intergenerational foundation
Fairness for Future Generations

Second State Pension Age Review: Independent report call for evidence

To: Department for Work & Pensions

By: The Intergenerational Foundation

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The Intergenerational Foundation (www.if.org.uk) is an independent charitable think tank researching fairness between generations. IF's guiding principle is that policy should be fair to all – the old, the young and those to come.

Introduction

The Intergenerational Foundation (IF) welcomes the opportunity to comment on the long-term direction of government policy towards the State Pension Age (SPA). The Second State Pension Age review's independent report raises many valid issues regarding the State Pension, particularly in relation to the themes of affordability and intergenerational fairness. IF would like to make the reviewers aware of the following points before the next stage of the Review is undertaken:

3.1.1. As people are living longer, how do we ensure the costs of State Pension are shared fairly across generations?

The two baby booms of the mid–1940s and 1960s in combination with longer life expectancies mean that the UK will experience a significant demographic shift in coming decades. The number of pensioners per 1,000 working-age people is projected to rise from 284 in 2022, to 337 in 2047, to 430 in 2085.[1] This drastic shift will lead to increasing strains on the State Pension system. The 2020 OBR forecast projects that State Pension expenditure will rise from 4.8% of GDP in 2021/22 to 6.2% in 2049/50. As the State Pension is unfunded, this increased expenditure pressure will either have to be matched with increasing tax receipts (higher national insurance contributions or funding through other taxes) or decreasing costs (raising the state pension age or making the state pension less generous).

One approach would be to simply raise taxes to pay for this increased expenditure. At present, the State Pension is nominally funded through National Insurance Contributions (NICs) – a tax on the earned income of working-age people, primarily on low and middle earners. IF believes that simply raising NICs in order to support the current State Pension system would be intergenerationally unfair, as it would mean that the costs of an ageing population would fall solely on younger generations of working-age adults. Such action would also not take account of unearned forms of income that are currently more lightly taxed than earned income. We offer several policy recommendations to increase funding for the State Pension in ways that spread the cost more fairly across generations:

[1] Government Actuary's Department (2022) "Government Actuary's Quinquennial Review of the National Insurance Fund as at April 2020" https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1061530/QR_2020_Report_17_Mar_2022.pdf, 13

- Revoke the lower 2% NICs rate on earned income over £50,000. Contrary to popular belief, NICs pay for the pensions and benefits of current recipients and do not act as a future retirement pot for current taxpayers. This regressive marginal tax rate therefore makes little sense; it simply means that higher earners are not paying their fair share of social benefits.
- People who continue to work past State Pension Age (SPA) should pay NICs at the same rate as younger workers, ending the 12% tax break they currently receive. Such action would ensure that existing older generations contribute more towards their own increasing older ages rather than passing that bill on to younger generations to pay. Previous IF research finds that it is higher-paid professionals who tend to continue to work post-SPA, and who receive an effective 12% pay rise over their younger colleagues simply due to their age.
- Fund the State Pension through capital taxation which would be indiscriminate of age – discussed in greater detail in section 3.3.1

Raising the SPA is a means of slowing the rise in the old-age dependency ratio, which would also reduce the cost burden on working-age income. Primary legislation has already set out that the SPA will rise to 67 between 2026–2028 and to 68 between 2044–46, but life expectancy increases continue to outstrip the SPA rise. The Government Actuary's Department 2020 Quinquennial Report suggests that finds that the current trajectory is not fiscally sustainable in isolation, and will require more rapid increases in the SPA, increased NICs receipts or Treasury Grants.[2] In order to maintain the fiscal sustainability of the State Pension, the current review should consider raising the SPA faster than currently legislated.

A third possible option is the introduction of a means-test for the State Pension. Although means-testing is controversial, IF believes that this outcome would be desirable for several reasons. Most importantly, it would not only improve fairness between different generations by counteracting the divergence in incomes between current pensioners and those of working age, it would also increase intra-generational fairness by addressing inequality within each cohort of pensioners. Figure 10 of the Cridland Review Interim Report demonstrates that incomes among the current generation of pensioners are extremely unequal: the state pension accounts for only 34% of the incomes of the richest fifth of pensioners, but represents almost the entire income (94%) of the poorest fifth of pensioners.[3] Means-testing the state pension could enable spending on pensioner benefits to be kept sustainable while also enabling the government to do more to help the poorest and most vulnerable pensioners.

3.3.1. What is the most sustainable and affordable way of managing the cost of the State Pension in the longer term? What are the advantages and disadvantages of potential options?

The Government Actuary's 2020 Quinquennial Review estimates that, without policy changes, State Pension benefit expenditure in 2085 will be 88% higher in real terms than in 2020. The significance of this drastic increase is obvious, considering the State Pension currently accounts for around 11% of government spending.

In order to fund this increased expenditure, the average Class 1 NICs rate (which comprises both employee and employer contributions) would have to rise from its current rate of 21.85% to 33.61% by 2085.[4]

[2] Government Actuary's Department (2022), 17
[3] Cridland , J. (2016) Independent Review of the State Pension age: Interim Report: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/559943/independent-review-of-the-state-pension-age-interim-report.pdf, 40
[4] Government Actuary's Department (2022), 14

This would represent an intergenerationally unfair increase to the tax burden on the working-age population and their employers. As such, IF believes that the government should find supplementary ways to fund the state pension other than NICs by revoking the triple lock, in addition to the measures outlined above.

Wealth and capital income is significantly under-taxed in relation in income in the UK. ONS data show that the labour share of national income in the UK is around 60%[5] and that NICs and income tax comprise around 47% of government revenue.[6] This leaves the remaining capital share of income at 40%, whilst business rates and company, capital and council taxes amount to 19% of government revenue. IF believes that the government should increase the tax rates on capital gains, landlord income, inheritance and dividends, and put these tax receipts towards funding the State Pension. Funding the State Pension through capital taxation as well as via NICs would force the wealthy to pay their fair share regardless of age, rather than focusing on the earned income of younger working-age people.

The 2020 Quinquennial Review estimates that the triple lock will increase State Pension expenditure by 24% by 2085 relative to 2020.[7] Unpicking the triple lock would therefore also be a substantial step towards making the State Pension more sustainable in the long term. The triple lock ensures that State Pension entitlements are uprated by whichever is highest out of CPI inflation, earnings increases or 2.5%, while NICs receipts only increase by the growth in earnings. The triple lock therefore causes benefit expenditure to increase relative to contribution income in the long term, threatening the fiscal sustainability of the scheme. IF recommends reforming the triple lock to a double Lock, whereby the State Pension is uprated in line with wage or price inflation, whichever is higher. This reform would be a significant step towards making the State Pension more sustainable in the long-run.

If you would like to learn more about the work of the Intergenerational Foundation or would like to organise a meeting to discuss the points we raise, please contact:

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[5] ONS (2021) *"Labour Costs And Labour Income, UK"*: https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/bulletins/labourcostsandlabourincomeuk/2021#:~:text=The%20UK's%20first%20official%20estimate,average%20between%202010%20and%202019.
[6] IFS (2021) *"Where Does The Government Get Its Money?":* https://ifs.org.uk/taxlab/key-questions/where-does-government-get-its-money.
[7] Government Actuary's Department (2022), 14