LCP on point

Can the Chancellor escape his pensions 'triple lock'?

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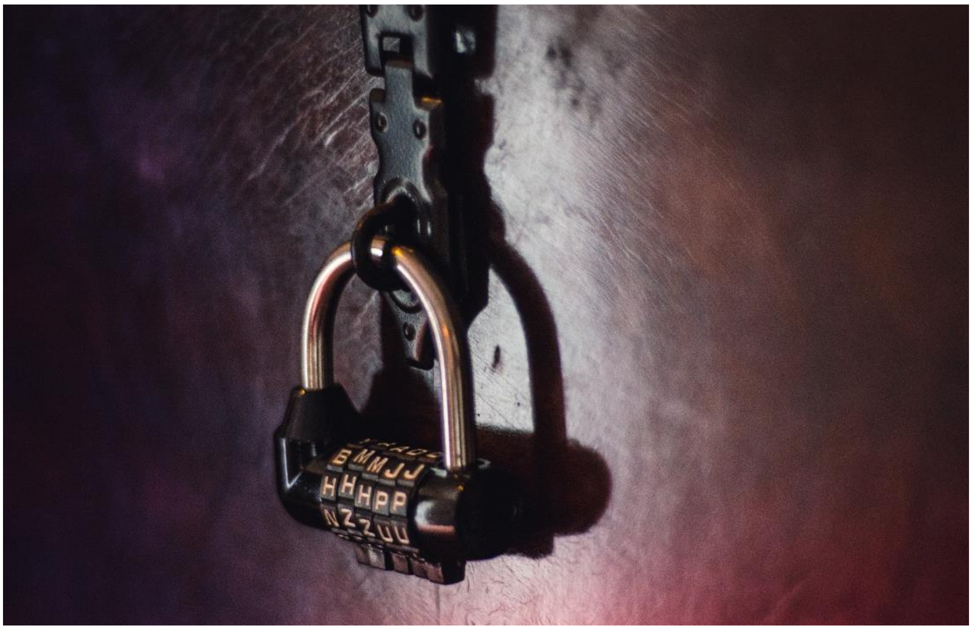

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01 Executive Summary

Since the 2010 General Election, annual increases in the rate of the basic state pension each April have been according to the highest of three numbers:

- The growth in prices in the year to the previous September
- The growth in average earnings in the year to the previous July
- A floor of 2.5%

Since 2010, this 'triple lock' formula has added around £10 per week to the rate of the basic state pension compared with an inflation link, and by more than £13 per week compared with a link to earnings growth over the decade. With more than 12 million people receiving a state pension, these increases have a significant effect on public spending and will come under increasing scrutiny given the state of the public finances.

The triple lock formula could come under particular focus over the next two years for two main reasons:

- The formula would be likely to imply **a 2.5% increase in April 2021**, with price inflation and earnings growth low or negative; this would give a significant real-terms boost to pensioners, but at a time when many people of working age may be losing their jobs;
- Based on OBR assumptions, the formula could imply **a 5% increase in April 2022**, on the assumption that earnings levels bounce back from the depressed levels paid to those who have been 'furloughed'; this would be another substantial above-inflation increase, and far more than the amount that the government had expected to spend;

There is a wide range of ways in which the Chancellor could respond to these challenges, and much depends on his judgment as to the political cost of breaking the triple lock promise which was contained in the recent Conservative manifesto.

Options most likely to be considered include:

- Suspending the triple lock for the next two years, arguing that these are extraordinary times, and making ad hoc decisions for the next two state pension upratings;
- Modifying the triple lock, perhaps by lowering the 'floor' from 2.5% to (say) 1.5% or 1%; however, this would not solve the 2022 issue;
- Scrapping the triple lock, though compared to the huge budget deficit expected this year, the amount saved may look relatively modest in the short term unless the Chancellor was willing to freeze pensions;
- Implementing a 'double lock' where increases are the higher of the growth in prices or earnings; however, this would still imply a 5% increase in 2022 and a politically challenging increase in 2021 in line with inflation which could be close to zero;

The main things that the Chancellor will be looking for will be:

- To control spending
- To avoid unduly favouring the retired population relative to the working age population
- To avoid a derisory cash increase, as with the '75p' increase in 2000/01
- To avoid ripping up a recent manifesto commitment

The most likely compromise would be to apply the principles of the triple lock but over a two year period rather than one year. Over the next two years as a whole, the growth in prices and the growth in earnings is likely to be under 5%. This would imply that the third leg of the triple lock – 5% over two years – would bite. The Chancellor could go for a 2.5% increase in April 2021 and the same again in April 2022. This would allow him to say he had kept his promise to apply the triple lock, would avoid a surge in pensions in 2022 and would avoid a very small cash increase in 2021. As DWP spending plans are premised on increases of at least 2.5%, the money is already in the 'baseline' spending plans for government. **We estimate that from 2022/23 onwards this would save nearly £1.5bn per year compared with the year-by-year application of the triple lock.**

The Chancellor could, of course, go further but the triple lock policy has proven surprisingly durable since it was introduced a decade ago. Ideally, he would also use this opportunity to start a discussion about the purpose of the state pension and what this implies about the level at which it should be paid. This could pave the way for a more sustainable process of annual upratings in the medium term.

02 Background – where did the triple lock come from?

The first law requiring annual increases in the state pension was introduced by a Conservative government in 1973 and required an increase in line with price inflation. The Labour government elected in 1974 promptly legislated that longer-term benefits such as the state pension should rise by the higher of prices and earnings. This policy (generally known as 'the earnings link') was only in force for a few years until the Conservative government of Mrs Thatcher reverted to price indexation with effect from 1980. That policy remained in place for the next thirty years[1].

