PENSIONS POLICY INSTITUTE PPI

Dependency on the State Pension through retirement

Introduction

Most pensioners will experience a number of transitions or life events over the course of their retirement. These transitions and life events can include: leaving work or a partner leaving work; changes to benefit or pension entitlement; divorce or bereavement; the need for care or a partner's need for care.

These events will affect retirement income levels, while the sources of income increase at different rates. This can result in some losing value in real terms as pensioners grow older. This leads to the proportion of their income that comes from the State Pension and state benefits varying over time.

In light of the State Pension changes, such as the introduction of the new State Pension (nSP) and some of the debates around the State Pension, such as the maintenance of the triple lock, it is important that there is clarity on the role that State Pension plays in pensioners lives at all ages and between cohorts. This Briefing Note uses data from the English Longitudinal Study of Ageing[1] (ELSA) to explore the role of the State Pension in people's lives by measuring dependency (the proportion of income from the State Pension).

Main findings

- **The State becomes increasingly important at older ages as other sources of income may lose value in real terms.**
- **All cohorts have relied upon the State Pension to the same degree at older ages**
- **Those with below median retirement income on average receive half of their income from the State Pension.**
- **Those with the lowest incomes prior to retirement see an increase in their income on retiring.**
- **Bereavement or separation dramatically impacts sources of income and is more detrimental to women than men due to inequality in private pension wealth.**

Background

The State Pension has recently undergone several major policy changes. In 2016, a new single-tier State Pension (nSP) was introduced and is currently £159.55 per week (full rate 2017/18).

In 2011, the triple lock was implemented which increases both the basic State Pension (bSP) and nSP each year by the higher of the growth in average earnings, the Consumer Prices Index (CPI), or 2.5%. Over time, this measure means the value of the bSP and nSP will increase more quickly than earnings, making up some of the value lost since the 1980s when

Technical notes:

Equivalised income

To make better comparisons of financial wellbeing across households, it is necessary to consider equivalised income.

Equivalisation is the process of adjusting a household's income to take into account the size and composition of different households.

Dependency on a source of income

Dependency in this Briefing Note is defined as the proportion of income an individual receives from that particular source. Those in receipt of a high proportion of income are considered to be more dependent upon that source of income than those in receipt of a low proportion.

- State Pension dependency considers only State Pension.
- Total State dependency includes State Pension and other benefits, including:
  - Means-tested benefits, including Council Tax Benefit/Support and Housing Benefit;
  - Universal benefits, including Winter Fuel Payment and Christmas Bonus.

PPI Briefing Notes clarify topical issues in pensions policy.

State Pension was delinked from earnings. The full nSP is currently worth 24% of National Average Earnings, 2% less than the bSP peak of 26% in 1979.

The UK State Pension system provides a lower replacement rate than the OECD average. It also represents a smaller fraction of retirement income, resulting in lower State Pension dependency in the United Kingdom when compared to the OECD average.[2]

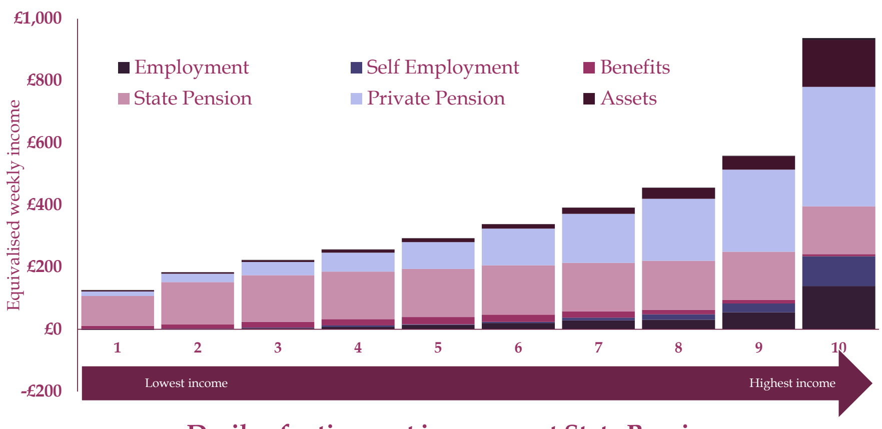
Those who became eligible for State Pension prior to the introduction of the nSP do not benefit from triple lock indexation being applied to their full State Pension income. It is only applied to their bSP entitlement, currently £122.30 per week (2017/18). Any entitlement to additional State Pension (SERPS and State Second Pension) is uprated in line with the historically lower increase in prices, CPI. As a result, the triple lock is of greater benefit to those who reached State Pension age (SPa) after April 2016.

