How do cost-of-living increases affect pensioners?

Pensions Policy Institute
PPI

PPI Briefing Note Number 129

Introduction

The cost of living is increasing as a result of price inflation, mainly on energy and transport. Increases in price inflation are particularly significant for those on lower incomes, a group which includes many pensioners; 18% of all pensioners were in relative poverty After Housing Costs (AHC) in 2019/20, though by the time pensioners reach age 85 and over, 27% are in relative poverty.[1] Pensioners can also be distinctly affected by inflation, as they tend to spend income on specific goods and services in different proportions than the general population. This Briefing Note will explore the impact of changes in inflation on pensioner households.

Summary of key points

- The cost of living as measured by the Consumer Price Index including owner occupiers' housing costs (CPIH) rose by 4.9% between January 2021 and January 2022.
- Pensioners are affected differently by cost-of-living increases because they spend on goods and services in different proportions than the rest of the UK population.
- Pensioner income does not always increase at the same rate as the cost of living.
- The cost of living is increasing more quickly for pensioners than their income in 2022/23.
- Cost-of-living increases, particularly those associated with housing and energy, will hit older and single pensioners hardest, as they spend more on these goods than younger and pensioner couples.
- Further rises to energy prices, scheduled for April 2022, will hit pensioners particularly hard.
- The war in Ukraine is also leading to cost inflation, which could exacerbate the effects of the general cost rises and energy price increases being introduced in April 2022.
- Household Cost Indices (HCIs), which are under development, could provide a helpful way of protecting pensioner living standards in future, if income from State and private pensions and benefits rises in line with these HCIs, or at a rate above.

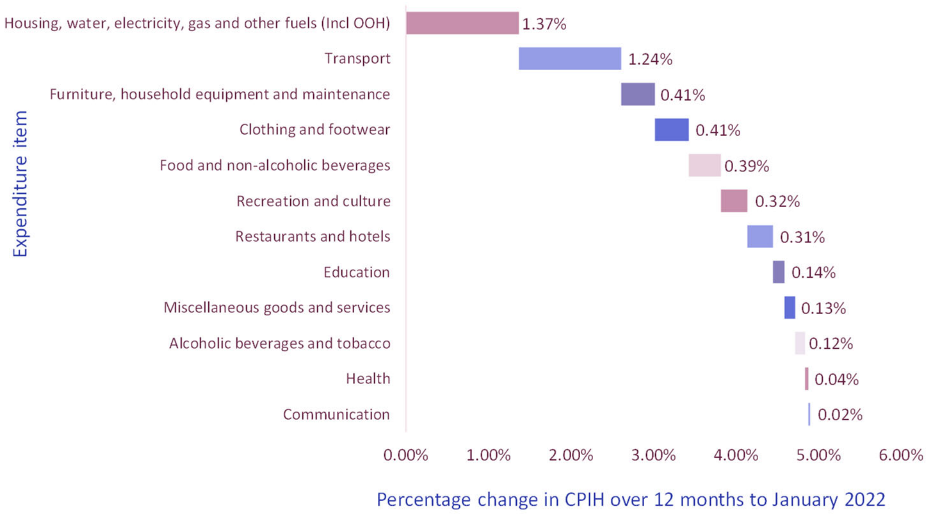
The CPIH has gone up by 4.9%

Between January 2021 and January 2022, the CPIH, which tracks changes in the cost of living in the UK, rose by 4.9%. The CPIH is a weighted UK average; individuals will experience different inflation rates depending on the proportions of income that they spend on different goods and services. This rise is mainly due to increases in the costs of "housing, water, electricity, gas and other fuels" (up by 1.37%) and "transport" (up by 1.24%).

Housing and fuel costs have increased because of rises in the price of gas and electricity, due to increases in global gas prices. Personal transport costs have increased because of higher petrol prices, resulting from rises to motor fuel prices, and more expensive second-hand cars, due to greater demand for cars during the COVID-19 pandemic[2] (Figure 1).

