The Pensions Review

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Jonathan Cribb
Carl Emmerson
Paul Johnson
Heidi Karjalainen

The future of the state pension: Executive summary

IFS Institute for Fiscal Studies

abrdn Financial Fairness Trust

UKRI Economic and Social Research Council

Executive summary

In this major report of the Pensions Review, led by the Institute for Fiscal Studies in partnership with the abrdn Financial Fairness Trust, we consider the role of the state pension in the UK pension system, analyse the key challenges for future generations of pensioners and set out policies that would improve the current system.

The state pension: where are we?

- The state pension can be claimed from age 66 (rising to 67 by 2028). The Department for Work and Pensions (DWP) estimates that by the mid 2030s, 80% of those reaching the state pension age will receive the full 'new state pension', currently worth £203.85 per week. At 30% of median (full-time) earnings, the full new state pension is at a higher level than the basic state pension was at any point since at least 1968.
- The state pension is an important source of income across the income distribution, although more important for poorer households. For example, among households with someone aged 66–70 where no one is in paid work, the state pension makes up 71% of income for the poorest fifth and 23% for the richest fifth. Indeed, if one wanted to buy an index-linked annuity to provide a pension that was equal to the current value of the new state pension (and then price indexed) from the age of 66, then that would require an outlay of over £200,000. This is a significant sum even at the top of the income distribution.
- Although many older pensioners – and a particularly large proportion of women who reached state pension age before 2010 – are receiving much less than the full new state pension, most new retirees receiving this amount (alongside any means-tested housing benefit and support for council tax) are close to or above the relative poverty line, even if they have no other income.
- Government spending on social security payments to pensioners is expected to be £152 billion (5.9% of national income) in 2023–24. Of this total, spending on the state pension, pension credit and winter fuel payment comprises £132 billion, or 5.1% of national income (the vast majority of the rest of the social security spending is on disability benefits and means-tested housing benefit). The 5.1% compares with 4.4% of national income spent on these payments (state pension, pension credit and predecessors, and winter fuel payment) in 1983–84 and 4.2% of national income in 2003–04.

Challenges facing the state pension

We have identified four key challenges facing the state pension system:

1. **The ageing population will add considerable pressure on public finances in coming decades.** According to the Office for Budget Responsibility (OBR), under current population projections and government policy (maintaining the triple lock and the state pension age rising to 68 by 2046), spending on the **state pension, pension credit and winter fuel payment is expected to rise** by 1.2% of national income (£32 billion per year in today's terms) by 2050. One key driver of this is that there are expected to be 25% more pensioners in 2050 than today, with another driver being how the state pension is indexed. The pressures due to health and social care are much bigger, with spending projected to rise by 4.1% of national income (£105 billion per year in today's terms) over the same period.
2. While there is naturally a debate about the right level of the state pension, **the 'triple lock' indexation policy (which increases the state pension each year by the highest of inflation, average earnings growth and 2.5%) ratchets up the value of, and spending on, the state pension over time in a way that creates uncertainty around what the level of the state pension will be relative to average earnings, and for the public finances**. Compared with increasing the state pension in line with average earnings, we project that – on its own – the triple lock could easily cost anywhere between an additional £5 billion and £40 billion per year in 2050 in today's terms.
3. **If the government wants to rein in state pension spending, then relying *only* on raising the state pension age to achieve this, rather than moving to less generous indexation, would hit those with lower life expectancy harder.** This is because the same increase in the state pension age has a larger proportional impact on the expected state pension wealth of people who die at younger ages than for people who live longer. People who die at younger ages do not benefit as much from the triple lock, which increases the value of the state pension in the future. Groups with lower life expectancy include poorer people (compared with richer people).
4. **Despite its new-found simplicity, there is a mixture of confusion and pessimism about the state pension.** Although the state pension has increased at least as fast as inflation every year since 1975, 38% of people think that in the next 10 years it will not keep up with inflation. Pessimism is also widespread; a third of people do not think the state pension will exist in 30 years' time.