SPa is also rising in stages, from age 60 for women and age 65 for men in 2010 and is proposed to reach age 68 for both by 2039.

Alongside these changes, pensioners have recently seen their income increase more quickly than working-age households when considered in aggregate after housing costs.[3] This has led to controversy around the maintenance of the triple lock. The average income level for all pensioners has been boosted by new pensioners with higher private pension incomes and may be receiving income from earnings alongside their pension income.

Chart 1: Those at lower deciles are more dependent upon the State Pension

Amount of income from different sources by income decile post SPa



Source: ELSA Wave 7[1]

The State Pension supports those with lower incomes

While income levels and sources of income vary, the State Pension is a significant part of retirement income for pensioners at all income levels [Chart 1]. Those with below median incomes (deciles 1 to 5), receive over half of their retirement income from State Pension. For those on the lowest incomes (decile 1), 78% of their income comes from the State Pension. Their total State dependency is even higher when other benefits are taken into consideration.

Lower incomes have a detrimental effect upon health and are associated with higher mortality, particularly for poorer older age adults.[4]

Income levels need to be capable of supporting consumption needs. Typically consumption levels decrease throughout retirement, with the highest consumption at younger ages. Consumption in later life may increase where there is a need to finance long-term care however this is atypical.[5]

Younger pensioners are better off on average than older pensioners

While it is true that pensioners as a group have experienced a faster rate of increase to their income than other age groups, individuals may not have experienced these rises in their personal income. Half of those aged 60 and over in 2008/09 had seen their income fall in real terms by 2014/15.[6]

Each younger cohort has a higher level of income across the distribution [Chart 2]. However, there is variation of income levels within each cohort, and this inequality means that there is still a considerable overlap of incomes between different cohorts.

Individuals become more dependent upon the State Pension as they get older

The State Pension is a prominent source of income to all pensioners. At older ages, it forms a greater proportion of total income, across all cohorts [Chart 3].

The change in dependency upon State Pension by age reflects a number of factors. Some factors are slow acting, such as State and private pension indexation and changes to state benefits. There are other factors with more immediate impacts, which could occur throughout retirement.

Withdrawing from the labour market, and changes to a household circumstances through bereavement, divorce or separation may all increase dependency upon the State Pension.

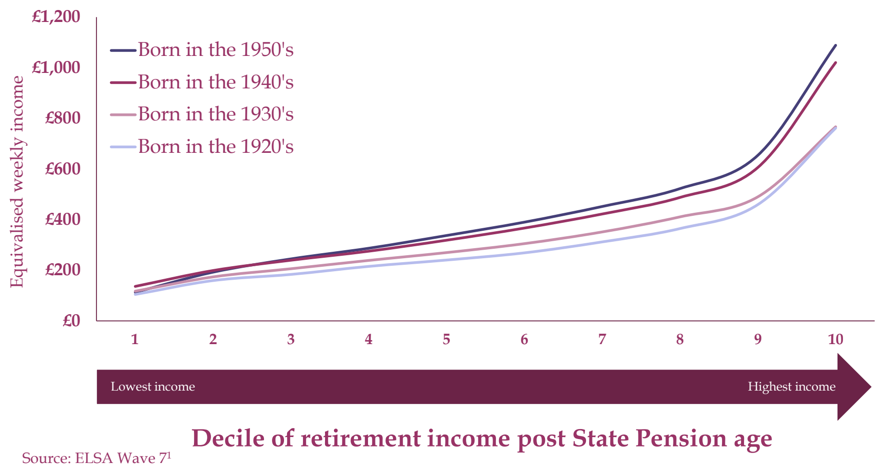
Those aged up to age 55 generally receive a very low proportion of State Pension income. State Pension income at these younger ages is based on household income. Individuals under SPa will not be receiving State Pension themselves, but may be living with someone who is.

