PENSIONS POLICY INSTITUTE

PPI

Incentives to save and means-tested benefits

TECHNICAL APPENDIX

Technical Appendix

1. In order to project Pension Credit eligibility, detailed projections need to be made for:
   - Basic State Pension
   - State Second Pension
   - Private pensions
   - Other earnings and savings

2. This appendix presents detailed results for the projection of each of these individual income components in the PPI central scenario.

Basic State Pension

3. The PPI models do not make a detailed projection of the average level of future entitlements to Basic State Pension (BSP) for new cohorts of pensioners. This would require access to a representative sample of National Insurance records.

4. Instead, the PPI models are closely based on published Government projections of future entitlements to BSP, such as those in the May 2006 White Paper[1]. By 2050, the vast majority of pensioners are assumed to receive the full amount of BSP, of around £76 a week (in 2006/7 earnings terms)[2].

State Second Pension

5. The second tier state pension in the UK has changed considerably over time. Figures in this document are labelled as 'State Second Pension' for simplicity, however, some explanation of the full definition of second tier pensions used in the modelling is required:
   - State Second Pension (S2P) plus its predecessor SERPS are included.
   - Contracting-out equivalent are generally not included, being treated as private income.
   - However, one portion of the contracted-out equivalent of S2P is included in the definition used by the PPI models (rather than being included in private pension figures). This is the contracted-out equivalent of S2P that is accrued in

[1] DWP (2006) ***Security in retirement: towards a new pensions system*** page 20
[2] Assuming that the BSP is re-linked to average earnings from 2012

respect of earnings below the Lower Earnings Threshold. This definition allows the PPI models to model the expected flattening of income from S2P over time, improving projections of Pension Credit eligibility.

6. The proposed reforms include widening the credit system for S2P. However, it is important to note that the future distribution of income from S2P amongst the pensioner population is still uncertain:
   - Around 25% of working age people would not have qualified for the reformed S2P if the reforms had been in place in 2004/5[3], as a result of not earning enough and not qualifying for a credit. For example, due to earning below the lower threshold or caring for fewer than the required 20 hours a week to qualify.
   - If employment rates or rates of receiving caring or other credits increase in future, then the 25% could reduce. However, it seems likely that there will be a significant amount of working age people who do not qualify for S2P in any one particular year.
   - It is not clear whether the 25% of working age people would be the same people in each year, as this would depend on future transition rates into and out of work and caring. The uncertainty around future transition rates means that the future distribution of S2P is uncertain.

7. The distribution of S2P in payment is projected to change significantly in the PPI central scenario over the next 45 years (Charts 7 and 8):
   - Almost all pensioner benefit units are projected to receive some S2P by 2050. This is a significant change from today, when just over one-third (34%) of pensioners do not receive any[4].
   - The average entitlement of S2P is projected to increase from £17 a week to £36 a week for single pensioners between 2004 and 2050, in 2006/7 earnings terms[5]. The corresponding