Figure 1: Recent cost of living rises are mainly due to rises in transport, energy and fuel costs

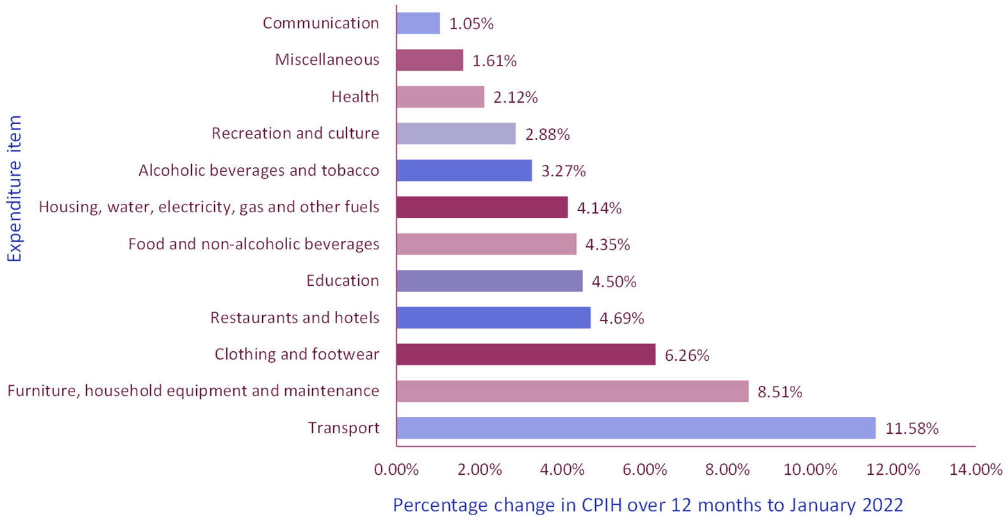
Contributions to changes in CPIH items between January 2021 and January 2022 (total rise 4.9%)



Source: ONS (2022) *Consumer price inflation, UK: January 2022 - Price indices, percentage changes, and weights for the different measures of consumer price inflation*, Table 12

Figure 2: The absolute cost of transport has increased the most

Rise in absolute cost of goods and services by category between January 2021 and January 2022



Source: ONS (2022) *Consumer price inflation, UK: January 2022 - Price indices, percentage changes, and weights for the different measures of consumer price inflation,*

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Whether or not people can afford cost of living rises depends on the rate at which their income increases, or if they have disposable income and/or savings above the level required to meet day-to-day needs. In 2022/23, very few pensioner income sources increase in line with the cost of living, except perhaps for some Defined Benefit (DB) incomes which may increase in line with rises to the Retail Price Index (RPI) – which was 4.9%. Income from the basic State Pension (bSP) and new State Pension (nSP) generally increase with at least earnings - though in 2022/23 the earnings link has been temporarily broken. It is also worth noting that many costs of living rise during the year, while increases through benefits, pensions and earnings are only applied at the end of the financial year. This means that costs go up before income does, making it harder for people on low incomes to meet basic needs.