Over time, governments have considered three factors as being potentially relevant when setting state pension rates[2]:

a) **Price inflation** – it is generally accepted that the retired population, who are mostly not in a position to go out to work to boost their income, should not see a decline in their real living standards through retirement (at least as far as state pensions are concerned); on this basis, the state pension should increase at least in line with the general increase in prices;

b) **Earnings growth –** the purpose of a pension is to support individuals who can no longer rely on earnings; if pension rates fall relative to average earnings, then the effectiveness of the pension system in smoothing the transition from work into retirement will decline; a prolonged fall in the relative value of the state pension could lead to a 'cliff-edge' where living standards fall sharply at retirement; as a result, there is a case for some form of relationship between the level of the state pension and the level of the average wage;

c) **Avoiding small absolute increases –** when inflation is high, the cash amount of annual increases can look quite generous, even if they are simply intended to keep pace with rapidly rising prices; however, when inflation is low, the cash increase can create presentational problems; this was most acute when setting the April 2000 pension rate; inflation had been 1.1%, implying an increase of just 75p which was duly applied; such was the controversy around this increase that a one-off above-inflation £5 increase was awarded the following year.

Ever since the 'earnings link' was broken in 1980 there had been campaigns to have it restored, notably by organisations such as the National Pensioners Convention. But the experience of a 75p increase in 2000 suggested that a third consideration – avoiding low absolute increases – also needed to be considered.

[1] For more information, see the House of Commons Library research note on the 'triple lock': https://commonslibrary.parliament.uk/research-briefings/cbp-7812/

[2] Note that this discussion relates purely to the 'basic' state pension and the new 'flat rate' state pension. Different indexation rules apply to earnings-related state pensions such as SERPS. See Appendix 2.

As a result, in their 2010 Election Manifesto[3] the Liberal Democrats argued for a 'triple lock' under which:

> *"We will uprate the state pension annually by whichever is the higher of growth in earnings, growth in prices or 2.5 per cent". (p18).*

Following the formation of the Conservative-Liberal Democrat Coalition Government in 2010, this policy was included in the Coalition Agreement.

As explained in the next section, this policy has been in force for each uprating from April 2011 to April 2020. In general, the policy has had all-party support with the exception of the 2017 Conservative party manifesto which proposed a 'double lock' (dropping the 2.5% floor). However, following the 2017 General Election the Democratic Unionist Party insisted on the retention of the Triple Lock policy as a condition for its support for the Government. In 2019, the Conservative manifesto reverted to supporting the Triple Lock.

[3] See: https://www.markpack.org.uk/files/2015/01/Liberal-Democrat-manifesto-2010.pdf

03 What difference has the triple lock made?

When deciding how much to increase the state pension between one April and the next, the triple lock policy indicates that the government should have regard to three numbers:

a. The level of price inflation in the year to September; for the April 2011 increase only, inflation was measured using the RPI; for all subsequent increases the CPI was used;
b. The level of earnings growth – by convention, the government has used the earnings figure reported in the year to July;
c. A floor of 2.5%;

The following table (produced by the House of Commons library) shows the outturn figure for each element and the actual uprating which applied:

State Pension triple lock: uprating factors used in each financial year

Setting State Pension amounts in financial year:	Triple lock		Reference indices for triple lock		*Memo: Retail Prices Index (RPI) inflation (b)*
	Factor	based on:	Consumer Prices Index (CPI) inflation	Average earnings	
2011/12	(a)		+3.1%	+1.3%	*+4.6%*
2012/13	**+5.2%**	CPI	**+5.2%**	+2.8%	*+5.6%*
2013/14	**+2.5%**	2.5%	+2.2%	+1.6%	*+2.6%*
2014/15	**+2.7%**	CPI	**+2.7%**	+1.2%	*+3.2%*
2015/16	**+2.5%**	2.5%	+1.2%	+0.6%	*+2.3%*
2016/17	**+2.9%**	Earnings	-0.1%	**+2.9%**	*+0.8%*
2017/18	**+2.5%**	2.5%	+1.0%	+2.4%	*+2.0%*
2018/19	**+3.0%**	CPI	**+3.0%**	+2.2%	*+3.9%*
2019/20	**+2.6%**	Earnings	+2.4%	**+2.6%**	*+3.3%*
2020/21	**+3.9%**	Earnings	+1.7%	**+3.9%**	*+2.4%*

Notes
(a) State Pension amounts for 2011/12 were raised by 4.6%, in line with RPI.

As the table shows, each element of the triple lock (prices, earnings and 2.5%) has applied on three occasions.

As at April 2010, the basic state pension stood at £97.65 per week. Since April 2020 the rate has been £134.25 per week following the implementation of the triple lock policy over the decade. The Table below shows what the pension would have been on three different scenarios:

a. If the pension had simply been linked to inflation[4], as was the policy between 1980 and 2010;[5]
b. If the pension had simply been linked to earnings; this is in fact the statutory position – the government is required by law to increase the basic state pension at least in line with the growth in average earnings;
c. If a 'double lock' had been in force, using the higher of price or earnings growth, but without the 2.5% floor.

Table 1. Basic state pension rate in 2020/21 under alternative assumptions about policy since 2010

Assumption	Rate	Difference (£pw)
Actual (triple lock)	**£134.25**	
Price indexation	£123.65	-£10.60
Earnings indexation	£120.75	-£13.50
Double lock	£132.05	-£2.20

The Table shows that a continuation of the pre 2010 policy of price indexation would mean a state pension just over £10 per week lower, whilst linking to earnings growth (which has been very sluggish in the last decade) would mean the pension was more than £13 per week lower. A basic pension subject to a 'double lock' over the last decade would be just £2.20 per week lower.

[4] Note that we abstract here from the change in definition of inflation from RPI to CPI which applied from 2012 onwards; we assume that 'inflation' in all scenarios was RPI up to the 2011 uprating and CPI thereafter
[5] Where inflation is negative, we assume that the state pension would simply have been frozen rather than cut.

04 Why is there a problem now?

With the December 2019 Conservative manifesto having promised to maintain the Triple Lock, it would be reasonable to assume that the first uprating decision since the General Election – the one which sets the state pension for April 2021 – would be a straightforward matter of applying the Triple Lock. However, the impact of the Covid-19 pandemic and knock-on economic effects mean that simply 'turning the handle' on the Triple Lock formula could cause problems. These relate both to the calculation for April 2021 and for April 2022. Although no decision has to be made yet for April 2022, as will become apparent, a farsighted Chancellor may well want to consider both upratings at this point.

a. The uprating for April 2021

We do not yet have the inflation figure (year to September) or the earnings figure (year to July) that the Chancellor would need for the triple lock calculation, but all the indications are that both could be relatively low this year.

