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The long-term impact of the state pension 'triple lock'.

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Concerns about increasing costs and inter-generational unfairness have made the state pension 'triple lock' increasingly controversial. However, the popularity of the policy with voters (since it was introduced by the coalition government in 2010) means that political parties have been reluctant to advocate its abolition. In this Brief, the Sheffield Political Economy Research Institute explores the merit of the criticism the triple lock attracts by considering the policy's long-term impact on state pension outcomes; in short, the triple lock is assessed as a *pensions* policy, not simply a *pensioner* policy. The analysis places the triple lock within the context of the wider operation of the UK state pension system for different age groups, after comparing the UK state pension system with those of other developed countries. The Brief argues that the triple lock helps to nudge the value of the state pension towards the OECD average – albeit arguably far too slowly – and considers, finally, other policy options that might mean that the same goal can be achieved in a more fiscally sustainable manner.

Background

- Despite having a significantly higher proportion of people aged 65 or over than the OECD average (18.1 compared to 16.2 per cent), the UK spends significantly less overall on pensioner benefits, including state pensions, than the OECD average (5.6 compared to 7.9 per cent of GDP) (OECD, 2015).

- The value of the UK state pension is among the lowest in the developed world, contributing to a very low state pension 'replacement rate' compared to most similar countries.

- The replacement rate signifies the proportion of average earnings which different forms of pensions saving and pension-related benefits are equivalent to. In the UK, the net replacement rate for mandatory, state-provided pension schemes (taking into account lower tax rates on pension income than working-age earnings) is 29 per cent. This is among the lowest in the developed world (the OECD average is 63 per cent) (OECD, 2015).

- The introduction of the 'single-tier' state pension (STSP) compounds these circumstances by abolishing the state second pension (S2P). While the new state pension represents a much higher value than the 'basic' state pension (BSP) it partially replaces, it is set at a much lower level than many future pensioners can expect to have received in combined BSP and S2P awards, and is largely equivalent only to the means-tested minimum income guarantee (MIG) designed to ensure pensioners do not become impoverished.

- The 'triple lock' relates to the annual uprating of the STSP (for people reaching state pension age after April 2016) and BSP (for people reaching state pension age before April 2016), ensuring that pension awards rise by the higher of average earnings growth, the consumer price index (CPI; a measure of price inflation) or 2.5 per cent each year.

- Due to sluggish earnings growth and low inflation since the triple lock was introduced by the coalition government in 2010, the 2.5 per cent safety net has been called upon more frequently than expected (while working-age benefits have generally been frozen or uprated in line with CPI).

- 62 per cent of the electorate support the triple lock (while 16 per cent are opposed); indeed, the policy is popular among all age groups (YouGov, 2017). Accordingly, the Labour Party and Liberal Democrats have committed to retaining the triple lock for the duration of the next Parliament; at the time of writing, however, the Conservative Party has yet to match this commitment.

Criticisms of the triple lock

- Two main criticisms of the triple lock are aired fairly frequently. Firstly, many commentators argue that the policy is unaffordable. Secondly, some argue that, by privileging current pensioners, the policy is inter-generationally unfair. This argument is often made alongside a critique of the recent indexation arrangements, noted above, for working-age benefits.
- Both criticisms are unfair. In recent years, if the BSP had been uprated by only a 'double lock' of earnings growth or CPI, it would have cost around only £1 billion less per year (House of Commons Library, 2017).
- In 2015/16, for example, the triple-locked BSP cost £68 billion, while a double-locked BSP would have cost £67.1 billion. It is worth reiterating that, before 2016/17, the triple lock applied only to the BSP, which is set at a rate far below the MIG, that is, the poverty line.
- It is also worth noting that, despite the triple lock, state pension expenditure has somewhat remarkably risen by less than it would have had indexation by the retail price index (RPI; an alternative measure of price inflation) continued to operate – as it had done before 2010 (House of Commons Library, 2017).
- In 2015/16, for example, a BSP uprated by only RPI would have cost £68.8 billion, £800 million more than the BSP uprated by the higher of earnings growth, CPI or 2.5 per cent.
- In the long term, depending on future state pension age changes, state pension expenditure could rise from around 5.2 to 7 per cent of GDP (House of Commons Library, 2017).
- The notion that the triple lock is inter-generationally unfair overlooks the impact of the policy on the *de facto* state pension accrual rate for today's young people. The triple lock should be seen as a *pensions* policy, not simply a *pensioner* policy; it clearly affects current pensioners, but is also designed to modify the functioning of the UK pensions system more generally.
- As detailed below, the triple lock's greatest impact on the value of the state pension will be over the long term, and as such it generally benefits younger cohorts far more than current pensioners.
- This impact is particularly important given that today's young people face greater risks in saving for a pension privately due to the shift to individualised 'defined contribution' pensions. Indeed, a higher state pension acts as a saving incentive because it means that the funds being put 'at risk' in a private pension represent a lower proportion of expected retirement income being put at risk.