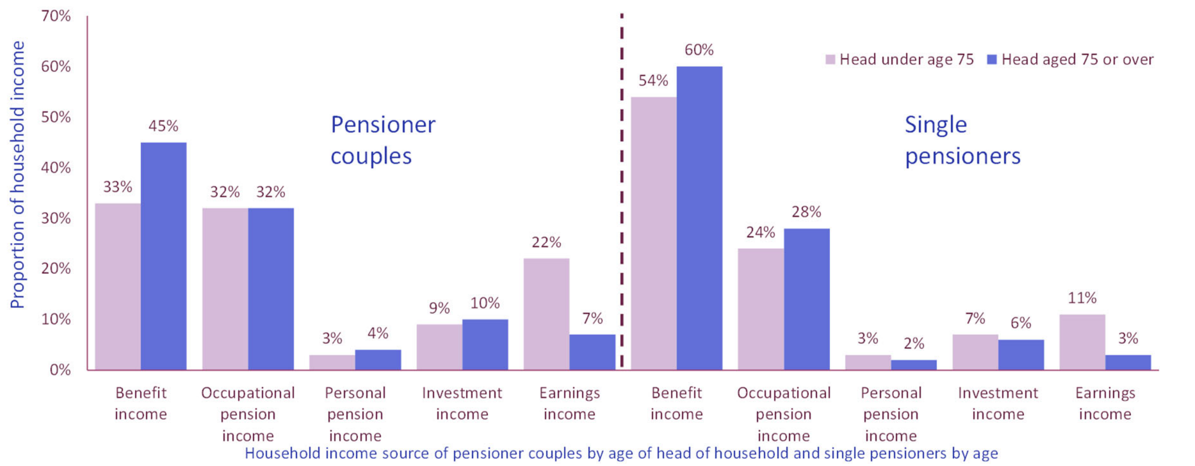
The cost increases shown in Figure 1 are based on the average expenditure of people in the UK. For example, while the absolute cost of transport increased by 11.58% between January 2021 and January 2022, for an individual spending the average amount on transport, costs will increase by £1.24 for every £100 they spend. So, for example, for every £100 spent in January 2021, an individual can expect to pay £104.90 in January 2022, £1.24 of which is made up of higher transport costs, the total cost of which has gone up by 11.58%. Someone who spent their entire £100 on transport in January 2021, would see their costs rising to £111.58 in January 2022. Therefore, those spending more than the average amount on transport will experience more significant rises in expenditure. Out of all expenditure items, the costs of transport increased the most in absolute terms between January 2021 and January 2022 (Figure 2).

The proportion of income from different sources changes as pensioners age, as well as by household status

As pensioners age, the proportion of income that they receive from different sources changes. Single and couple pensioner households also receive income in different proportions. Total income changes by a blend of all the different increases from each component (Figure 3).

Figure 3: Proportions of income by source vary with pensioner age and household status

Proportion of household income from different sources by age and household status (2019/2020)



Source: DWP (2021) Pensioner's Income Series, Tables 2.5 & 2.6

The most significant variations in income sources by age and household status are from benefit income (including State Pensions) and earnings. Couples with the head of the household under age 75 receive on average 33% of their income from benefits and 22% from earnings, compared to those with a head aged 75 or over, who receive 45% of income from benefits and only 2% from earnings. Single pensioners receive a larger proportion of income from benefits than pensioner couples: below age 75, on average 54% of income comes from benefits, and 60% for those aged 75 or over.

Income from different sources inflates in line with different indices

Wages increase by prices or less, but tend to taper off for pensioners

Earnings income for the population tends to increase, on average, in line with earnings inflation, due to promotions and people changing jobs. However, within a single job, wages are more likely to increase in line with prices (either by the Consumer Price Index (CPI) or RPI), another index, or in some cases on an ad hoc basis. Some companies will freeze pay or only offer small rises when there are economic difficulties. Pensioners in work are less likely to be changing jobs or receiving promotions than younger workers, and are more likely to be planning a retirement date and/or working flexibly or part-time.[3] As a result, pensioner income from earnings will generally rise with, or at a level below, prices and will taper off over time as they reduce their hours to zero.

Benefits income increases by different indices

Benefit income rises in a variety of ways:

- Income from the nSP and bSP is "triple locked" and increases by the highest of earnings rises, price rises or 2.5%. However, in 2022, due to the impact of the pandemic on earnings (resulting in an artificially high single year earnings increase), the link to earnings was suspended and these State Pensions will rise by 3.1%, in line with CPI in 2022/23.
- Income from additional State Pensions (S2P, SERPS &GRB)[4] and Protected Payments[5] rises in line with CPI inflation (September 2020 to September 2021) and will therefore also go up by 3.1% in 2022/23.
- Income from Pension Credit is legislated to rise at least in line with the increase in earnings, However, due to the same change which affected the State Pension, in 2022/23 it will also increase by 3.1%.[6]

DB pension income rises by CPI or RPI, while increases to Defined Contribution (DC) savings income varies widely