CPI inflation in the year to July 2020 stood at 1.0%. It is generally expected to fall in July, partly because price increases from a year earlier will drop out of the figures and partly as stimulus measures such as 'eat out to help out' and the VAT reduction on tourism and hospitality start to take effect. This suggests that the crucial September CPI figure (used for the Triple Lock calculation) will be less than 1%.

Average earnings in the three months to June 2020 were 1.2% down on the year earlier. This figure will have been heavily influenced by the fact that around 10 million workers were covered by the 'furlough' scheme which often covers 80% of their wages. Even allowing for the gradual unwinding of the furlough scheme, it seems very likely that earnings growth in the year to July (as used for the Triple Lock calculation) will be negative.

At one level, this means that the Triple Lock calculation for April 2021 will be very simple. With prices probably rising by less than 1% per year and wages falling, the state pension would simply rise by 2.5%. This is the assumption published by the OBR[6] in July 2020.

From a presentational point of view, the main challenges with a 2.5% increase would be:

- With low inflation, a 2.5% increase would represent a significant real-terms boost to pensioners at a time when those in work have actually seen pay cuts and/or have been losing their jobs; this could raise issues of intergenerational fairness;

[6] OBR Fiscal Sustainability Report, July 2020: https://obr.uk/fsr/fiscal-sustainability-report-july-2020/ p107

- With pressure to tackle the budget deficit through spending cuts and tax rises, paying pensioners an increase which is both above inflation and above earnings growth may seem to be the wrong priority for scarce funds;

b. The uprating for April 2022

The key challenge when thinking ahead to the April 2022 uprating is the likely trajectory of average earnings. Current expectations are that earnings may well display a 'V' shape with a fall in the year to July 2020 but a substantial bounce-back in the year to July 2021 (as the 80% furlough scheme drops out of the figures and those workers mostly either revert to their normal wage or become unemployed). Any high earnings figure would be likely to dominate the triple lock calculation (assuming no surge in price inflation) and could add considerably to the pensions bill.

In its July 2020 forecasts, the OBR assumes the triple lock calculation will generate a 5% state pension increase for precisely this reason.

The challenges here would be:

- Earners who saw their wages dip in 2021 and return to their previous level in 2022 are back where they started; but pensioners could see a 2.5% increase followed by a 5% increase, leaving them substantially better off relative to the working age population;

- If inflation remained at or below the Bank of England target of 2%, a 5% pension rise would represent a second successive real-terms increase for pensioners; again, at a time when public spending in other areas could be under pressure and taxes being increased, this may seem like a questionable priority;

In the next section we consider the wide range of options which the Chancellor may be considering in response to these challenges.

05 What are the Chancellor's options?

Given the presentational and fiscal challenges associated with going ahead with an unamended triple lock, there is a wide range of alternatives open to the Chancellor. These include relatively modest amendments, such as tweaking the triple lock 'floor', moving to a double lock or simply linking to prices or earnings. More creative options could include measuring the various elements of the triple lock over a two year rather than one year period, or a more fundamental re-think of the principles of pension uprating. We consider the options in turn, starting with the implications of going ahead with the existing policy.

Before going through those options however, it is worth setting out some of the criteria that the Chancellor will – or should – apply to the different options. These include:

- Fiscal impact – the total bill for the state pension is around £102bn per year, of which the elements covered by the triple lock (the basic state pension and the new state pension) account for roughly £80bn; uprating decisions can have a large cumulative impact over a period of years; as the Box shows, each 1% off the uprating would save the Government around £580 m each year, allowing for knock-on effects on taxation and means-tested benefits;

- Political impact – the Chancellor will have regard to the importance of pensioners as a group who make up a large and growing part of the population, who vote in large numbers and who, at present, are disproportionately likely to support his party;

- Fairness between the generations – in principle, generous pension increases at a time when the working age population is facing wage pressure and rising unemployment may seem unfair; however, it is worth remembering that today's young people may be more dependent on the state pension in their old age than today's retirees, so it is important to look at the long-run impact of state pension policies and not just at the present-day impact;

- Fairness between men and women – on average, a woman retiring today derives more than half of her income from the state pension; although pensioners on average are doing better than in previous generations, the state pension remains very important for women in particular, many of whom still have limited private pension provision; someone with a large private pension can withstand a squeeze on the state pension much more readily than someone who is largely dependent on state provision;

BOX: How much difference does 1% make?

The triple lock policy currently applies to two elements of the state pension system:

- The (old) basic state pension for those who reached pension age before 6th April 2016; the maximum rate is currently £134.25 per week;
- The new state pension up to the flat rate amount of £175.20 per week (but excluding any 'protected payments' above this level);

There is however no uprating for those living in 'frozen' countries such as Australia, New Zealand, South Africa and Canada.

In 2020/21, the total amount spent was as follows:

Basic state pension:	£66.5 billion
New State pension (excluding protected payments):	£14.0 billion
Total subject to triple lock:	£80.5 billion

With regard to 'frozen' countries, around 1.3% of all state pension expenditure is paid to people in 'frozen' countries[7]. In round numbers, this suggests that £80 billion is a reasonable figure to use for the amount of state pension expenditure affected by the triple lock decision as at 2020/21.

Whilst a 1% increase in the basic / new state pension will therefore cost around £800m, this figures needs to be adjusted for two factors to get the net impact on public spending:

a. Means-tested benefits

For those in receipt of means-tested benefits, an additional increase to their state pension could result in a reduction in their benefits. For pensioners, the most important means-tested benefit is Pension Credit. In 2020/21, 1.67m people were in receipt of Pension Credit, including roughly 0.3m couples. This suggests that just under 2m people on state pension would see some or all of any increase clawed back in reduced Pension Credit[8].

The majority of people on Pension Credit are receiving the 'guarantee credit' where any other income is clawed back pound-for-pound from their pension credit. Assuming just under 12 million people on state pension in non-frozen countries, this suggests roughly 1/6 of the gross cost of any state pension increase will be clawed back in reduced pension credit. With a £800m gross figure, this means the net cost is around £660m.

b. Taxation

[7] Source: Author's calculations based on DWP 'stat xplore' statistics: https://stat-xplore.dwp.gov.uk/

[8] There would also be some savings in reduced Housing Benefit payments, reduced Council Tax support by local government etc.but we focus here on the largest single area of saving to central government.