The increase in dependency begins as people start to pass SPa from age 60 until 65. At these ages there is a cohort effect due to the increase of women's SPa. This delays the rise in an individual's State Pension dependency until they have reached SPa.

The level of dependency plateaus approximately at age 75 with State Pension accounting for 40% to 50% of overall income thereafter.

Chart 2: Younger cohorts of pensioners have higher incomes

Distribution of retirement income with each birth cohort



Source: ELSA Wave 7[1]

Private sources of income may lose their value or be unsustainable over the course of a retirement

Private pension income forms an increasingly important source of income through the higher deciles. This pension income may increase over time, through indexation most likely linked to prices, either RPI or CPI, or may not change, for example in the case of a level annuity. Increases to such income are unlikely to keep pace with increases to the State Pension over the long-term. Over the past 10 years, CPI increased by 26.6%, RPI by 32.4% and average earnings increased by 41.7%. This has resulted in an increasing dependency by age upon the State Pension [Chart 3].

Those with the highest incomes may also have a significant income from either:

- Employment, generally at the younger ages. Only a very small minority, 4% of men and 2% of women, worked beyond the age of 75;[7]
- Asset based income from savings and investments. The importance of this source of income through retirement will depend upon investment returns and any withdrawal from the capital.

All cohorts have relied upon the State Pension to the same degree at older ages

Despite younger pensioners having higher incomes than older pensioners, they come to depend upon the State to the same degree. At the age of 80, a pensioner receives approximately 48% of their income in the form of State Pension regardless of whether they were born in the 1920s of 1930s, up from 45% at age 75.

Dependency on state benefits has decreased over time at all ages

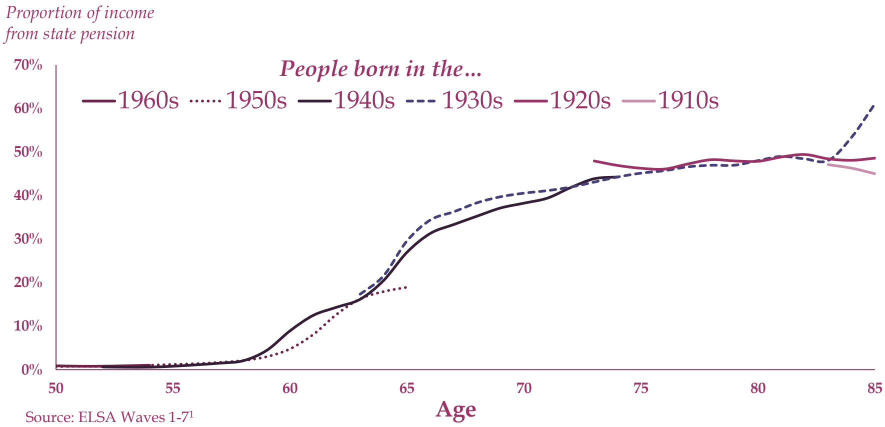
The proportion of income received from the State has reduced between generations [Chart 4]. The reduction in total State dependency is around 3% within each age group for every 10-year cohort. This reflects a reduction in benefits, in income terms, for older pensioners. This has been matched by a relative increase in other sources of income in younger cohorts.

Spending on benefits directed at pensioners, excluding the State Pension, has increased in real terms (2017/18 prices) from £25.5 million in 2002/03 to £28.8 million in 2014/15, peaking in 2010/2011 and reducing thereafter.[8] However the number of people claiming State Pension increased by 16% over this period (from 11.2 million to 13 million) which has resulted in a real terms reduction in benefit per capita.