The next most significant source of income for pensioners is workplace pension income, which mainly derives from DB pensions currently, but will derive more from DC savings in future. This is because DB provision has declined in the private sector, and automatic enrolment has led to around 10 million people saving into a DC scheme.[7]

Inflation from DC savings, which currently represents a small proportion of pensioner income, varies widely. Those who use their savings to buy an annuity may take a level (non-inflating) income, or choose an annuity which increases in line with an index or set percent. In Q3 2021, only 16% of annuities purchased were escalating, the remainder were level.[8] Those who purchase drawdown will receive inflationary increases to investments, but may not increase withdrawals in line with inflation. Those who take cash lump sums can withdraw in variable amounts; the amount people withdraw in lump sums varies over time in reaction to micro and macro circumstances, for example, during the pandemic, the number of lump sum withdrawals reduced.[9]

DB income inflation is generally linked to prices. 64% of private sector DB schemes increase benefit income by RPI, usually with a cap, and the rest increase by CPI.[10] Public sector DB scheme benefits all increase by CPI. The actual rate used will vary between schemes and depend on what caps and floors are in place. CPI growth for September 2020 to September 2021 was 3.1% and RPI 4.9%.[11] There is an inherent disconnect between private pension income increases and costs of living rises, as the former are tracked to CPI/RPI and the latter uses CPIH (Figure 4). It is also worth noting that there is generally lag between the actual rise to prices and the increases to income.

Figure 4: inflation from different pensioner income sources generally and in 2022/23

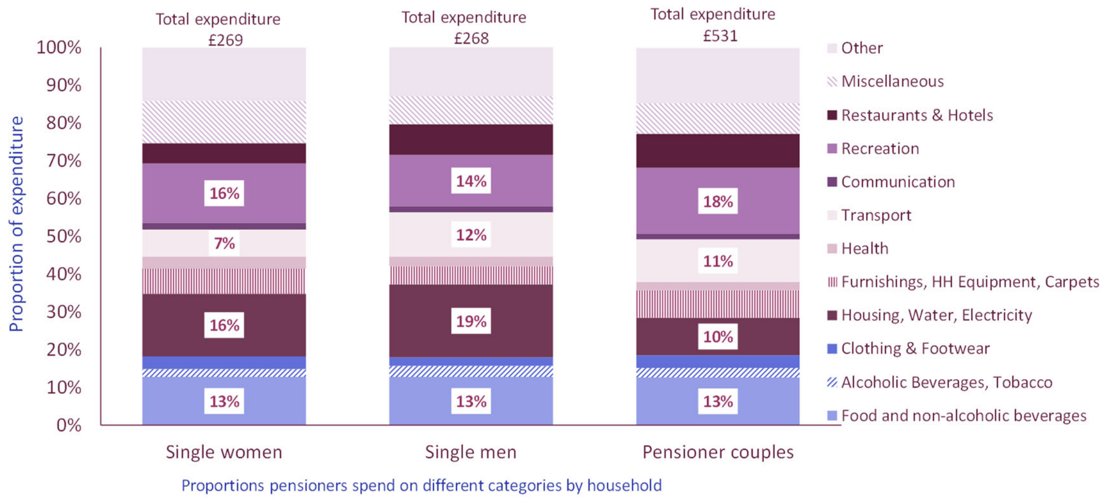
Income source	General inflation	2022/23 inflation
Earnings	Prices or below	Prices or below
bSP and nSP	Triple Lock	3.1%
Earnings related State Pension (GRB, S2P, SERPS)	CPI	3.1%
Pension Credit	Earnings	3.1%
DB pension income	RPI or CPI	RPI (4.9%) or CPI (3.1%)
DC pension income	Variable	Variable
Rise in CPIH	n/a	4.9%

Figure 4 demonstrates that pensioner income inflates via different indices, and that, in 2022/23, most pensioner income is increasing by less than the January 2021 to January 2022 4.9% rise in CPIH - even State Pension and Pension Credit, which are generally raised in line with the increase in earnings or higher.