The state pension is taxable and just over half[9] all pensioners pay income tax. The overwhelming majority of these pay at the basic rate of 20%. This suggests that around 10% of any increase in state pension is returned in higher income tax revenues (assuming no changes to tax thresholds etc). Assuming around 10% of the £800m gross increase comes back in income tax**, a reasonable approximate net figure for 1% on the triple lock would be £580m per year.**

a. Baseline – retain the triple lock

The simplest option, and one which keeps faith with the 2019 Conservative manifesto would simply be to retain the triple lock policy for the 2021 uprating. This would not commit the Chancellor to anything for future upratings. Although this may seem like an 'expensive' option, it is worth noting that going for a 2.5% uprating in 2021 rather than (say) a 1.5% uprating on the basic pension (and new state pension) would only save around £580m in 2021/22. In the context of government borrowing which is set to exceed £300bn in 2020/21, the Chancellor may well decide that the political cost of dropping this manifesto commitment more than outweighs the small proportionate impact on annual borrowing.

It is also important to understand the way in which government accounting works and how budget decisions are 'scored'. The government has already published spending plans for 2021/22 and successive years and these are premised on the assumption that the triple lock remains in force. The costs of the triple lock are therefore 'baked in' to the baseline.

On that basis, when it comes to the Budget 'scorecard' which lists all the tax and spending measures in the Budget, retaining the triple lock would score as a 'zero' – indeed it would not even appear as a Budget measure. Clearly *not* reforming the triple lock would be to pass up an opportunity to save money, but behaviourally it is a much bigger step to actively change the policy (and break the manifesto commitment) than simply let the policy run on for another year. Such behavioural factors can be surprisingly important in shaping the decisions of ministers on such occasions.

However, an alternative way of looking at the cost of the triple lock is to compare it with the current level of the national debt – now in excess of £2 trillion. Although the saving from an increase 1% lower in 2021 would be 'just' £580m in that year, this saving would continue in subsequent years, as the new 'lower' figure would form the baseline for future upratings. If savings were made purely in the upratings for 2021 and 2022 but then 'baked in' for all future years, the cumulative savings could reduce the national debt by many billions over the next decade, depending on the exact approach chosen.

b. A modified triple lock with a lower floor;

If the Chancellor wanted to save money but say that he was retaining the triple lock, one option would be to redefine the triple lock. At the moment, the floor for the triple lock is 2.5%, and this is designed to avoid derisory cash increases in the pension. But the 2.5% figure was set a decade ago when nominal pension rates were much lower. In addition, growing numbers of people now get

[9] HMRC figures for 2020/21 give 6.25m taxpayers over state pension age, compared with around 11.2m state pensioners in the UK (not counting 1.1m outside the UK) or roughly 55%. See: https://www.gov.uk/government/statistics/number-of-individual-income-taxpayers-by-marginal-rate-gender-and-age

the flat rate pension (£175.20 per week) rather than the basic pension (£134.25 per week) which means any given percentage increase looks larger.

In response to this, the Chancellor could say that he is keeping his manifesto commitment but updating the triple lock with a lower floor – say 1.5%. This would ensure that someone on the full basic state pension got an increase of at least £2 per week, and would save around £580m in every future year compared with a 2.5% uprating. Whilst £2 per week is still hardly a king's ransom, it would at least avoid the accusation that pensioners were getting 'pennies' which would be said if there was a simple inflation link.

The main downside of this approach – apart from the obvious dilution of the Manifesto promise – is that it only solves the problem of the 2021 uprating and does nothing to help with the potentially large earnings growth figure feeding in to the 2022 uprating.

c. A double lock – drop the 2.5% floor completely;

Given the relatively arbitrary nature of the 2.5% floor, the Chancellor could go one step further and move to a 'double lock' – in line with the policy in the Conservative manifesto of 2017. Under this policy, the pension would rise each year in line with the higher of prices and earnings. This would still be a relatively generous policy in historical context and would continue the 'upward ratchet' in value of the state pension relative to average earnings.

The problems with a 'double lock' would be:

- Assuming CPI to September 2020 is higher than earnings growth to July 2020, the CPI figure will determine the uprating under a 'double lock' policy; if CPI inflation is very low, the increase in the basic state pension could be under £1 per week which would be politically challenging;
- It doesn't help with the 2022 uprating problem; a surge in earnings to July 2021 would still turn into a big increase in April 2022;

It is hard to see that this offers much of a solution. Although it saves money on the next uprating, it would be politically very difficult and still leaves the problem unresolved for the following year.

d. Statutory indexation – link to earnings

It is easy to forget that, as well as the policy around upratings, there is the law of the land which also provides an underpin. Since 2012, the law has required the basic state pension to rise at least in line with average earnings, whilst other elements of the state pension (state second pension / SERPS etc) must rise in line with inflation.

One option therefore would be simply to revert to the statutory position. This ensures that the state pension never falls relative to the income of those in work. However, this would be a tough message as it would presumably imply a pension freeze in April 2021. The narrative would be that people of working age are losing their job and facing pay reductions and pensioners should share equally in that pain. It would also save significant sums (potentially around £1.5bn in every future year).

A consequence of moving to earnings indexation for April 2021 is that it would be very difficult not to apply it to April 2022 as well. Based on the OBR assumption of a 5% earnings figure, this would mean a big rise in April 2022. However, a freeze followed by a 5% increase would work out roughly the same as a 2.5% increase in each year which is in line with the baseline plans, so it would mean the earnings 'surge' expected for next year would be more manageable.

A lot depends on how much political flak the Chancellor is willing to take. It is one thing to break a freshly minted manifesto commitment to the triple lock, but somewhat further to impose a freeze in the value of the pension. Even with modest inflation, this implies a real terms cut in the living standard of 12 million pensioners, and that is likely to be seen as a step too far.

e. Index to prices

For thirty years, between 1980 and 2010, the policy was to link the rate of the state pension to price inflation. This was intended to ensure that the real spending power of the basic pension was maintained. One option – potentially for a two year period – would be to go back to that policy.