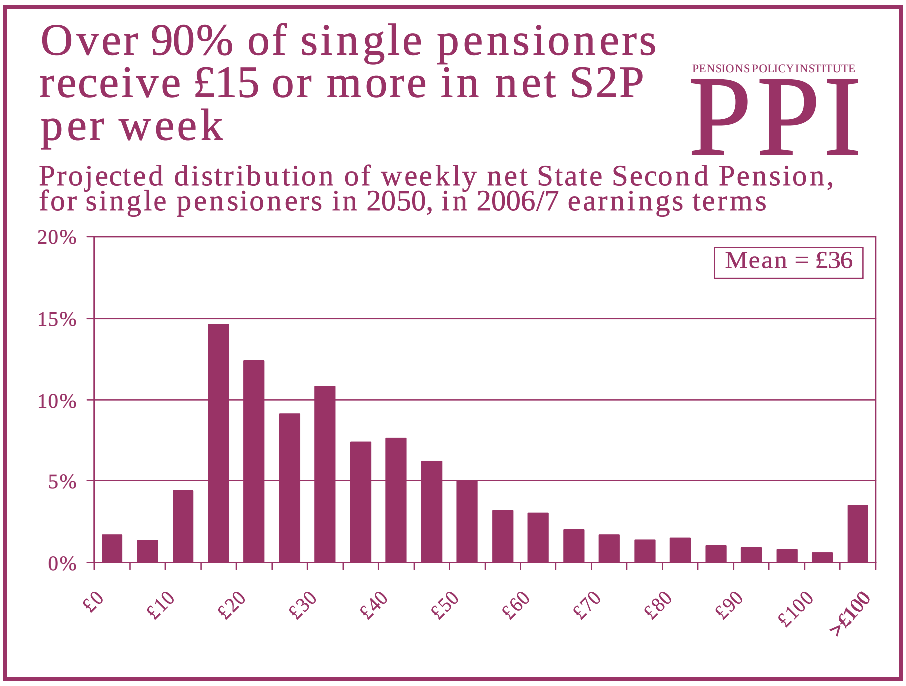
[3] PPI analysis based on the Family Resources Survey 2004/5
[4] DWP ***State Pension Summary of Statistics*** September 2004
[5] Note that 2004 figures are approximate. They are based on analysis of the Pensioners' Incomes Series (PIS) dataset, supplied by DWP. However, the PIS dataset has one field for 'state pension' and does not split this separately into BSP and S2P, so some hypothecation has been made.

increase for couples is from £17 a week to £43 a week. This reflects the maturing of S2P.

- Around 15% of single pensioners are projected to receive more than £60 a week in S2P, in 2006/7 earnings terms. This seems reasonable given the DWP's estimate that anyone who has been in employment or caring throughout their working life could receive £135 a week at retirement in state pensions[6] (i.e. £76 in BSP and around £60 a week in S2P). As income from S2P would fall relative to average earnings in payment, the majority of pensioners who are older than state pension age would receive less than £60 in S2P.

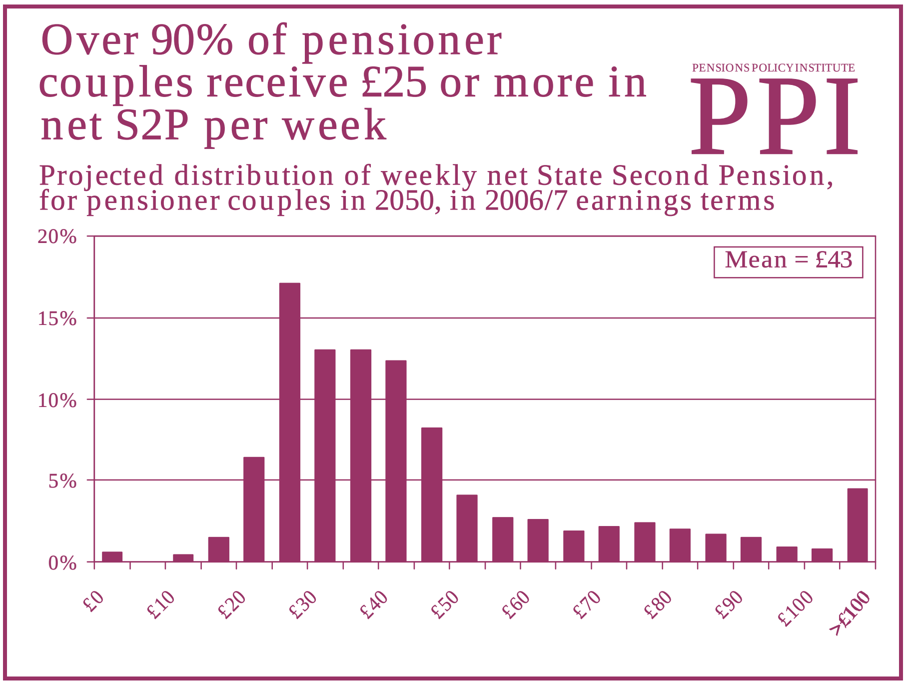
8. In addition, the PPI models project a 'flattening out' of income from S2P over time, so that the entitlements of lower income pensioners become more similar to the entitlements of higher income pensioners.