Consumption patterns vary between households and change as pensioners age

Figure 5: Pensioner couples spend more of their income on recreation while single pensioners spend more on housing, water and electricity

Proportion of total weekly expenditure on different categories by pensioner household (2019/20)



Source: PPI analysis of Living Costs and Food Survey

Households spend in different amounts and proportions. In 2019/20, single pensioners spent an average of around £269 a week, compared to around £531 for pensioner couples. As couples require less income than double that of a single household to achieve the same standard of living, pensioner couples can generally afford more discretionary spending than single pensioners. This is reflected in spending on recreation: in 2019/20, pensioner couples spent around 18% of total expenditure on recreation compared to around 15% on average for single pensioners (equating to an extra £6.50 per person).

By contrast, single pensioners, with less total income, spend a greater proportion of expenditure on basic needs, spending an average of 17% on housing, water and electricity, compared to only 10% for pensioner couples. This means that in 2019/20 single pensioners spent 75% more, per person, on housing costs than people in pensioner couples (Figure 5).

Differences in household consumption mean that changes in price inflation will affect the cost of living in different households by different amounts. As the price of housing, water and electricity went up by an average of 1.31% per person between December 2020 and December 2021, single pensioners, who spend an average of 7% more on these than pensioner couples, will see their cost of living increase by more.

As pensioners age, income and expenditure decreases

As pensioners age, their income tends to decrease which leads to reduced overall expenditure and decreased ability to spend on discretionary goods, such as recreation (Figure 6). Poverty also increases as pensioners age, with 15% of those aged 65 to 69 in relative poverty, 18% of those aged 70 to 79, 24% of those aged 80 to 84 and 27% of those aged 85 and over.[12]

Figure 6: Total average weekly income and expenditure of pensioners by age of household reference person (2019/20)[13]

Age	Income	Expenditure	Proportion of income spent
65-69	£630	£511	81%
70-74	£571	£433	76%
75-79	£540	£415	77%
80+	£480	£305	64%

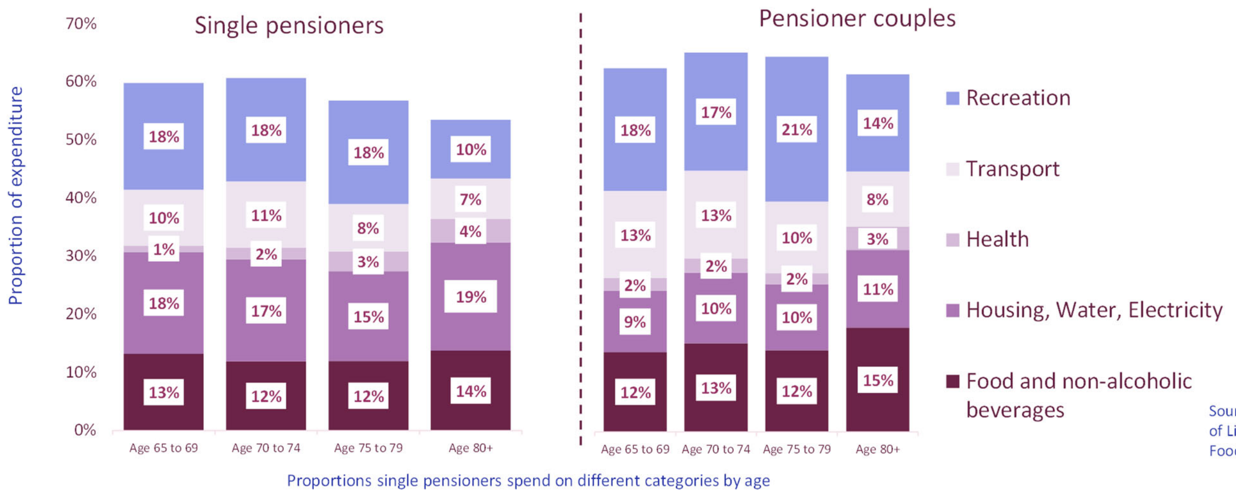
Average pensioner household income falls from around £630 between ages 65 and 69 to around £480 at ages 80 and above, a reduction of 24%. Meanwhile, expenditure drops more significantly than income, by around 40%. This drop in expenditure is likely to relate partially to a reduction in need for transport and recreation spending, as a result of reduced mobility. However, pensioners with reduced means may also choose to spend less of their total income in order to preserve savings for emergencies. Some pensioners will not be able to afford cost increases from their income and may have to draw upon savings.