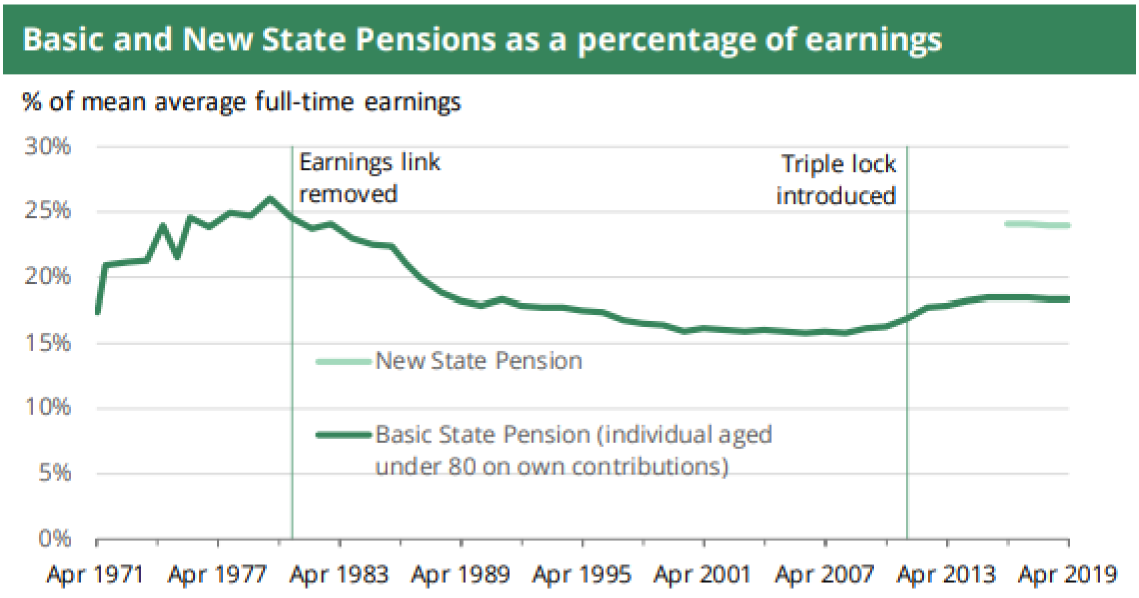
Whilst this would obviously be a breach of the triple lock policy, the Chancellor might find this attractive because:

- Pensioner living standards would be protected;
- For April 2021, the Chancellor could argue that whilst people in work have seen their wages fall, pensioners will still see their pensions increase;
- It would solve the 'earnings surge' issue for the April 2022 uprating;
- It would result in significant savings relative to a baseline assumption of 2.5% increases in each of the next two years.

However, as with the double lock policy, the absolute cash increase in April 2021 could be very small with an inflation link – perhaps under £1 per week if inflation falls sharply – and this could be politically challenging.

There is also a risk that this could turn into a long-term policy and this could undermine one of the real achievements of the triple lock mechanism, which has been to boost the state pension as a share of national average wages. As shown in Table 1, if price indexation had been in force for the last decade instead of the triple lock, the pension would now be around £10 per week lower.

Figure 1 shows how the value of the basic state pension has moved relative to average wages since the 'earnings link' was broken in 1980. Broadly speaking, the state pension fell substantially between 1980 and 2008 relative to the income of people in work, and has only recovered a small part of this lost ground in the last decade. A move back to price indexation could reverse this trend and increase the 'cliff edge' which people face when moving from living off a wage to living off a pension.



Source: House of Commons library

Opinions will, of course, vary as to what is the 'right' figure for the state pension as a percentage of the average wage. It is sometimes argued that the UK has one of the worst state pensions in the developed world and that it should be a much higher proportion of the average wage. We discuss this claim in more detail in the appendix, but it would be fair to say that the current level of the pension relative to average earnings is not especially generous. A long-term reversion to price indexation could therefore significantly reduce the effectiveness of the state pension in performing its fundamental role of providing a foundation for income in retirement, smoothing the transition from dependence on a wage to dependence on pension income.

f. Apply the triple lock over two years, not one

Most people would accept that we are living in exceptional times and that the triple lock policy was never designed with such times in mind. Whilst the principles of protecting the real living standards of pensioners, making sure pensioners do not fall behind the working age population and avoiding derisory increases are still appealing, many would accept some flexibility in how those principles should be implemented.

One way of keeping the principles of the triple lock (and the 'spirit' of the manifesto promise) could be to apply the rules over a two year period rather than one year.

Whilst it is very hard to predict what will happen to the economy over the coming years, it seems reasonable to think that, looked at over two years:

- Prices (CPI) will have gone up, but by less than 5%;
- Earnings will have gone down this year, up next year, but overall by less than 5%; (this is in line with the assumption of negative earnings growth this year followed by 5% increase as per the OBR's assumptions for the triple lock);

If these two assumptions are correct, then the triple lock would imply that over two years the increase should be 5% - two lots of 2.5%. The Chancellor could announce a 2.5% increase for April 2021, and then an indicative increase of 2.5% for April 2022, subject to the outturn of the price and earnings figures for the two years.

There are several attractions of this approach:

- The Chancellor can say that he has kept to the 'spirit' of the triple lock, but simply measured across a two year period to avoid year-to-year volatility;
- He would avoid a derisory increase in April 2021;
- He would avoid a surge in the state pension in April 2022;

One practical problem is that this new policy would require primary legislation. This is because the April 2022 increase would almost certainly be by less than the growth in average earnings. However, it may be possible to pass a short 'one clause' Bill which simply temporarily suspended the link to average earnings for the purposes of the 2022 uprating only.

g. Fundamental rethink – eg Australian approach?

One of the criticisms of the triple lock is that it can be rather arbitrary in its effects. The outcome of the formula depends on the year-to-year fluctuations in the rate of inflation and earnings growth, and the level of the pension relative to average earnings follows no particularly logical path. Arguably, a more rational approach would be for policy makers – and the electorate – to decide on the 'right' level of the state pension (perhaps expressed as a percentage of the average wage) and then to keep it there.