The long-term impact of the triple lock

- The most important way of assessing the significance of the 'triple lock' – and therefore assessing the validity of the various critiques – is to consider how it impacts state pension outcomes over time.
- It is clear that, in the short term, the triple lock is likely to be irrelevant. Annual earnings growth is expected to be above 2.5 per cent for the forecastable future.
- There will undoubtedly be periods in the decades ahead when annual earnings growth falls below 2.5 per cent. However, analysis by the Office for Budget Responsibility (OBR, 2017)[1] suggests that, over the long term, the triple lock adds an average of only 0.34 percentage points to the cost of uprating by earnings or inflation alone.
- Today, the full STSP rate represents only 31.4 per cent of average earnings; this proportion will be maintained in perpetuity if the rate is indexed against only earnings.
- While STSP and BSP rates are not comparable, we can compare STSP to the level of the means-tested MIG. In 2010, the MIG represented around 30 per cent of average earnings.
- Original analysis undertaken for this Brief (see the Annex for full details) finds that, even with the triple lock in place, it will be eleven years (2028) until the state pension level surpasses 32 per cent of average earnings, and twenty years (2037) before it surpasses 33 per cent.
- It will take eighteen years (2035) for the value of state pension (in relation to earnings) to increase by more than 1.4 percentage points, that is, the difference between the value of the 2010 MIG and the 2017 STSP rate.
- Despite the triple lock, an individual aged 30 today can expect to receive a state pension worth only 35 per cent of average earnings when they retire in 2055.
- Similarly, an individual aged 18 today, retiring in 50 years at the age of 68, can expect to receive a state pension worth only 36.4 per cent of average earnings.
- It is clear that, compared to uprating by earnings or inflation alone, while the triple lock increases the value of the state pension over time, it does so only modestly.

Analysis

- We should not exaggerate the extent to which today's pensioners have experienced a meaningful increase in state pension outcomes due to the triple lock, given that it applies only to the BSP for those retiring before 2016. As noted above, the BSP would have risen more quickly had pre-2010 indexation arrangements remained in place.
- Moreover, the triple lock has operated at a time of significant cuts to health and social care spending, upon which older people are more dependent.

- The most significant impact of the state pension triple lock has been on the balance within welfare spending between pensioner and working-age groups. The savings in working-age benefit expenditure since 2010 have been largely offset by increases in state pension expenditure (Berry, 2016a).
- However, we should not assume that there is any straightforward trade-off between pensioner and working-age benefit expenditure. Some commentators have been too quick to accept the logic of the austerity narrative in assuming that state pension increases have meant that working-age benefit cuts have been more severe as a result. Young people themselves consistently report that they believe public spending on older people should be protected (see Berry, 2016b).
- Since it will take almost 40 years for the full STSP rate to reach 35 per cent of average earnings, the long-term impact of the triple lock is relatively minimal. In fact, if the UK is to succeed in 'catching up' other developed nations in terms of state pension replacement rates in the foreseeable future, the 2.5 per cent 'lock' is arguably far too low.
- The impact of the triple lock is more significant when assessed in terms of aggregate expenditure, but this is largely because population ageing means the state pension caseload is increasing.

Policy options

- Increasing the state pension age is the most obvious way of managing the cost of the triple lock, and the implications of population ageing more generally – although inequalities in life expectancy must be taken into account in this regard.
- The increasing costs could also be alleviated by lowering the 2.5 per cent lock to, say, 2 per cent. The triple lock mechanism would therefore operate much less frequently. This may be especially appropriate if we were to assume (reasonably, perhaps) that earnings growth may continue to be more sluggish than forecast by the OBR.
- However, a lower lock would mean that indexation arrangements would probably be much less effective in compensating today's young people for the long-term impact of STSP, that is, the loss of S2P awards.
- Such a move would impact particularly negatively on young people who are less likely to be saving privately for a pension due to being self-employed. Moreover, a higher state pension incentivises private saving.
- An alternative option would be to increase directly the state pension accrual rate, that is, the level of state pension entitlement being accrued for each year of National Insurance contributions. At the moment, indexation arrangements for state pensions in payment act as a *de facto* accrual mechanism in a nominal 'pay-as-you-go' system (meaning that the government of the day determines retrospectively the value of entitlements when deciding how to uprate the state pension).

- Crucially, accrual rates could be more generous for younger people, meaning that the value of the state pension would effectively rise significantly over time, but current expenditure would ostensibly be unaffected by current economic circumstances.
- However, communicating this system, and its implications, would be difficult, especially for young people with very limited pensions knowledge.
- The abandonment of the pay-as-you-go funding model would also require the government to shoulder greater fiscal risks, since it would have less flexibility to alter decisions made by previous administrations should unforeseen circumstances arise.
- The essential problem with the triple lock is perhaps that it only operates when earnings growth is sluggish, when the economy is likely to be experiencing a downturn (noting also the impact of downturns on tax revenues). A far more sustainable approach to increasing the state pension would be to develop a mechanism for over-indexing payments during periods of high or normal earnings growth.
- This mechanism (or, indeed, any mechanism) could be abolished once the UK state pension has reached a level comparable to other developed countries.