This reduction is countered at a population level by an increase in total retirement income. However, the increase in pensioner incomes is driven by new pensioners, with older pensioners being restricted to the income sources they already receive.

Chart 3: Different cohorts experience similar age-based levels of State Pension dependency

Proportion of income from state pensions by age and cohort: people born in the 1910s, 1920s, 1930, 1940s, 1950s and 1960s



Source: ELSA Waves 1-7[1]

Retiring and starting to claim State Pension is a complex process

'Retirement' is not a simple, instantaneous transition. The age someone withdraws from the labour market, when they access their private pension savings and when they reach SPa may all be different and in any order. This may be a gradual process taking place over many years.

Men are less likely than women to work until SPa. Less than 40% of men work to SPa compared to around 50% of women. Approximately 10% of men extend their working life beyond SPa compared with 20% of women.[9] This is influenced by a number of factors including health and financial needs, caring responsibilities and other household influences such as the retirement of a partner.

Approximately 25% of people leave work at SPa, with the rest leaving work either earlier or later. 'Retirement' is used within this Briefing Note to mean an individual both reaches SPa and leaves work (though not necessarily at the same time); this allows for the transition between sources of income.

New retirees are often better off compared to the other retirees than they were as workers when compared to older workers

When someone retires, they can end up in a more favourable financial position when compared to the rest of the retired population than when compared with the older age working population prior to retirement.

Those with the highest and lowest incomes in retirement are generally those who had the highest and lowest incomes in working life. However nearly 50% of retirees, particularly on more average incomes, move into a higher income decile of the retired population than they were in as a member of the population of older workers.

When people from the middle quintile (20%) of older workers move from work to retirement:

- 45% come out higher – in the top 40% of the retired population.
- 29% come out lower – in the bottom 40% of the retired population.

Because newly retired people may be better off, on average, than the retired population, this may affect perceptions of the financial position of pensioners as a whole, both among new retirees and the working population.

As pensioners grow older, their income will generally fall back in relation to the overall retired population. This is due to the evolution of the pensioner population as newer, richer, pensioners join.

Those with the lowest incomes prior to retirement see an increase in their income on retiring

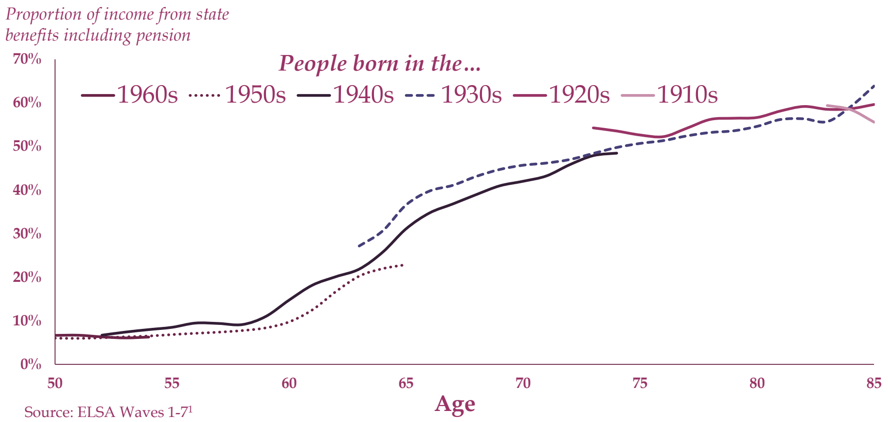
Passing SPa is associated with the transition from working age benefits to older age benefits, including the State Pension. Older people are not expected to fulfil work-related requirements in order to receive benefits such as Pension Credit, and means-tested pensioner benefits are more generous than means-tested working age benefits.

Those with the lowest incomes prior to SPa have limited income from private sources and approximately one third of their income comes from the State. After passing SPa, income from the State represents approximately one half of their income [Chart 5]. 80% of their increase in income stems from the State, while access to private pensions makes up the rest of the difference.

At higher income levels, the withdrawal from the labour market reduces income at SPa, as employment income is not entirely replaced by pension income from either the State or private saving.