The problem with simply keeping the state pension at a set proportion (eg one third) of the average wage is that this would imply a policy of earnings indexation ever year, regardless of what was happening to prices. As we have seen in recent years, in some years prices can rise faster than wages. Rigidly stick to earnings indexation would leave pensioners suffering real terms cuts in their spending power in some years.

A more subtle approach, as applied in Australia, would be to target a set percentage of average earnings but to have an underpin which ensured pensioner living standards never fell. If inflation exceeded earnings growth, pensioners would enjoy an inflation-linked increase. This would temporarily increase the pension as a percentage of the average wage. But when earnings started to outstrip prices again, some of this increase would be clawed back until the pension was back at its target percentage.

One of the attractions of this approach is that it presupposes a sensible conversation about the role of the state pension and the optimal level relative to earnings. Such a conversation is all too rare in government and would be a real step forward for pension policy[10].

h. Abandon a formula based approach altogether

All of the problems we have identified so far stem from one fundamental problem – they link the pension in a formulaic way to certain indicators such as inflation and wage growth which can both behave in erratic ways. Being required by law or manifesto policy to increase the pension in a way that seems at odds with the wider economic context may not be seen to be a rational basis for policy making.

One response to this would be simply to abandon any uprating formula and have ad hoc, year-by-year decisions on pension levels.

[10] Of course there are features of the Australian state pension system which the UK might be less well advised to adopt, notably the fact that in Australia state pensions are means-tested.

From the point of view of a Chancellor, this may be a very attractive approach. The Chancellor can take a balanced judgment each year of the state of the economy and of the public finances and can decide the right level of pension increase without adherence to an arbitrary formula.

However, there are a number of reasons why this is less than ideal:

- Pensions are a long-term business and people need to be able to plan; although governments can and do change their policy, some indication of the likely future level of state pensions is helpful; if my future state pension depends on dozens of ad hoc individual decisions by successive Chancellors it becomes very difficult to plan for retirement or know how much private saving I need to do; obviously, any approach adopted now could be changed (yet) again in future years, but the complete absence of any rule or principle for upratings leaves savers completely subject to the whim of the Chancellor of the day;
- The issues about keeping pace with prices and keeping pace with the working age population do not go away just because they are not in a formula; the Chancellor will still no doubt have regard to these two variables in setting an annual increase but will be doing so in a rather opaque manner;
- A formula such as the triple lock has had the merit of taking the pension uprating decision out of the annual budget 'bun-fight'; this has given a measure of protection to the state pension at a time of austerity; given the very low level of the pension relative to average earnings in 2010, a 'lock-in' of meaningful increases via a formula has been important to ratchet up the state pension to a more meaningful level;
- As noted in the previous section, presumably the government ought to have a view as to the purpose of the state pension and the 'right' level, for example, relative to average earnings; having decided on a purpose and appropriate level, it seems odd to then revisit that decision every year as part of the Budget process.

In short, it is no surprise that Parliament has chosen to legislate for annual pension upratings for well over forty years, even though it has varied in its view as to what the correct process should be. It is hard to think that the right outcome is to abandon all attempt to be systematic in setting the state pension level and simply to 'think of a number' as a result of a rather opaque Budget process each year.

06 The options compared

As we saw in the previous section, the Chancellor has a wide range of choices as to the approach he takes to uprating the state pension for April 2021 and April 2022, after which it is assumed that key economic indicators such as inflation and earnings growth return to more 'normal' levels. In this section we summarise how the different approaches would compare.

To do this, we assume:

- CPI Inflation – 0.5% in the year to September 2020[11] and 2.0% in the year to September 2021 (Bank of England target);
- Earnings – Nil/negative in the year to July 2020 (assuming pension will not be cut, any earnings figure below zero can be rounded up to nil), and 5% in the year to July 2021 (OBR assumption for triple lock);

This gives the following results shown in the Table opposite.

By far the biggest saving to be made over the next two years would be to simply ensure that the state pension keeps pace with prices. This was the policy for most of the 30 year period from 1980 to 2010 and would make sure that the real spending power of pensioners did not fall. However, the politics would be very challenging. Based on a basic state pension of £134.25, a 0.5% increase in 2021 would be worth just 67p per week. Announcing such a small increase less than a year after promising a minimum increase of 2.5% (£3.35 per week) might be a step too far for the Chancellor.

The next biggest saving would come from a pure earnings link, which would almost certainly imply a pension freeze in April 2021, followed by a large increase in 2022. However, if a 67p increase was thought to be politically infeasible, it is hard to see that a pension freeze would work either.

Of the remaining options, the one which saves the most money and which avoids a derisory increase in 2021 would be the 'two year triple lock'. This approach would enable the Chancellor to say that he was keeping to the spirit of his manifesto promise, to deliver a pension increase in 2021 (and probably 2022) that was above inflation and still to save nearly £1.5 billion each year going forward compared with an unadjusted triple lock. This is likely to be a very attractive combination of options.

[11] CPI in year to July was 1.0%. Expected to fall in August 2020 as price rises from year earlier drop out, and modest downward impact of government stimulus measures such as VAT cut.

Table: Impact of alternatives to triple lock indexation in 2021 and 2022

	2021 increase	2022 increase	Total increase[12]	Annual saving in 2022/23 v triple lock
Triple Lock	**2.5%**	**5%**	**7.5%**	**-**
Lower Triple Lock (1.5% floor)	1.5%	5%	6.5%	£0.58bn
Double Lock (prices or earnings)	0.5%	5%	5.5%	£1.16bn
Pure earnings link	0%	5%	5%	£1.45bn
Pure prices link	0.5%	2%	2.5%	£2.9bn
Two year triple lock	2.5%	2.5%	5%	£1.45bn

[12] For simplicity we simply add together the two increases, though in practice they would be multiplied.

07 Conclusions

The state pension triple lock was designed for a mix of economic and political reasons. The link to prices prevents pensioners from facing a real cut in their standard of living, whilst the link to earnings makes sure that pensioners keep pace with the working age population. The 2.5% floor is designed to avoid embarrassingly small increases, such as the notorious 75p increase in April 2000. The effect of the triple lock has been to increase the state pension by more than £10 per week since 2010 compared with the previous policy of an inflation link.