Annex

The value of the state pension 2017-2068 under earnings and 'triple lock' indexation (£)

	Average weekly earnings (AWE)	State pension value: earnings indexation[4]	% AWE	State pension value: triple lock indexation[3,4]	% AWE
2017/18	509[(2)]	159.55	31.35	159.55	31.35
2018/19	523	163.90	31.35	163.85	31.35
2019/20	538	168.80	31.35	168.80	31.35
2020/21	557	174.50	31.35	174.50	31.35
2021/22	577	180.80	31.35	180.80	31.35
2022/23	600	188.05	31.35	188.65	31.45
2023/24	624	195.55	31.35	196.85	31.55
2024/25	649	203.35	31.35	205.35	31.65
2025/26	675	211.50	31.35	214.30	31.76
2026/27	704	220.60	31.35	224.25	31.86
2027/28	734	230.10	31.35	234.65	31.97
2028/29	766	240.00	31.35	245.50	32.07
2029/30	799	250.30	31.35	256.90	32.17
2030/31	833	261.05	31.35	268.85	32.28
2031/32	869	272.30	31.35	281.30	32.38
2032/33	906	284.00	31.35	294.35	32.49
2033/34	945	296.20	31.35	308.00	32.60
2034/35	986	308.95	31.35	322.30	32.70
2035/36	1028	322.25	31.35	337.25	32.81
2036/37	1072	336.10	31.35	352.90	32.92
2037/38	1118	350.55	31.35	369.30	33.02
2038/39	1166	365.60	31.35	386.40	33.13
2039/40	1217	381.35	31.35	404.35	33.24
2040/41	1269	397.70	31.35	423.10	33.35
2041/42	1323	414.85	31.35	442.75	33.46
2042/43	1380	432.65	31.35	463.30	33.56
2043/44	1440	451.25	31.35	484.80	33.67
2044/45	1502	470.65	31.35	507.30	33.78
2045/46	1566	490.90	31.35	530.80	33.89
2046/47	1633	512.00	31.35	555.45	34.00
2047/48	1704	534.05	31.35	581.20	34.11
2048/49	1777	557.00	31.35	608.20	34.23
2049/50	1853	580.95	31.35	636.40	34.34
2050/51	1933	605.95	31.35	665.95	34.45
2051/52	2016	632.00	31.35	696.85	34.56
2052/53	2103	659.15	31.35	729.15	34.67
2053/54	2193	687.50	31.35	763.00	34.79
2054/54	2288	717.05	31.35	798.40	34.90
2055/56	2386	747.90	31.35	835.45	35.01
2056/57	2489	780.05	31.35	874.20	35.13
2057/58	2596	813.60	31.35	914.80	35.24
2058/59	2707	848.58	31.35	957.20	35.36
2059/60	2824	885.10	31.35	1001.65	35.47
2060/61	2945	923.15	31.35	1048.10	35.59
2061/62	3072	962.85	31.35	1096.75	35.71
2062/63	3204	1004.25	31.35	1147.65	35.82
2063/64	3342	1047.40	31.35	1200.90	35.94
2064/65	3485	1092.45	31.35	1256.60	36.06
2065/66	3635	1139.45	31.35	1314.90	36.17
2066/67	3791	1188.45	31.35	1375.95	36.29
2067/68	3954	1239.55	31.35	1439.75	36.41

Notes

1. The OBR analysis considered how much the state pension would have increased between 1991 and 2021 (the end of its short-term forecast period, as of January 2017) had the triple lock been in place, compared to earnings indexation (of course, earnings indexation was itself not in place for the vast majority of this period).

2. The average weekly earnings figure for 2017/18 is from the Office for National Statistics' Labour Market Survey; it refers to average weekly earnings in the referent period for state pension uprating, i.e. September 2016. The figure has been uprated in line with OBR forecasts: 2.7 per cent, 3 per cent, 3.4 per cent and 3.6 per cent, respectively, for the period 2018/19 to 2021/22, and 4.3 per cent for 2026/27 onwards. The OBR has not published a forecast for the years falling between its short- and long-term forecasts; as such, the analysis assumes that the mid-point between its latest short-term forecast and the long-term forecast applies.

3. In the absence of an official earnings growth forecast for the period 2022/23 to 2025/26, the analysis applies the long-term triple lock supplement of 0.34 percentage points to this period as well as the period from 2026/27 onwards. In practice, this supplement is unlikely to take effect during the earlier period; the Brief therefore probably over-estimates the long-term impact of the triple lock (albeit negligibly).

4. State pension values have been rounded to the nearest 5 pence.

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