Older pensioners spend more on health and housing

As pensioners age, their health needs change, with higher prevalence of disability and reducing mobility.[14] 57% of retired households contain a member with a disability, compared to 32% of non-retired households.[15] As pensioners age, and spend more time at home, the proportion of income spent on food, health, housing and energy increases. However, as a result of staying home more, spending on transport decreases, which is another area that has undergone significant cost rises recently (Figure 7).

Figure 7: Pensioners spend a higher proportion on housing, food and health, but reduce expenditure on recreation and transport as they age

Proportion of total weekly expenditure on different select categories by age (2019/20)



Source: PPI analysis of Living Costs and Food Survey

Between the ages of 65 to 69 and 80 and over, spending, in proportional terms, on:

- food *increases* by 1% for single pensioners and 3% for pensioner couples,
- housing costs (including energy) *increases* by 1% for single pensioners and 2% for pensioner couples,
- health *increases* by 3% for single pensioners and 1% for pensioner couples,
- recreation and transport *reduce* by 8% and 3% respectively for single pensioners and 4% and 5% for pensioner couples.

Spending on food increases more for older pensioner couples than it does for older single pensioners. This may be because single pensioners experience more of a reduced income and cannot afford to spend as much of their income on food as couples, rather than this difference reflecting variations in actual need. Likewise, single pensioners may reduce spending on recreation and transport more than couples, out of necessity, rather than preference.

Pensioner cost of living rose by around 4.5% between December 2020 and December 2021

As pensioners spend in different proportions, their actual cost of living increases by a different measure than the overall CPIH increase. Based on the average levels of expenditure, the cost of living for pensioner households grew by 4.5% between Decembers 2020 and 2021.[16]

Cost increases on housing, water and electricity affect single and older pensioners more than other pensioner households

As a result of older and single pensioners spending more on housing, water and electricity than other pensioners, increases in the price of these will increase their cost of living by a higher proportion and reduce their standards of living more than for other pensioners. This means that the expected increases to energy prices in April 2022 is likely to impact older and single pensioners the most.

The cost of living will rise further in April 2022 as caps on energy prices are raised

Further cost of living increases are due, as global gas price rises have resulted in Ofgem announcing that they will raise the cap on energy prices by 54% from 1st April 2022, affecting around 22 million households.[17] Typical household energy prices will increase:

- for direct debit payers on default tariffs by £693 from £1,277 to £1,971 per year,[18] and
- by £708, from £1,309 to £2,017, for those using prepayment meters (pay-as-you-go), which are generally used by those on low incomes.

Around 600,000 people aged 60 or over were using a pre-payment meter to pay for energy use in 2017/18.[19]

These new caps will come into force in April 2022, exacerbating the effect on living costs of the 4.9% inflation increase.

The war in Ukraine, which began in February 2022, could lead to further cost of living increases

The war in Ukraine and corresponding financial sanctions on Russia, has led to further rises to global energy prices and increasing uncertainty around both supply and distribution going forward (due to Russia being a key supplier of global energy). The persistence of this war could lead to continued increases, with cost-of-living rises potentially reaching around 8.4% in April 2022.[20] These rises could exacerbate the effects of the general rise and existing energy price increases, making it harder for pensioners on low incomes to meet basic needs.

Could increasing pensioner income by 'pensioner-specific' indices help maintain their standards of living?

Pensioner living costs do not always increase in line with those of the rest of country. While the latest increase of 4.9% is higher than the increase of 4.5% faced, on average, by pensioners in 2022/23, future increases which may be led by goods which pensioners spend more on, could result in pensioners experiencing a higher increase in living costs than the rest of the population.