Chart 7



[6] DWP (2006) ***Security in retirement: towards a new pensions system*** page 20

Chart 8



9. A different distribution of S2P incomes could have a significant impact on eligibility for Pension Credit. Quite small changes to the distribution S2P could move large numbers of pensioners just above or just below the thresholds for Guarantee Credit and Savings Credit.

Private incomes

10. This section presents results for ‘private incomes’ (i.e. private pensions plus earnings). For consistency with DWP analysis, figures for this section do not include non-pension saving or Personal Accounts, although the full PPI projection for Pension Credit eligibility does take both into account.

11. Private incomes are projected to decline relative to average earnings but remain significant. For single pensioners, average private income is projected to decline from £75 to £59 a week between 2004 and 2050, while for pensioner couples it is projected to decline from £220 to £143 a week (2006/7 earnings terms)[7].

[7] 2004/5 figures consistent with DWP (2006) ***The Pensioners’ Incomes Series 2004/5*** Table 2.2

12. The decline is a consequence of the assumptions made about private pensions[8]:
    - An assumed fall in the proportion of the workforce who are active members of private sector Defined Benefit (DB) schemes, by 50% by 2035.
    - An increase in longevity but no compensating increase in average contribution rates to DB and Defined Contribution (DC) schemes.

13. Over the next 45 years (Charts 9 and 10):
    - The percentage of pensioners without any private income remains roughly at today's levels, at around 40% for single pensioners and around 15% for pensioner couples.
    - But the number of very large private incomes falls in future, partly as a result of the assumed future decline in DB pension provision.

Income from non-pension saving

14. Incomes from non-pension savings are also significant for future Pension Credit eligibility. As described above in paragraph 36, incomes from other non-pension savings are assumed in the PPI projections to increase in line with average earnings in future.

[8] See PPI (July 2006) ***An assessment of the White Paper state pension reforms*** modelling appendix 6 for full details of the assumptions used in the central, base case scenario

Chart 9

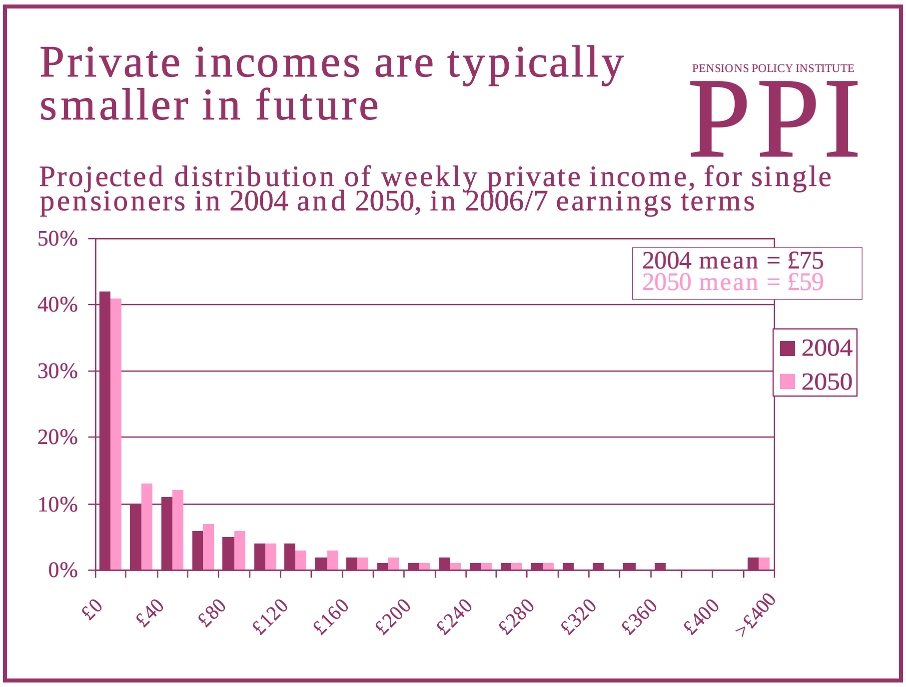


Chart 10