Gain from the triple guarantee and the point of gain from State Pension and occupational pension uprating policies

July 2011

DWP Department for Work and Pensions

Contents

Background

1) The basic State Pension and the additional State Pension

The State Pension is a regular payment people can claim when they reach State Pension age. Most people build up some State Pension, but the amount they get varies. The amount of State Pension someone receives depends on how many qualifying years of National Insurance they have built up. Entitlement is built up either through paying National Insurance contributions or through National Insurance credits.

The State Pension is comprised of two main parts - basic State Pension (bSP) and Additional Pension (AP). Additional Pension includes entitlement built up under the State Earnings-Related Pension Scheme (SERPs) and the State Second Pension. Some people will not receive all of their State Pension directly from the state as they will have contracted out of Additional Pension.

For people in contracted out employment Additional Pension received directly from the state is known as 'net Additional Pension'. On the other hand, where figures include the Additional Pension someone receives from the contracted out element through their private pension the whole amount is called 'Gross Additional Pension'.

Further information on the State Pension can be found at:

http://www.direct.gov.uk/en/Pensionsandretirementplanning/StatePension/index.htm

2) Occupational pensions

Individuals can build up any amount of occupational pension so there is not any particular expected amount pensioners will receive. In 2009/10 the median occupational pension income for a single person was £79 per week (Pensioner Income Series 2009/10).

Once in payment, the occupational pension will increase according to scheme rules subject to increasing by at least the statutory minimum. For example, scheme rules may specify that all pension increases by the Retail Prices Index (RPI) capped at 5%.

The statutory minimum requirements are that pre-1997 accruals do not have to be indexed, accruals between 1997 and 2005 have to be indexed by at least the Consumer Prices Index (CPI) capped at 5%, and that post 2005 accruals have to be indexed by at least CPI capped at 2.5%

3) Changes to the uprating of basic State Pension, additional State Pension and occupational pensions

The weekly full rate of bSP and a person's weekly gross AP were formerly both uprated each April by the 12-month percentage increase of the Retail Prices Index (RPI), recorded in the September of the previous year.

The basic State Pension was increased in April 2011 by the RPI. From April 2012 onwards, the basic State Pension will be increased by the highest of the growth in average earnings, as measured by the Average Weekly Earnings statistic (AWE), price increases as measured by CPI, or 2.5%. This policy is called the ‘triple guarantee’.

From April 2011 onwards, gross AP will be increased each year with reference to the CPI, rather than the RPI.

Two changes were made in 2010 to the uprating of occupational pensions:

- Public service pensions were moved from RPI to CPI uprating. As many former public sector employers used the same references in scheme rules to uprating as used in the public sector, this also moved these schemes (such as British Telecom) to CPI uprating.
- Statutory minimum uprating was changed from being based on RPI to being based on CPI. Schemes uprating by the statutory minimum were affected by this change.

In this analysis, occupational pension is assumed to rise in line with uncapped CPI. This is to ensure that the results cover the worst-case scenario which applies to a large number of people, given this covers public service schemes.

Others affected by the change from RPI to CPI may not be so significantly affected, if for example their scheme did not uprate pre-97 accruals.

Gain over an average retirement from the basic State Pension and additional State Pension uprating policies

Methodology

1) Introduction

We examine a hypothetical individual, who reaches State Pension age at the start of the 2011/12 financial year. The individual is entitled to a full basic State Pension[1] and the projected median gross additional State Pension for people reaching State Pension age in 2011/12[2], and does not defer their claim. We assume they live for 25 complete financial years after 2011/12[3]. We do not include amounts of State Pension inherited from a deceased spouse or partner.

The full weekly rate of basic State Pension in 2011/12 is £102.15. The projected median gross AP for people reaching State Pension age in 2011/12 is £58.40 (rounded to the nearest 10p). This is from DWP projections based on the lifetime labour market data base[4].