In any event, pensioner income is unlikely to rise in line with a 4.5% increase in living costs (which excludes rises to energy prices that are being introduced in April 2022). As discussed above, State sources of income will increase by 3.1% in 2022/23 and income from earnings and private pension income could increase by RPI, CPI or less.

The ONS is currently working on constructing HCIs which would provide a cost-of-living measure for different households, for example, low-income, single parent, disabled and retired households.[21]

It is possible that once these indices are constructed, they could provide an easier way of ensuring that pensioner income rises in line with costs of living, by linking State and private pension payments to a minimum of the HCI, while allowing for higher increases in the case of, for example, the State Pension and the triple lock. This would at least ensure that pensioners don't experience drops in standard of living as they age or as household makeup changes.

Conclusions

Pensioners are affected differently by cost of living increases because they spend on goods and services in different proportions than the rest of the UK population, and these proportions vary by age and household type. In particular pensioners spend more on housing and less on recreation and transport as they age.

Pensioner income does not always increase at the same rate as the cost of living. Though the bSP and nSP are usually uprated by the highest of the increase in earnings, prices or 2.5%, the link to at least earnings was suspended in 2022/23, and these will rise by 3.1% in line with CPI, due to the impact of the pandemic on earnings causing an artificially high single year earnings increase. Increases to the nSP and bSP by at least earnings will resume in 2023/24. Income from earnings and private pensions may also rise by a price index (RPI or CPI) or below.

As a result, the cost of living is increasing more quickly for pensioners than their income, even though pensioner cost of living could be calculated as increasing by 4.5% rather than 4.9%, due to spending in different proportions.

Cost of living increases, particularly those associated with housing and energy, will hit older and single pensioners hardest, as they spend more on these goods than younger and single pensioners.

Further rises to energy prices, scheduled for April 2022, will hit pensioners particularly hard, as they typically spend more on household energy than working-age people. HCIs, which are under development, could provide a helpful way of protecting pensioner living standards in future, if income from State and private pensions and benefits rises in line with these.

Footnotes

1. DWP (2021) *Households below average income: an analysis of the income distribution FYE 1995 to FYE 2020,* table 6.5db; 22% of the overall population is in relative poverty; relative poverty is income below 60% of median income; AHC = After Housing Costs
2. ONS (2021) Consumer price inflation, UK: December 2021 - Price indices, percentage changes, and weights for the different measures of consumer price inflation Available at https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/december2021 (accessed 10 February 2022)
3. Crawford, R. *et. al.* (2021) *Changing patterns of work at older ages IFS*, London
4. S2P = State Second Pensions, SERPS = State Earnings Related Pension Scheme, GRB= Graduated Retirement Benefit
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7. Wilkinson, L. *et. al.* (PPI) (2021) *The DC Future Book 2021: In association with Columbia Threadneedle Investments* Pensions Policy Institute, London
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11. ONS data
12. DWP (2021) *Households below average income: an analysis of the income distribution FYE 1995 to FYE 2020 table,* 6.5db
13. PPI analysis of Living Costs and Food Survey data
14. Wilkinson, L. Jethwa, C. (PPI) (2019) *Living through later life* Pensions Policy Institute, London
15. ONS (2020) Household Costs Indices, UK: third preliminary estimates, 2005 to 2019 Available at https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/householdcostsindices/thirdpreliminaryestimates2005to2019#retired-and-non-retired-households (accessed 03 March 2022)
16. PPI calculations based on CPIH and Living Costs and Food survey
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18. Direct debit customers who are not on a default tariff will not be directly affected by these changes
19. Age UK Analysis (May 2020) of Living Cost & Food Survey 2017-18; Number of households by household size and age of household reference person (HRP), English regions and UK constituent countries, 2019
20. Corlett, A. Try, L. (2022) *The Living Standards Outlook 2022* Resolution Foundation, London
21. https://www.ons.gov.uk/economy/inflationandpriceindices/articles/developingthehouseholdcostsindiceshcis/october2020#development-of-the-household-costs-indices

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