It is important to note that the new state pension at its current level is just about enough by itself to keep most people out of income poverty (according to standard government metrics). However, there are some people – in particular, single households living in private rented accommodation – for whom the new state pension and means-tested benefits are not enough to keep them above the income poverty line. Take-up of means-tested benefits among retirees is also far from complete; the design of these benefits will be considered in a later report of the Pensions Review.

Even for households for whom the new state pension is enough to keep them above the income poverty line, it is not enough on its own for a comfortable retirement or to provide most people with a standard of living they have been used to in working life. Instead, for most people, the state pension is a basis for building upon with their own savings, rather than the whole of their pension provision.

The future of the state pension: a new way forward

Despite these challenges, our view is that the state pension is not in need of wholesale change. Indeed, its structure has much to commend it. Given where we are, we think we should retain a flat-rate state pension that is neither earnings-related (which would mean higher state pensions for people with higher earnings over their lifetime) nor means-tested (which would mean lower state pensions for pensioners with higher private incomes). Although the state pension is higher than in the past, given its current level we think it should continue to be accessible from a single universal state pension age, rather than being made available from an earlier age at a permanently reduced amount.

However, improvements are needed to address the key challenges set out above, in order to build on the strengths of the current system and provide a sustainable long-term future for the state pension.

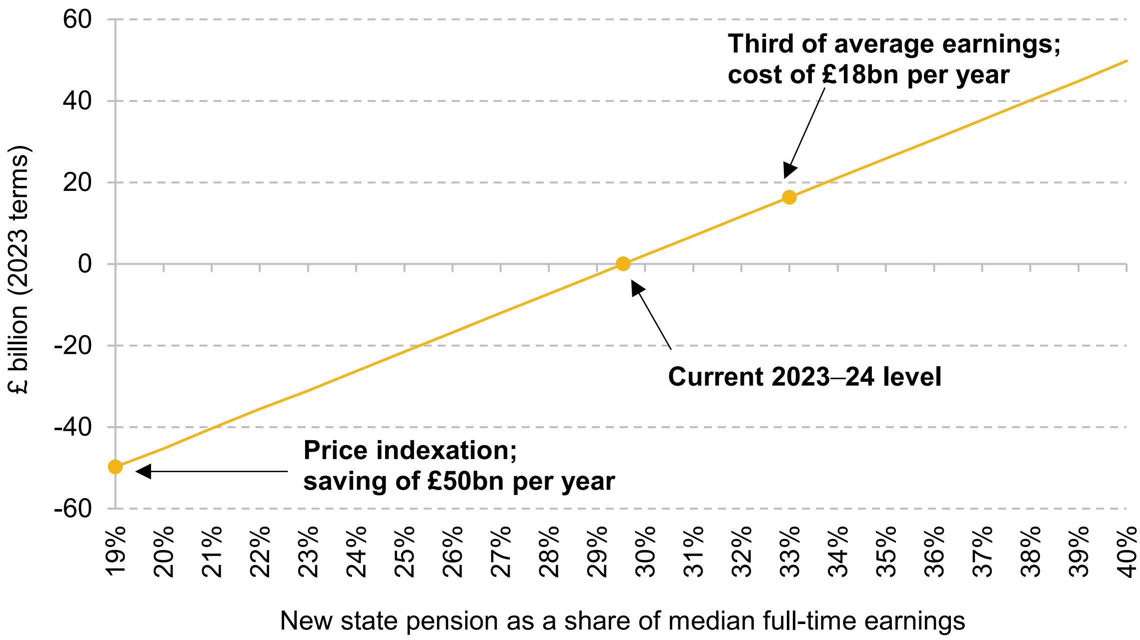
We suggest a new **'four-point pension guarantee'** to achieve this:

1. There will be a government **target level for the new state pension**, expressed as a share of median full-time earnings. Increases in the state pension will in the long run keep pace with **growth in average earnings**, which ensures that pensioners benefit when living standards rise.
2. Both before and after the target level is reached, the state pension will continue to increase **at least in line with inflation** every year.
3. The state pension **will not be means-tested**.
4. **The state pension age will only rise as longevity at older ages increases, and never by the full amount of that longevity increase.** To increase confidence and understanding, the government will write to people around their 50th birthday stating what their state pension age is expected to be. Their state pension age would then be fully guaranteed 10 years before they reach it.