However, the triple lock was not designed with the current extraordinary economic backdrop in mind. Simply 'turning the handle' on the formula could produce some perverse outcomes, especially when it comes to the 2022 uprating.

As we have seen, the Chancellor has a wide range of options and how he responds is in large measure a political as much as an economic decision. We can however make the following observations:

- It makes sense to consider the April 2021 and April 2022 upratings in the round; some 'solutions' for 2021 (such as applying an earnings link or a 'double lock') do little to solve the problem of a potential surge in the pension in April 2022;

- If the Chancellor wanted to preserve the 'spirit' of the triple lock whilst avoiding a surge in pension spending, he could reasonably apply the triple lock test to increases over the whole two year period;

- There is much to be said for some sort of 'formula' for increasing the state pension; it makes the process transparent and provides a degree of predictability which is useful for retirement planning; reverting to annual 'ad hoc' decisions would in many ways be the worst of all worlds;

- This may be the right time to step back and ask what is the 'right' level for the state pension, based on an open discussion of the relative role of state and private pension provision; this should also consider the contribution of the state pension to the retirement incomes of women relative to men, and the impact on different generations of alternative approaches to the state pension.

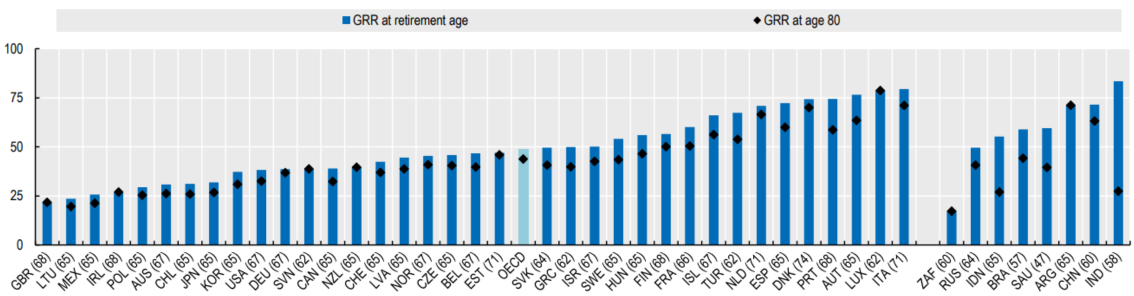
Appendix 1 - is the UK state pension 'one of the worst in the developed world' or 'unsustainably expensive' – or both?

In any debate on the level of the state pension it is common to hear two, apparently irreconcilable views expressed. The first is that the UK state pension is 'one of the lowest' in the developed world and therefore needs to be significantly increased. The other is that an ageing population over the coming decades will put great pressure on public spending and therefore increases in the state pension need to be constrained. Whilst these two statements are not logically incompatible, it is certainly hard to understand how a state pension system can be simultaneously inadequate and unaffordable. So in this short note we consider the basis for these two claims.

1. Is the UK state pension particularly low

Comparing the generosity of state pension systems between countries is fraught with challenges, but the OECD publishes a report which contains some comparative information. In its 'Pensions at a Glance' report, published in 2019, the OECD looks at a wide range of countries and compares state pension rates at retirement as a percentage of pre-retirement earnings, which is one way of measuring the 'generosity' of a state pension system. The striking results are shown in this chart:

Figure 5.1. **Gross pension replacement rates: Average earners at retirement age and age 80**



Source: OECD pension models.

The bar on the extreme left of the chart is for Great Britain and shows a replacement rate of a little under 22%, which is one of the lowest of all the countries covered. The OECD average figure is 49%, whilst the figure for Italy is 79.5%. On this basis, it would be hard to argue that the UK is not something of an outlier when it comes to the generosity of its state pension provision.

However, there are several reasons why this comparison only tells part of the story:

a. In terms of those coming up to retirement today, the standard rate of the 'new' state pension is £175.20, compared with the old 'basic' state pension of £134.25; although not everyone gets the new flat rate, a majority of new retirees do so, and by the end of this decade around 80% of new retirees will be on the flat rate; in terms of future policy it will make increasing sense to focus on the rate of the new state pension;

b. With regard to the UK system, automatic enrolment provides for a semi-mandatory additional pension for workers; although workers are free to opt out, and coverage is not 100%, around 90% of eligible UK workers stay in the pension scheme into which they are automatically enrolled, with a mandatory employer contribution; this is an important feature of the design of the UK pension system which needs to be factored in;

c. As far as living standards in retirement are concerned, what matters is total income rather than purely the state component; the UK has historically relied on a partnership between state and private provision, with occupational pensions being a major part of retirement income for many people; according to the House of Commons library note on international comparisons of pensions[13]

"A comparison of state pension alone shows the UK providing a lower level of pension than most other advanced economies relative to average earnings, however, the relative position of pensioners converges if income from all sources is considered" (p3)

In summary, whilst there is no question that the UK state pension is indeed one of the lowest of comparable countries, it is important to consider retirement provision as a whole. The fact that the UK state pension is low relative to average earnings does not mean that pensioners as a group are necessarily doing badly and need bigger state pension increases. Indeed, relative to the working age population, pensioners in the UK have been improving their relative position in recent years.

However, before becoming too complacent about the UK system as a whole there are two key caveats to this analysis:

- Big variations around the average – the analysis so far is based on the position of the average earner in retirement; but, as noted earlier, the pension position of different groups in retirement can vary considerably; for example, women tend to have lower incomes from state and private pensions than men and older pensioners tend to be poorer than younger pensioners; the state pension is a much more important contributor to the incomes of some groups than others and any decisions about the right level of state pensions needs to take account of this variation;
- Position of different generations – those currently coming up to retirement are often regarded as a 'golden' generation in the sense that they often complement their state pension with relatively generous occupational pension provision; but this is likely to change in coming years as the progressive closure of private sector defined benefit pension schemes starts to feed through into retirement incomes; the amounts going into newer, defined contribution, pension arrangements are generally much lower than the amounts which have been put into defined benefit pension schemes; as a result, today's younger workers are likely to have lower private pension income than their parents' generation, and may be more heavily dependent on the state pension; paradoxically, a tougher approach to state pension expenditure may not turn out to be in the long-term interests of today's younger generations, even though they may welcome the slightly lower tax burden which they would enjoy until they retired;

[13] See: https://commonslibrary.parliament.uk/research-briefings/sn00290/

2. Is the state pension expenditure sustainable in the long term?

One argument often advanced for scrapping the 'triple lock' is that the future cost of state pensions will be unaffordable, especially in the context of an ageing population.