2) Calculation of the gain over an average retirement from the triple guarantee policy applied to the basic State Pension

Projected weekly rates of full bSP under the triple guarantee policy from 2012/13 onwards are calculated using Office for Budget Responsibility (OBR) forecasts of price inflation and average earnings growth[5],

[1] Currently around 75% of women and over 90% of men reaching State Pension age will get a full basic State Pension. See Department for Work and Pensions (2007), *The gender impact of pension reform*. Available at http://www.dwp.gov.uk/docs/genderimpactassessment.pdf

[2] DWP projection based on Lifetime Labour Market Database data, 1% sample of the National Insurance Recording System.

[3] Latest 2008-based cohort life expectancy projections are available from the Office for National Statistics at
http://www.statistics.gov.uk/StatBase/Product.asp?vlnk=15098&Pos=1&ColRank=1&Rank=272

The projected life expectancy for women in the United Kingdom aged 61 at the end of the 2011 calendar year is 27.8 years; for men aged 65, it is 21.4 years. A length of retirement after 2011/12 of 25 years is chosen as an average.

[4] DWP estimates based on 1% sample administrative data.

[5] July 2011 OBR Fiscal Sustainability forecasts are used, available at

http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2011

Beyond OBR's forecast period from 2016/17, a long run assumption of 3.20% is applied for RPI inflation, 2% for CPI inflation, and 4.70% for average earnings growth plus 0.2% in line with the triple guarantee policy[6].

At each uprating, the projected full bSP rate is rounded to the nearest 5p.

The weekly rate in each year of retirement is multiplied by 52.178 (365.25 days divided by 7 days in a week) to produce projected annual cash flows of bSP income.

The projected flows are deflated to 2011/12 real terms using the forecast financial year GDP deflator series consistent with OBR forecasts[7]. The GDP deflator series is extended beyond OBR's forecast horizon from 2016 by assuming annual percentage increases of 2.70%.

The projected real income flows are discounted to 2011/12 by the relevant discount factor of 3.5% (in line with the methodology specified in Annex 6 of The Green Book[8]), to produce a stream of net present values.

These present values are summed to produce a total net present value of bSP income over retirement under the triple guarantee.

The same procedure is followed, this time applying RPI-uprating of the basic State Pension, in line with the previous uprating policy.

The two final net present values are compared. The difference is the gain over retirement in terms of basic State Pension income from the triple guarantee. It is rounded to the nearest £1,000.

3) Calculation of the loss over an average retirement from the switch to CPI-uprating of gross additional State Pension

The methodology followed is similar to that the for the basic State Pension calculation.

The projected median gross AP for people reaching State Pension age in 2011/12, £58.40, is uprated by CPI in payment, in line with current policy. The corresponding net present value of flows is compared to the net present value of gross AP flows uprated by RPI.

At each uprating the projected median gross AP rate is rounded to the nearest 1p.

[6] See Annex 2 for detail on the methodology behind the AWE plus 0.2% triple guarantee assumption.

[7] The GDP deflator series consistent with the OBR's Fiscal Sustainability Report Forecasts, July 2011

[8] Available at http://www.hm-treasury.gov.uk/d/green_book_complete.pdf

Results

Following the methodology laid out above, the gain in terms of basic State Pension income from the triple guarantee over an average retirement, for someone reaching State Pension age and claiming a full basic State Pension at the start of the 2011/12 financial year, is estimated to be £11,000.

The loss in terms of gross Additional Pension income from the switch to CPI-uprating of gross additional State Pension is estimated to be £7,000.

The net gain in terms of gross State Pension income (basic State Pension income plus gross additional State Pension income) over an average retirement is estimated to be £4,000.

All figures have been rounded to the nearest £1,000.

These figures use the latest July 2011 OBR Fiscal Sustainability Report forecasts of price inflation and average earnings growth. The figures will be affected by future changes in these forecasts[9].

These figures do not include uprating policies applied to income related benefits and disability benefits, which are important for pensioners' incomes.

[9] Estimates were first produced in January 2011 in response to a Parliamentary Question, using OBR's November 2010 economic forecasts. The response, to question 37003 (Rachel Reeves, Leeds West) is published in Hansard, dated 31.01.11, volume 222, column 589w. The gain from the triple guarantee was estimated to be £15,000. The loss from the CPI-uprating of gross AP was estimated to be £5,000. The net gain in terms of gross State Pension income was estimated to be £10,000.