To set the target level, as the government has done with the minimum wage, politicians should state what they believe to be an appropriate level for the new state pension (and the basic state pension) relative to average earnings (as measured by median full-time earnings). They should then legislate a pathway to meeting that target with a specific timetable. This would result in an explicit commitment from the government to target a level of state pension relative to average earnings, which would then be maintained in the long run too.

In choosing the level of the new state pension, the government has to consider the trade-off between a higher income for pensioners and the public finance implications that will have. As an illustration of the cost of increasing the value of the state pension relative to average earnings, Figure ES.1 shows the cost in 2050 of different levels of the state pension (measured in today's terms) relative to keeping the state pension, as today, at 30% of median full-time earnings (which itself would lead to a saving of £24 billion per year in today's terms compared with the expected cost of the triple lock).

Figure ES.1. Impact on state pension spending in 2050 relative to earnings indexation from 2023 onwards



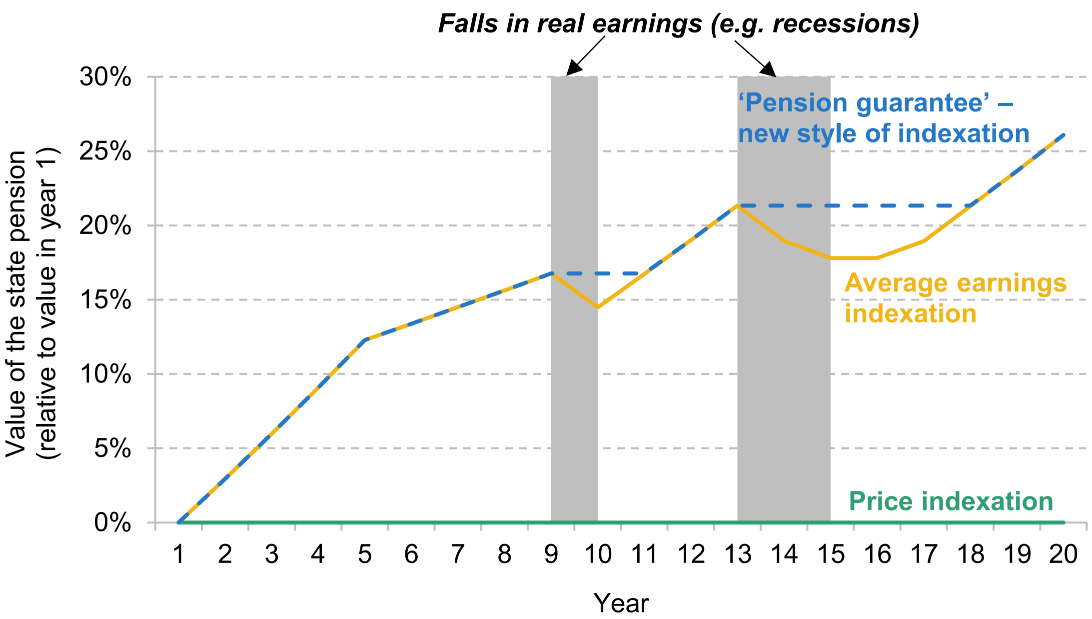
Note: Current level of the new state pension relative to median full-time earnings is 29.6%.

Source: Authors' calculations using OBR 2023 projections of state pension spending and long-term economic determinants.

For example, increasing the state pension to be a third (33.3%) of average earnings in 2050 would cost an additional £18 billion per year in today's terms (about 0.7% of national income), compared with keeping the state pension at the current 30% of average earnings. It would also deliver a state pension equivalent (in terms of today's earnings) to £230 per week, or £26 higher, than today's full new state pension of £204 per week.

Once the government has chosen and reached a target level for the new state pension relative to average earnings, the state pension should then be indexed in line with our suggested pension guarantee. It is worth noting that this process is how the state pension in Australia is indexed. Figure ES.2 illustrates how this would work in practice by showing the real value of the state pension over time, given an illustrative 20-year period. The figure shows that in periods of relative economic stability, when average earnings growth is above inflation, the value of the state pension rises in real terms, growing in line with average earnings (the blue dashed line follows the yellow line). The rate at which the value of the state pension rises depends on how fast average earnings grow. As the figure shows, when real earnings growth is faster (years 1–5), the real value of the state pension also rises faster than when earnings growth is slower (years 6–9).