Chart 4: Younger cohorts experience a reduction in age-based levels of total state dependency

Proportion of income from state pensions and other state benefits by age and cohort: people born in the 1910s, 1920s, 1930, 1940s, 1950s and 1960s



Source: ELSA Waves 1-7[1]

While the income of those who work past SPa is boosted by earnings from employment, the proportion who work decreases at older ages. When employment income post-SPa is excluded, the impact of passing SPa is to:

- Increase income for the lowest (1st and 2nd) deciles;
- Have no impact for the 3rd decile;
- Reduce income by up to 20% for the 4th, 5th and 6th deciles;
- Reduce income by approximately one third for the 7th, 8th and 9th deciles;
- Reduce income by 50% for the top (10th) income decile.

Due to the different ways sources of retirement income are indexed there is an increasing total State dependency with age. This is because increases in private pension income are unlikely to match the increases to the State Pension.

The State Pension and its uprating becomes increasingly important in maintaining the income level of pensioners as they age. This is most significant to those on the lowest incomes as they are more dependent upon the State Pension. Any changes will therefore affect these groups to a greater degree.

Changes in household composition dramatically impact sources of income

Becoming single in retirement as a result of bereavement or separation will impact household income. Equivalised household income will generally be reduced through changes to differing sources:

- State Pension is paid individually (although pre-2016 pensioners may be able to increase their pension based on their partner's contribution record);
- Private pension income may confer some survivorship

benefits, however this is generally at a reduced level;

- Assets may be transferred to a spouse and income from these may not be reduced;
- Means-tested benefits may increase to replace income for those with low incomes.

Those on lower incomes are protected upon becoming alone

Means-tested benefits can help replace lost income when someone loses a partner and is reassessed as a single person.

After becoming alone, those in the lowest two deciles of income receive an increase in equivalised state benefits (including State Pension). However this forms a smaller proportion of their total income due to changes to other sources of equivalised income.

Those who had been in receipt of higher incomes suffer a loss of income which could impact upon their financial wellbeing as there is no income source offering a significant mitigation for the loss of the second income.

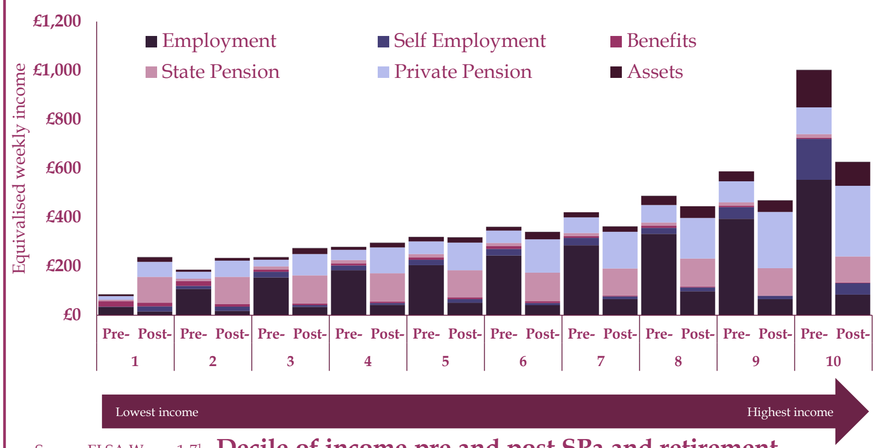
Most private pension income belongs to men, widows tend to see a reduction in income

For those whose partners had higher levels of private pension income, being widowed or separated may severely reduce household income.

Defined Benefit (DB) pension schemes may include a widow's benefit, typically at 50% of the previous pension level. Pension income that has been taken from a Defined Contribution (DC) pension schemes will continue to a spouse only if a joint life annuity

Chart 5: Those at lower deciles see income increase post SPa while those at higher deciles see income decrease

Proportion of income from different sources by age and income decile pre and post SPa



Source: ELSA Waves 1-7[1] **Decile of income pre and post SPa and retirement**

has been purchased or the funds have not been crystallised. Under one third of annuities purchased in 2017[10] will provide an income to a second individual in case of death, leaving many at risk of a reduction of income.

