Fiscal policy

*In the first of two articles, **Sarah Smith** of the Institute for Fiscal Studies explores aspects of the pension problem faced by many OECD countries with ageing populations*

UK state pensions

In the 1999 Budget, the Chancellor attracted criticism by announcing an increase in the basic state pension of just 75 pence a week. In fact he was doing no more than following the example set by Chancellors for the past twenty years and raising the basic state pension in line with the general increase in prices. But the low level of inflation meant that the headline increase was very small – at a time when many pensioner groups were calling for a real increase in the basic state pension.

Pensions are an increasingly big policy issue for most OECD governments. The ageing of these countries' populations is placing existing pension systems under strain and forcing many governments to face hard political choices between cutting benefits for pensioners, or raising taxes on the working population. In the first of two articles, we describe state pensions in the UK – and highlight some of the key reforms of the past thirty years. We look at how well-placed the UK state pension system is to withstand the pressures of an ageing population compared to other developed countries. In the next article we look in detail at the arguments for pension reform, and in particular, at the cases for and against greater private pension provision.

Wendy Sighe discussed some aspects of the demographic aspect of the pension problem in 'Population – doom or boom?' in the September 2000 issue of *Economic Review*.

The basic state pension is the most expensive single item of government spending, costing more than £32 billion a year. It was introduced in 1948 as part of William Beveridge's social insurance scheme. It is not a universal benefit – to get it someone has to have made sufficient National Insurance contributions when working - and many older married women are only eligible for a dependant's addition to their husband's pension. It is a flat-rate benefit, originally paid at a rate of £1.30 a week (about 14% of average earnings), now paid at a rate of £67.50 a week. The rate is increased each year – between 1948 and 1981 it was typically increased more than in line with earnings, but since 1981 it has only been increased in line with prices. Real wage growth has meant that the value of the pension has fallen relative to average earnings – from a level of 20% of average earnings in the early 1980s to 15% of average earnings today.

The flat-rate basic state pension in the UK contrasts with the earnings-related pension systems that developed in most European countries. An earnings-related pension – the State Earnings Related Pension Scheme (SERPS) – was introduced as a second tier in the UK system from 1978. In maturity this was to have provided a top-up to the basic state pension worth one-quarter of someone's best twenty years of earnings. Over the past twenty years, however, successive reforms have dramatically reduced its future generosity.

State pensions in the UK (comprising the basic state pension and SERPS) are considerably less generous than state pensions in most other OECD countries. This can be seen in the table below which shows typical replacement rates (defined as the level of pension as a proportion of average male earnings) in a number of countries for people with different levels of earnings.

The table highlights the relative generosity of pensions across countries and the extent to which the level of pensions is linked to earnings. Notice that if people received a pension equal to their earnings, the figures in the three columns would be 50%, 100% and 200% respectively. The Netherlands and New Zealand, for example, have flat-rate state pensions which pay the same proportion of average earnings whatever someone's earnings. The presence of SERPS means that UK state pensions are not completely flat-rate across different levels of earnings, but there is a far smaller link between earnings and pensions in the UK than in countries such as France, Germany and Italy. Also, the table shows how relatively ungenerous UK state pensions are at all earnings levels. For someone on average earnings, state pensions in the UK are less generous than those in all of the other countries shown here.

International replacement rates – pensions expressed as a % of average earnings

	Pension as a percentage of male average earnings for		
	Someone on half average earnings	Someone on average earnings	Someone on twice average earnings
Canada	50%	51%	51%
France	48%	95%	165%
Germany	34%	72%	150%
Italy	32%	82%	192%
Netherlands	41%	41%	41%
New Zealand	38%	38%	38%
UK	25%	34%	48%
US	32%	55%	64%

The fact that state pensions are relatively ungenerous does mean that the UK is well-placed compared to many other OECD to keep state spending on pensions relatively low in spite of its ageing population. At the moment there is one person over retirement age in the UK for every three people of working age. By 2040 there will be two people over retirement age for every three people of working age. This has implications for pensions because of the way state pensions are funded. Pensions paid to people in retirement are funded from contributions levied on the current working population (the so-called *pay as you go system*). An increase in the number of people in retirement relative to the working-age population means that there is a diminishing pool of people to finance the pensions of a growing number of pensioners.

Without reform to state pensions, ageing populations in most OECD countries mean that government spending on pensions will grow in the future. As the table below shows, most countries already spend a far higher proportion of their GDP on pensions than the UK; the current projections are for this to increase further. The UK stands out as being the one country where government spending on state pensions is not predicted to grow as a proportion of GDP. The fact that the basic state pension is linked to prices – whereas GDP tends to grow in real terms each year – and cuts in the future generosity of SERPS mean that by 2050 the proportion of UK GDP spent on state pensions will actually be smaller than it is today.

For other OECD countries, the projected increases in state spending on pensions have sparked big debates about pension reform. To continue to finance generous state pensions with an ageing population would require large increases in contributions. Governments are facing the difficult political choice between raising taxes on the working population or cutting pensions. Many are considering privatisation of pensions as a potential way to solve their problems. In the next article we will consider possible arguments for – and against – greater private pension provision.

Projected future state spending on pensions as a percentage of GDP

	2000	2010	2030	2050
Canada	5.0%	5.3%	9.0%	8.7%
France	9.8%	9.7%	13.5%	14.4%
Germany	11.5%	11.8%	16.5%	17.5%
Italy	12.6%	13.2%	20.3%	20.3%
Japan	7.5%	9.6%	13.4%	16.5%
Netherlands	4.8%	5.2%	8.3%	9.8%
New Zealand	4.8%	5.2%	8.3%	9.8%
UK	4.5%	5.2%	5.5%	4.1%
US	4.2%	4.5%	6.6%	7.0%