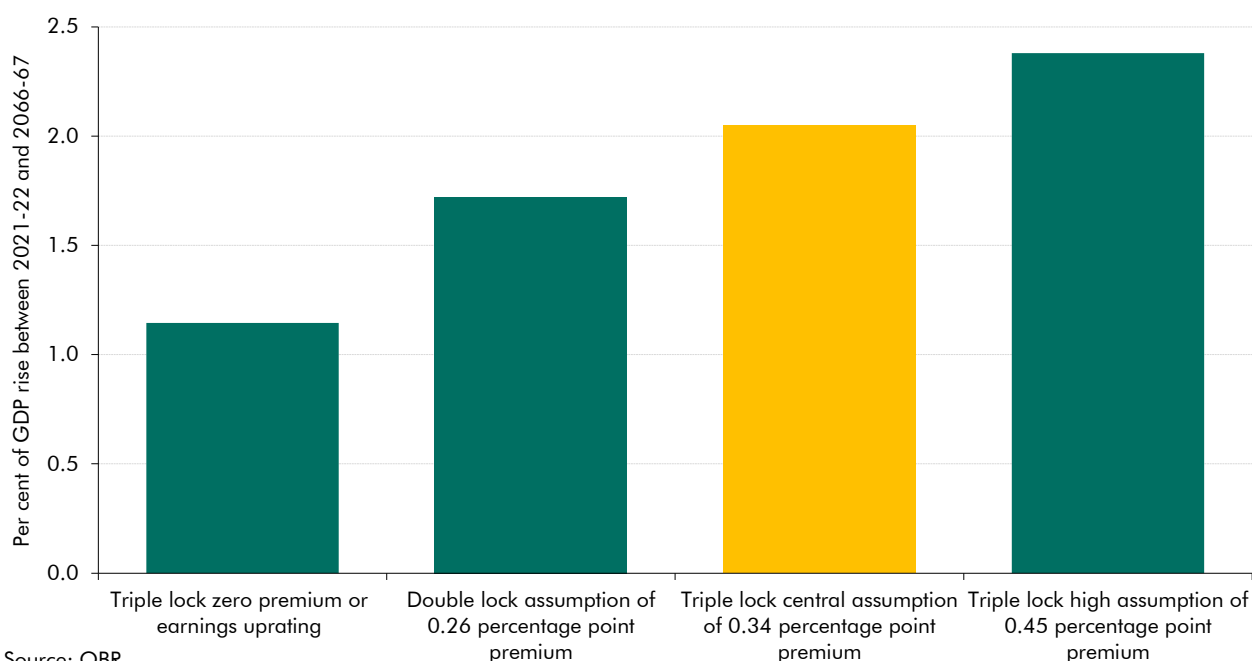
¹⁰ This is calculated as the average difference between two hypothetical paths for state pensions uprating – by earnings or by the terms of the triple lock – between 1991 and the end of our medium-term forecast (see Chart 6.6 and Chapter 3 of our 2017 FSR).

earnings growth were to remain weak, the recent past could prove a better guide to the long-term cost of the triple lock, which would be expected to bite more frequently.

6.32 Applying the same approach used to generate an estimated ‘double-lock’ premium relative to earnings growth would imply only a small drop in its cost – from 0.9 to 0.6 per cent of GDP in 2066-67. This is consistent with the IFS’s conclusion that removing the 2.5 per cent element of the lock would have only a modest effect on spending because it “*does little to change the projected long-run generosity of the state pension*” as it has been rare for both average earnings and inflation to be below 2.5 per cent.¹¹

6.33 Several other commentators see risks to fiscal sustainability associated with the triple lock. For example, Parliament’s Work and Pensions Committee has suggested that “*in the absence of reform the state pension would inevitably grow at a faster rate than the rewards of work and would account for an ever-greater share of national income. In particular, we find no objective justification for the 2.5 per cent minimum increase.*”¹²

Chart 6.6: Change in pension spending under different uprating factors



¹¹ IFS, *Moving from a Triple to a Double Lock does little to long-run state pension affordability*, 2017.

¹² Work and Pensions Committee, *Intergenerational fairness*, HC 59, November 2016.