Figure ES.2. Illustration of how our suggested new style of indexation would operate



Note: Assumes inflation of 2% and average earnings growth of 5% in years 1–5 and 3% in years 6–9. In the first period of negative real earnings growth, average earnings growth falls to 0% for one year. In the second period of lower average earnings growth, which lasts four years, the rates are 0%, 1%, 2% and 3%. Between the periods of negative real earnings growth, the nominal average earnings growth rate is 4%, as it is in the final three years.

Source: Authors' calculations.

However, during any period where average earnings growth is below inflation, such as a recession (highlighted in grey in the figure), the value of the state pension rises in line with prices (and is therefore constant in real terms). This protects the purchasing power of the state pension in times of an economic downturn (so the blue dashed line is horizontal and above the yellow line). The state pension then continues to be indexed to prices, rising at the rate of inflation, until it reaches the target level again (so the blue dashed line does not rise until the yellow line reaches it), and then continues to rise again in line with average earnings.

This report sets out our key findings and suggests a way forward for the future of the UK state pension. These policy suggestions are based on new findings in this report, evidence from specially conducted polling and focus groups, and discussions with expert stakeholders. Together with a commitment from the government to target a level of the state pension relative to average earnings, the suggested ‘four-point pension guarantee’ is carefully designed to build on the strengths of the current state pension system and to address some of the key challenges we have identified. In particular, it would help ensure people can have confidence and certainty over the state pension as a future source of income to protect them from poverty and provide a solid bedrock on top of which they can build private pension saving.

Key findings

1. **The UK state pension system has a number of attractive features that work well. Much of this follows from the success of the recommendations of the Pensions Commission almost 20 years ago.** Following reforms legislated in 2007 and 2014, we are moving towards a flat-rate state pension which most people who spend most of their adult life in the UK will receive in full. The full new state pension is set at a level that means most new pensioners do not need to rely on the means-tested pension credit. Even with no private income, most people receiving the full amount are very close to or above the relative poverty line. The first universal increase in the state pension age was legislated and implemented with relatively little controversy. The state pension age – and the fact it is rising – is relatively well understood.

2. **There is widespread pessimism about the future of the state pension, and a mixture of confusion and pessimism about the level of the state pension.** Only one in five working-age people (20%) know even approximately how much a full state pension is. Despite it being increased every year by at least inflation since 1975, 38% think that the state pension will rise by less than inflation over the next decade. One-third do not think the state pension will exist in 30 years’ time. This is likely a driver of many (41%) thinking they will not have a good standard of living in retirement.

3. **The state pension should remain flat-rate, i.e. neither earnings-related nor means-tested. This maintains the post-Pensions-Commission settlement for a pension system that balances state and private pensions in retirement.** Many other European countries provide an earnings-related state pension. However, earnings-related pensions have an unhappy history in the UK, and we sense no political appetite for raising taxes in order to fund bigger state pensions that benefit middle and higher earners in particular. Widespread means-testing of the state pension

is not an attractive option when we rely on private saving to supplement the state pension for so many, as it could significantly reduce saving incentives and risk undermining the success of automatic enrolment. The risk of distorted saving incentives applies to most workers, as the state pension is an important source of income for many who are not poor; for example, it makes up nearly half of income for recently retired middle-income pensioners.

4. **The UK should maintain a single universal state pension age, rather than introduce an 'early access' age in return for a reduced award as is possible in some countries.** Allowing early access would mean that people approaching the state pension age would have to make a complex financial decision about the timing of claiming their state pension, which would have long-lasting consequences. It would also complicate the concept of the state pension age, which is perhaps the best-understood part of the system. Allowing early access at a permanently reduced rate would increase individuals' risk of income poverty at older ages and place greater demands on means-tested support for pensioners. This means the case for allowing early access would be stronger if the state pension were made more generous relative to average earnings. We will consider the case for additional state support for those who find it hard to work prior to state pension age in a later report in this Review.