Point of gain over an average retirement from State Pension and occupational pension uprating policies

Methodology

1) Introduction

We examine a hypothetical individual, who reaches State Pension age at the start of the 2011/12 financial year and is entitled to a full basic State Pension[10], additional State Pension and an occupational pension. The individual does not receive Pension Credit and does not defer their claim. We assume they live for 25 complete financial years after 2011/12[11]. We do not include amounts of State Pension inherited from a deceased spouse or partner.

The full weekly rate of basic State Pension in 2011/12 is £102.15.

2) Calculation of the gain over an average retirement from uprating policies applied to the State Pension and occupational pensions.

Projected weekly rates of full bSP, gross AP and gross occupational pension from 2012/13 onwards are calculated using Office for Budget Responsibility (OBR) forecasts of price inflation and average earnings growth[12]. As per current policy, basic State Pension grows in line with the triple guarantee and AP and occupational pension are indexed by CPI.

Beyond OBR's forecast period, a long run assumption of 3.20% is applied for RPI inflation, 2% for CPI inflation, and 4.70% plus 0.2% for average earnings growth in line with the triple guarantee policy.

---

[10] Currently around 75% of women and over 90% of men reaching State Pension age will get a full basic State Pension. See Department for Work and Pensions (2007), *The gender impact of pension reform*. Available at http://www.dwp.gov.uk/docs/genderimpactassessment.pdf

[11] Latest 2008-based cohort life expectancy projections are available from the Office for National Statistics at
http://www.statistics.gov.uk/StatBase/Product.asp?vlnk=15098&Pos=1&ColRank=1&Rank=272

The projected life expectancy for women in the United Kingdom aged 61 at the end of the 2011 calendar year is 27.8 years; for men aged 65, it is 21.4 years. A length of retirement after 2011/12 of 25 years is chosen as an average.

[12] July 2011 OBR Fiscal Sustainability forecasts are available at

http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2011

At each uprating, the projected basic State Pension rate is rounded to the nearest 5p and Additional Pension and occupational pension is rounded to the nearest 1p.

The weekly rate in each year of retirement is multiplied by 52.178 (365.25 days divided by 7 days in a week) to produce projected annual cash flows of bSP, AP and occupational pension income for each year.

The projected flows are deflated to 2011/12 price terms using the forecast financial year GDP deflator series consistent with OBR forecasts[13]. The GDP deflator series is extended beyond OBR's forecast horizon by assuming annual percentage increases of 2.70%.

The projected real income flows are discounted to 2011/12 terms by the relevant discount factor of 3.5% (in line with the methodology specified in Annex 6 of The Green Book[14]), to produce a stream of net present values.

The values from all the years of retirement are summed to produce a total net present value of overall pension income over retirement under current uprating policies.

The same procedure is repeated to obtain a second set of figures, this time applying RPI-uprating in line with the previous uprating/indexation policy.

3) Calculation of the break even point

To calculate the breakeven point, the total of the weekly gross AP and occupational pension in 2011/12 in cash terms is treated as a variable to be adjusted up or down, holding the value of bSP constant. The same figure is applied to each indexation scheme. When adjusting this figure, the breakeven point is reached when the total net present value of overall pension income is approximately equal across both current and previous indexation schemes.

The sum of weekly gross AP and occupational pension that generates the break even point is added to the full weekly bSP rate. This gives the maximum weekly pension income at which the individual is better off over retirement as a result of changes to uprating of state and occupational pensions. This value is multiplied by 4.36 (30.5 days divided by 7 days in a week) to produce the corresponding monthly value.

[13] The GDP deflator series consistent with the OBR's Fiscal Sustainability Report Forecasts, July 2011

[14] Available at http://www.hm-treasury.gov.uk/d/green_book_complete.pdf

Results

Following the methodology laid out above, an individual reaching State Pension age in 2011/12 and in receipt of a full basic State Pension, and not entitled to the Pension Credit Guarantee, will be better off over their retirement under the new uprating regime, if they have an overall pension income of up to £800 per month or £190 per week.

These figures use the latest July 2011 OBR Fiscal Sustainability Report forecasts of price inflation and average earnings growth. The figures will be affected by future changes in these forecasts. The monthly figure is rounded to the nearest £100 pounds; the weekly figure is rounded to the nearest £10.