Whilst there is no doubt that carrying on with the triple lock indefinitely will put a substantial upward pressure on public spending, there are two main reasons why the state pension is perhaps less important than might be imagined.

The first is that the biggest public expenditure impact of an ageing population comes from the rising costs of health and social care, and not from state pensions.

Although slightly dated, in 2013 the OBR published the following table showing how different areas of public expenditure (excluding spending on debt interest) were likely to grow over coming decades in light of an ageing population. The first two columns show the estimated outturn for each spending area as a share of national income, whilst the remaining columns provide a projection (in line with the Fiscal Sustainability Report) of spending levels into the future. **Crucially, note that this table was based on the assumption that the 'triple lock' would continue indefinitely.**

Table 3.6: Non-interest spending projections

	Per cent of GDP							
	Estimate[1]		FSR Projection					
	2012-13	2017-18	2020-21	2022-23	2032-33	2042-43	2052-53	2062-63
Health	8.1	7.0	6.9	7.0	7.6	8.2	8.5	8.8
Long-term care	1.2	1.3	1.4	1.5	1.8	2.1	2.3	2.4
Education	5.6	4.6	4.5	4.5	4.5	4.3	4.4	4.4
State pensions	6.0	5.8	5.7	5.8	6.6	7.5	7.6	8.4
Pensioner benefits	1.2	1.0	1.0	1.0	1.0	1.1	1.1	1.1
Public service pensions	2.2	2.3	2.2	2.2	1.9	1.6	1.4	1.3
Total age-related spending	**24.4**	**22.0**	**21.6**	**21.9**	**23.4**	**24.8**	**25.3**	**26.4**
Other social benefits	6.5	5.8	5.7	5.7	5.8	5.8	5.9	5.9
Other spending	9.6	8.8	8.7	8.4	8.4	8.4	8.4	8.4
Spending[2]	**40.5**	**36.7**	**36.1**	**36.1**	**37.6**	**39.0**	**39.6**	**40.6**

[1] Spending consistent with the March 2013 EFO.
[3] Excludes interest and dividends.

Source: OBR Fiscal Sustainability Report, 2013

The table shows that 'age-related' spending would account for 22% of national income in 2017/18 and this was forecast to rise to just over 23% by the early 2030s, nearly 25% by the early 2040s and just over 26% by the early 2060s.

A number of points emerge from this table:

- The overall increase between 2017-18 and 2062-63 is 4.4% of GDP; whilst this is clearly a large sum of money, we are talking about a period of nearly half a century, which suggests that we are unlikely to see large or sudden changes in tax levels to fund this increased spending;
- Of the overall increase, around two thirds (2.9 percentage points) is attributable to the rising costs of health and social care;
- Most of the rest is attributable to a rise in state pension expenditure net of a reduction in spending on (unfunded) public service pensions as a share of national income;

A second key point is that the level of the state pension is only one of two main determinants of state pension spending – the other is the age at which state pensions become payable. These OBR projections do not take account of the acceleration of state pension increases which is planned, with state pension ages of 69 or 70 on the cards for today's younger workers. A relatively generous (and generously indexed) state pension may be more sustainable if it is accompanied by an increase in the age at which it is payable.

CONCLUSIONS

As we have seen, the argument that the UK state pension is low by international standards is clearly true. However, it does not follow from this that it must be increased more rapidly. Assuming that total income amongst the pensioner population in the UK is broadly in line with that of comparable countries, this would not suggest a need for big pension increases, especially amongst those coming up to retirement today. However, if the contribution of private pensions were to decline – as it is expected to do – then a rebalancing towards state pension provision, underpinned by generous indexation, would be one policy option.

Conversely, the argument that an ageing population makes the triple lock simply unaffordable is also rather questionable. There is no doubt that the ageing of the population does present economic challenges, though these fall more in the area of spending on health and care than on pensions. And, if desired, future state pension expenditure can be controlled by further changes to state pension ages rather than purely by reining in annual increases.

Appendix 2 - The basic state pension and the new state pension

Until the pension reforms of April 2016, the state pension system had two main components – a 'basic' state pension payable to those with 30 years or more of NI contributions and an earnings-related element variously known as the State Second Pension (S2P) or SERPS. For those who reached pension age before 6th April 2016, all of the discussion in this paper relates purely to the basic state pension element of their overall state pension. Their S2P or SERPS pension is increased in line with inflation as defined by the CPI, although the rules are more complex for those who 'contracted out' of SERPS and are members of occupational pension schemes.

For those reaching State Pension Age since April 2016 there has been a single 'new state pension' which in effect combines both the basic pension and the earnings-related state pension. The triple lock policy has been applied to this full 'flat rate' figure. Because the flat rate figure is higher than the old 'basic rate', the triple lock policy is therefore somewhat more generous to the recently retired (who come under the new system).

Table A1 shows how two pensioners both on the same total pension can get a different increase depending on whether they come under the old or new system.

Table A1. Pension increase on old or new system, pensioner on £175.20 total pension

Type of pension	Amount	Uprating
New State Pension	**£175.20**	**All covered by triple lock**
Old State Pension		
- **Basic pension element**	**£134.25**	**Covered by triple lock**
- S2P element	£40.95	Uprated by CPI

In years when earnings rise by more than prices or when inflation is below the 2.5% triple lock floor, the pensioner on the new state pension will get a larger increase than the pensioner on the old system.

It is worth noting that for the poorest pensioners, the legal requirement is for the rate of the guarantee credit element of pension credit to be indexed by the growth in average earnings. If earnings growth is negative, pension credit rates could be frozen in April 2021, meaning that the poorest pensioners would get the smallest increases, unless the Chancellor chose to make a discretionary above-earnings increase for one year only.

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