5. **The ageing population will add considerable pressure on public finances in coming decades.** Under legislated state pension age increases (eventually to 68) and the triple-lock method of indexation, spending on state pension, pension credit and winter fuel payment is projected to rise from 5.1% of national income in 2023–24 to 6.4% in 2050–51 under the OBR's central scenario. Pressures on the health and social care budgets are even larger – set to push up spending from 9.5% of national income now to 13.6% in 2050–51. While there is considerable uncertainty around these precise numbers, it is clear the ageing of the population represents a substantial challenge for the public finances.

6. **The triple lock increases the value of, and thus public spending on, the state pension relative to both prices and average earnings over time.** Compared with increasing the state pension in line with average earnings, we project that the triple lock could reasonably be expected to cost anywhere between an additional £5 billion and £40 billion per year in 2050 in today's terms, equivalent to between 0.2% and 1.6% of national income. A government that wants to control future spending on the state pension, while maintaining the near-universal and flat-rate nature of the state pension, would need to abandon the triple lock or increase the state pension age even further than currently legislated.

7. The latest government-commissioned Independent Review of the State Pension Age proposed that spending on the state pension should be capped at 6% of national income. **The projections from that report suggest that even with a state pension age of 70 in the early 2050s, spending on a triple-locked state pension would exceed this cap at that point, though these projections are very uncertain, in particular because of the uncertainty generated by the triple lock.** The cap is badly designed – for example, it would allow a much more generous deal to those from small birth cohorts than to those from large cohorts – and it should not be implemented.

8. **Keeping the triple lock while raising the state pension age would hit poorer people more because the loss of a year of income is more important for those with lower life expectancy, as they spend fewer years above the state pension age. On the other hand, those with a higher life expectancy benefit relatively more from the triple lock, as they are more likely to be receiving a generously indexed state pension in their 90s and beyond.** If one were to increase the state pension age from 66 to 67 today, that would on average reduce the lifetime value of the state pension by 6%, but it would reduce it by 8% for the poorest fifth of men and by 5% for the richest fifth of men. In contrast, the impact of moving away from the triple lock and to earnings indexation – also a 6% reduction in expected value of the state pension on average – would be a reduction of 4% for the poorest fifth of men and 6% for the richest fifth of men. The patterns for women are similar.

9. **The triple lock ratchets up the value of, and spending on the state pension over time in a way that creates uncertainty for individuals around what the level of the state pension will be relative to average earnings, and for the public finances.** Because of the ratcheting effect of the triple lock, which locks in any above-earnings-growth increases in the state pension, the range of possible levels of the triple-locked state pension relative to earnings is wide. Based on the past 30 years of inflation and earnings data – and uprating decisions – a reasonable range (occurring 80% of the time) for the state pension in 2050 would be 30% to 37% of median full-time earnings, a range of £10,900 to £13,400 (in terms of today's earnings). The long-term risks for the sustainability of the public finances also increase the likelihood of other cuts to the state pension system being introduced in future decades, such as an even higher state pension age.

10. **The introduction of the new state pension in 2016 and (to a lesser extent) the triple lock since 2010 together have resulted in the full rate of the new state pension approaching 30% of median full-time earnings – higher than the basic pension was at any point since at least 1968.** We therefore now have a flat-rate state pension that is more generous, relative to median earnings, than it was when the

earnings link was broken by the Conservative government in 1980. Despite this, on average, people in younger generations are likely to receive lower state pension incomes under the flat-rate new state pension than if earnings-related state pensions had not been abolished. Though, due to automatic enrolment, many more people from younger generations are also likely to accumulate at least some private pension wealth.

11. **A more generous state pension would of course lead to a higher income for current and future pensioners – and would be particularly valuable to low- and middle-income pensioners – but this would also have implications for public finances.** If, for example, the government decided that the new state pension should be worth a third of median full-time earnings, this would mean that the new state pension would be 13% higher than it currently is – £230 per week, or £26 higher, in today's earnings terms than the current full new state pension of £204 per week – costing an additional £18 billion per year by 2050 (relative to keeping the new state pension at 30% of median earnings).