These figures do not include uprating policies applied to income related benefits and disability benefits, which are important for pensioners' incomes.

Regarding private pension indexation, the Government sets the statutory minimum indexation requirements however ultimately it depends on the scheme as to whether or not they adopt CPI.

The analysis excludes impacts on the value of people's private pensions of switching statutory minimum revaluation to CPI. We ignore these because we are examining individuals reaching State Pension age in 2011/12, the year the policy comes into force, who are therefore unaffected by these changes.

Rebecca Davenport (rebecca.davenport@dwp.gsi.gov.uk)

Department for Work and Pensions

27th July 2011

Annex 1

Explanation of the changes to gains from the triple guarantee

Recent changes to the OBR's long term economic assumptions have had a significant impact on the gain over an average retirement from basic State Pension and additional State Pension uprating policies.

Previous long term assumptions were from Budget 2008 and medium term assumptions were from the 2010 autumn fiscal statement. Under these assumptions the gain in basic State Pension income from the triple guarantee over an average retirement, for someone reaching State Pension age and claiming a full basic State Pension at the start of the 2011/12 financial year, was estimated to be £15,000. This now stands at £11,000.

Under Budget 2008 forecasts, a long run assumption of 2.87% was applied for RPI inflation, 2% for CPI inflation, and 4.93% for average earnings growth. The latest OBR July 2011 forecasts assume 3.20% RPI inflation, 2% CPI inflation and 4.70% average earnings growth in the long run. Therefore the key driver behind the changes in gains from the triple guarantee is from increased RPI inflation.

The gap between RPI and CPI is partly explained by the use of different formulae for measuring inflation, known as the formula effect. The difference between RPI and CPI as a result of the formula effect rose from around 0.5ppts over 2009 to around 0.8ppts over 2010. The OBR have assumed that this difference will be sustained, implying a permanent increase in the long run difference of RPI and CPI of 0.3ppts. This increased gap is driven by changes to the level of RPI inflation. Since January 2010 changes have been made to the collection of data on clothing prices and due to the way that RPI is calculated, has affected its level.

Annex 2

Average Earnings plus 0.2% triple guarantee methodology

Background

From April 2012, the basic State Pension will be uprated by the highest of the growth in average earnings as measured by the Average Weekly Earnings Index (AWE), price increases as measured by the Consumer Price Index (CPI) or 2.5%. This is known as the ‘triple guarantee’.

To estimate the future expenditure on the basic State Pension, the triple guarantee is applied using the Office for Budget Responsibility’s (OBR) published medium term Economic Assumptions. In the long run the central assumption is that the triple guarantee will be equal to earnings growth plus 0.2%. This note explains why we apply earnings growth plus 0.2% in the long run.

Methodology

When estimating future expenditure on the basic State Pension it was previously assumed that in the long term, the triple guarantee was equal to earnings growth, as earnings growth is expected to be higher than price growth and 2.5%. This is supported by recent historical data from 1990 to 2010[15] .

However, there have been periods of volatility when earnings growth has been lower than price growth or 2.5%. Therefore, simply uprating the basic State Pension by earnings growth for the long term may be underestimating the future expenditure of basic State Pension.

Applying the triple guarantee and earnings growth to the value of the basic State Pension over the past 20 years[16] and then calculating the average difference at the end of the period shows a differential of approximately 0.2% a year. Given this, we propose to use the assumption that the basic State Pension will be uprated by earnings growth plus 0.2% in the long term.

The future volatility of price and earnings growth cannot be predicted with any certainty. The assumption of an additional 0.2% takes into account potential periods of volatility and is based on data over the last 20 years. A longer or shorter period could be used, for example, using the last 40 years would mean the triple guarantee would grow by earnings plus 0.4%. Restricting the analysis to the past 20 years gives a sufficient time series of data on which to base future projections and is consistent with the inflation-targeting period introduced after 1992.

[15] Price increases measured by September annual changes for RPI and CPI. Earnings growth from 2001 measured by the AWE index, the Average Earnings Index (AEI) for periods before the AWE existed, 1990 to 2000. Data sourced from the Office of National Statistics.

[16] 1990 - 2010