Men are more likely than women to have higher levels of private pensions, so on becoming alone will become less dependent upon the State Pension as private pension income is reduced less than other sources. Women, who statistically outlive men, will see a greater reduction in their household income as private pension ceases or reduces, resulting in a greater reliance upon the State [Chart 6].

There is an increase in the amount of asset income for those on lower than average incomes. This may be a result of realising assets which were previously jointly used, downsizing a home or receiving assets from death benefits. Such an increase in income from assets may not be sustainable throughout retirement.

How may these patterns evolve in the future?

Current circumstances will continue to influence pensioner incomes for decades to come. For individuals retiring in 2016, in the last days of the basic State Pension system, 10% of the men are expected to survive until 2049, and 10% of women are expected to survive until 2053.[11] For younger workers who have accrued DB entitlement, these benefits may be payable for close to a century into the future.

Many of those retiring now and in the future will have a different experience of the retirement process to those who have already retired. This is a result of the changing legislation and the pension landscape; including the introduction of the nSP, changes to SPa, the decline of DB occupational pensions, the introduction of automatic enrolment and flexibilities introduced to private pension access. The impact of these changes will take decades to filter through the system.

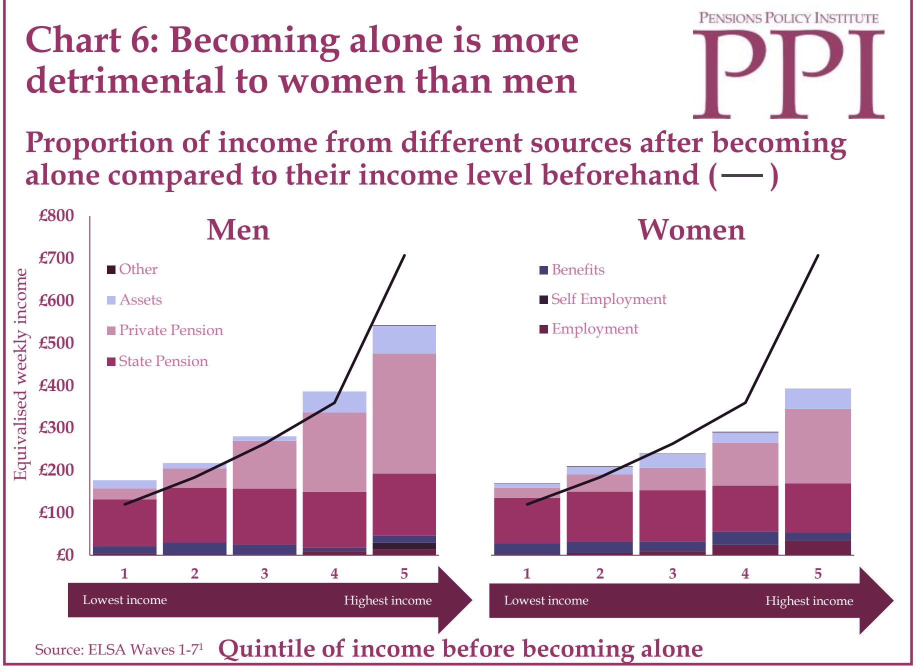
Other forms of wealth and saving may be harnessed in future to provide retirement incomes. Freedom and choice has given greater flexibility of access to pension funds, including the ability to treat pension funds as an asset throughout retirement. The use of options such as uncrystallised funds pension lump sums (UFPLS) allows for a decumulation strategy which more closely resembles the options for taking income from other financial assets. These options do not provide longevity insurance, and this may result in a change in retirement income when private funds become exhausted and a greater degree of State dependency is the only alternative.

The transfer of private pension rights to a spouse on death for new pensioners will increasingly depend upon the income decisions taken at retirement. Drawdown products offer a more transferable option, but survivor benefits associated with DB pensions will decline.