12. **Despite many believing so, it is not true that only people paying National Insurance contributions generate eligibility towards the state pension.** Ever since 1948, there have been credits for periods of unemployment and incapacity due to poor health. The state pension is now much more generous in its coverage than in the past, with those reaching state pension age after 2010 able to get recognition for time spent out of the labour market due to childcare and other caring responsibilities. There is no longer a reduced pension available to married women for those who got married after 1977. The new state pension offers a better deal to the self-employed than prior to 2016. There are a large number of complex rules over what counts as a 'qualifying year' which generates eligibility to a state pension. This leads to various inequities – for example, someone earning £5,000 per year who also receives universal credit will automatically qualify, whereas someone with the same level of earnings but with a higher-earning spouse, who is therefore not eligible for universal credit, is unlikely to qualify. We are rapidly moving to a state pension system in which most people who live in the UK all their adult life get a full state pension. But we are not quite there yet.

13. **There is a good case for simplifying the complicated eligibility rules and moving further towards a universal pension where essentially all people build entitlement to a state pension each year of life they live in the UK (up to a cap).** This would be a more transparent and arguably fairer system. To the extent that this move would have a cost to the exchequer, the number of years required for a full state pension could rise slightly from 35 years to make it cost neutral (or, if so desired, could be raised further). A more universal state pension would simplify the system, lead to some efficiency savings and reduce the risk of some people inadvertently falling through the net. But

the administrative challenge of accurately measuring who is resident in the country in each year would have to be overcome and the change would not lead to significant differences in state pension incomes for most people. In other words, altering the current system might be a substantial administrative challenge benefiting a relatively small group. That said, the obvious, and often unintended, inequities created by the current system mean that a change towards greater universality is, at the very least, worth exploring.

14. **Together, our new findings in this report, evidence from specially conducted polling and our discussions with various stakeholders suggest a 'four-point pension guarantee'. This guarantee is designed to: give people more confidence and certainty over what they can expect their state pension to provide; help them avoid old-age poverty; and provide a bedrock on top of which private pension saving can be built.** In order to achieve these goals, the guarantee has to be communicated coherently and transparently, and its implications have to be clear and understandable for both current and future generations of pensioners.

15. **The four points are:**
    1. There will be a government **target level for the new state pension**, expressed as a share of median full-time earnings. Increases in the state pension will in the long run keep pace with **growth in average earnings**, which ensures that pensioners benefit when living standards rise.
    2. Both before and after the target level is reached, the state pension will continue to increase **at least in line with inflation** every year.
    3. The state pension **will not be means-tested**.
    4. **The state pension age will only rise as longevity at older ages increases, and never by the full amount of that longevity increase.** To increase confidence and understanding, the government will write to people around their 50th birthday stating what their state pension age is expected to be. Their state pension age would then be fully guaranteed 10 years before they reach it.

16. **To set the target level, as the government has done with the minimum wage, politicians should state what they believe to be an appropriate level for the state pension relative to average earnings. They should then legislate a pathway to meeting that target with a specific timetable. This would result in an explicit commitment from the government to target a level of state pension relative to average earnings – which may be above its current level – and the four-point pension guarantee would then maintain that value in the long run too.**

1. Introduction

This report of the Pensions Review, led by the Institute for Fiscal Studies in partnership with the abrdn Financial Fairness Trust, considers the role of the state pension in the UK pension system. The UK state pension is an important feature of the UK's broader welfare state, providing income to older individuals, most of whom are no longer in paid work. First introduced in 1909, and then overhauled in 1948 following the Beveridge Report, the state pension system has been subject to substantial reform each decade since the mid 1970s in response to demographic shifts, fiscal considerations, and changes in political and economic priorities (see Bozio, Crawford and Tetlow (2010) for a comprehensive review of the history of the UK pension system).