The impact of inflation and indexation is likely to remain and future cohorts of new pensioners are likely to retire with higher levels of retirement income. They will also need to rely on this income until later ages due to longevity improvements.

Chart 6: Becoming alone is more detrimental to women than men

Proportion of income from different sources after becoming alone compared to their income level beforehand (—)



Source: ELSA Waves 1-7[1]

These factors need to be considered in the decumulation strategy of private pension wealth alongside access to other assets which may be used to support retirement income. The level of an initial income at retirement must be balanced against risks such as:

- Erosion of real terms value over the course of a long retirement;
- The exhaustion of funds without longevity insurance;
- The need to protect others who may be dependent upon income; and
- The desire to provide an inheritance.

There is clearly a need to address these risks for retirees, taking account of the mitigation currently being offered by the State Pension and other state benefits.

Despite all these changes, the State Pension persists as a significant source of income to future pensioners [Chart 7]. The nSP is projected to provide the same level of pension to all but the lowest quintile of retirees who are more likely to have access to means-tested benefits.[12] The assumed increase in level of the State Pension over the longer term, through maintaining the triple lock, boosts the proportion of income that is derived from the State.

This new balance to be struck between the State Pension and, largely DC, private pensions will depend upon future investment returns and the uprating of the State Pension. Investment returns upon DC savings are uncertain and should these fail to be realised, income levels will be reduced and dependency upon the State increased. Should the increases to the State Pension also be reduced in future below the projected triple lock, future retirees will see a reduction in projected income levels, potentially below the income levels experienced by today's retirees.

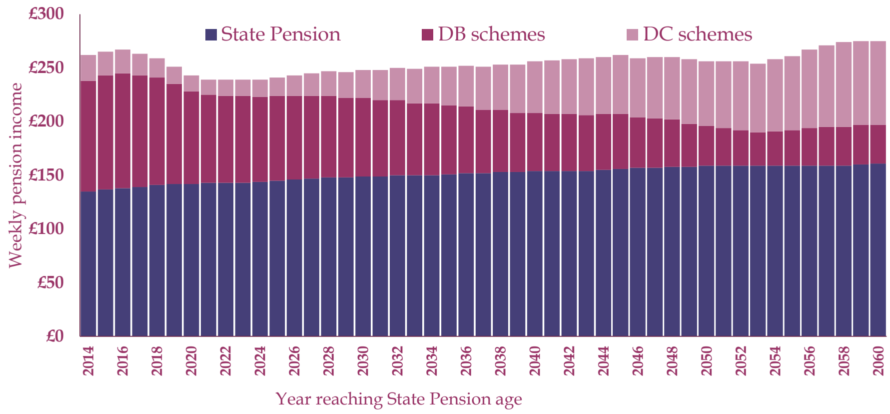
The continuing importance of the State Pension

The increasing reliance upon the State Pension throughout retirement addresses a number of factors:

- Helps the income level of older pensioners keep pace with the pensioner population as a whole;
- Provides long-term protection for changing circumstances including the loss of a partner;
- Provides a replacement for private pension income which may not be able to keep up with inflationary pressures; and
- Protects those in widowhood who can no longer rely on a partner's private pension.

Chart 7: The State Pension persists as a significant source of income in the future

Weekly mean amounts of pension, by pension type and year reaching SPa, 5 year moving average, 2014 earnings terms.



Source: DWP, Pensim2 dynamic microsimulation[12]

These factors will need to be considered as part of any debate about the future of the State Pension.

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[2] OECD (2015) *Pensions at a glance, Table 6.4*
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[4] Rachel Loopstra, Martin McKee, Srinivasa Vittal Katikireddi, David Taylor-Robinson, Ben Barr and David Stuckler (2016) *Austerity and old-age mortality in England: A longitudinal cross-local area analysis, 2007-2013*
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[10] ABI (2017) *Industry data*
[11] ONS (2015) *2014-based National Population Projections Lifetable*
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For more information on this topic, please contact
Tim Pike, Head of Modelling
020 7848 4488 tim@pensionspolicyinstitute.org.uk
www.pensionspolicyinstitute.org.uk