Today, the state pension system differs in important ways depending on the point at which an individual reached state pension age (SPA, the age at which the state pension can first be claimed). Those who reached this age before 6 April 2016 are typically entitled to the flat-rate basic state pension (BSP, full amount currently £156.20 per week). On top of this, many will also have some earnings-related state pension which they built entitlements for during working life. Those reaching the SPA on or after 6 April 2016 are typically entitled to the new state pension (nSP, full amount currently £203.85 per week), which is a flat-rate state pension higher than the BSP.[1]

This means that, over time, the system in place since 2016 will become increasingly dominant for pensioners as older people (who reached the SPA prior to 2016) gradually die, and as those in subsequent generations become more likely to be entitled to a full nSP, and no more, when they reach the SPA.

While this report provides some background information on the historical evolution of the UK state pension, in our analysis and recommendations we focus on the nSP. In particular, we do not propose any additional changes to the benefits of those currently receiving the BSP or other state pensions – we simply assume that any changes to the nSP would apply in a similar way.[2]

1 Those with entitlements under the earnings-related system before 6 April 2016 that are *higher* than the nSP will receive that higher amount. This was the case for many reaching the SPA shortly after April 2016, but becomes less common over time as no additional entitlement can be accrued after 5 April 2016. Many reaching the SPA since April 2016, even with long working lives, may not be eligible for a full nSP due to having been 'contracted out' for many years. While the effect of contracting out is still important for many people – particularly men – reaching SPA today (see Figure A.1 in the appendix), this will become much less important over the next decade or so. See Crawford, Keynes and Tetlow (2013).

2 There is also additional means-tested support available to those above the SPA which is more generous than that available to younger individuals (see Figure 5.3). The role of these benefits will be considered in subsequent reports of the Pensions Review.

State pension expenditure represents a significant portion of the UK government's total expenditure – it is the second-most expensive item of public spending after the National Health Service (NHS). Figures from the Department for Work and Pensions (2023c), which relate to Great Britain, put total state pension spending at £124 billion per year in 2023–24, or 4.8% of national income. Including some other pensioner benefits (pension credit and winter fuel payment), this rises to £132 billion (5.1% of national income), while adding in all cash payments to pensioners – including disability benefits and means-tested support for housing costs – brings this up to £152 billion (5.9% of national income). On top of this, there is also further means-tested support for council tax bills, and of course those over the SPA also make relatively more use of many public services – not least the NHS and social care systems.

There are a number of challenges facing the UK pension system and public finances in the future, in particular in the context of significant demographic change. Rising longevity at older ages, and falling fertility, mean that the UK has an ageing population. The proportion of the adult population in receipt of the state pension is therefore increasing over time, which puts pressures on the fiscal sustainability of the system in the long run. This has been exacerbated by the poor economic performance of the UK economy since 2008. But it is also the case that most pensioners rely on the state pension to provide the majority of their income in retirement. In the current year, 2023, 12.8 million individuals across Great Britain receive an average of £187 per week from the state pension. While most would need a considerably higher income in order to preserve their working-age living standards through retirement, it is a sum that very few who are retired could do without. It is therefore imperative that we have a secure and sustainable state pension system that continues to serve its purpose of providing an important source of income throughout retirement for future generations of pensioners.

This report offers a broad range of new analysis that we have conducted on the UK state pension system, considering its current state and challenges facing it in the future. Throughout this report, we also present evidence on the public's perception of the state pension system from polling and public engagement work which was specially commissioned for the Pensions Review by abrdn Financial Fairness Trust and conducted respectively by YouGov and Ignition House in the summer of 2023. Drawing on all this – and from discussions with our expert Steering Group (Alistair Darling, David Gauke and Joanne Segars), with three sets of Advisory Groups and with many others – we put forward reforms that would improve the current system and help ensure it will function well not just today, but also in the coming decades.

The report proceeds as follows. Chapter 2 introduces the UK state pension system in more detail and examines how the level of the state pension, and public spending on it, have evolved over time. Chapter 3 focuses on demographic change and its implications for the future of public finances. Chapter 4 discusses inequalities in state pension incomes and how they relate to eligibility rules. Chapters 5 and 6 analyse the key levers that the government has available within the current system to address public finance concerns: increases in the SPA and changes to state pension indexation, respectively. We also present evidence about how these changes affect different people. Chapter 7 concludes this report. These conclusions will feed into our final recommendations at the end of the Pensions Review.