PENSIONS POLICY INSTITUTE

PPI

The impact of a switch from the triple lock to uprating by earnings

The impact of the Government's single-tier state pension reform is a research project funded by the Nuffield Foundation

The PPI will publish a series of briefings in the coming months to provide a detailed, comprehensive and independent analysis of the impact of introducing the single-tier state pension.

The first briefing (June 2013) described the main components of the Government's state pension reform plans and an initial analysis of the possible impact of the reforms on individuals. The second briefing (October 2013) considered the management of the transition between the current system and the single-tier pension. Remaining analysis will cover issues such as:

- The impact on Defined Benefit pension schemes of the ending of contracting-out.
- The impact on future government spending, including the impact of ending contracting-out and trade-offs between the levels of the single-tier pension and how it is increased over time.

For more information, please contact the PPI.

This briefing presents the potential impact on the single-tier pension of a switch in the pension increase mechanism at the end of the current parliament from triple locking the pension to applying earnings linked increases.

Introduction

The triple lock is the mechanism currently used by the government for uprating the Basic State Pension (BSP). Under the triple lock, the BSP is increased each April by the higher of the growth in average earnings, the Consumer Price Index (CPI), or 2.5%. The triple lock was introduced by the Coalition Government in 2011 and is guaranteed until the end of the current parliament (which is likely to be May 2015). This briefing considers the impact on the single-tier pension of replacing the triple lock with a link to the growth in average earnings.

The current triple lock is only guaranteed until the end of the current parliament. After this date, the law will require the single-tier pension to be uprated annually in line with earnings. This briefing looks to assess the impact of this switch from the triple lock to a link to the growth in average earnings.

The triple lock

From 1979 until April 2011 the legal requirement for uprating Basic State Pension (BSP) was in line with growth in the Retail Prices Index (RPI). The RPI tended to increase at a lower rate than increases in earnings. While, in practice, there were years where the increase to BSP was in excess of growth in RPI, the BSP was falling as a percentage of average earnings during this period.

In order to halt this fall, the Labour Government introduced legislation that provides that the increase in the basic state pension must be at least at the rate of the increase in average earnings. The Coalition Government brought forward the date of the commencement of the re-establishment of the earnings link and set out the triple lock in the 2010 Emergency Budget.

The triple lock provides an uplift rate that is comprised of whichever is the greater of the CPI, the growth in average earnings or 2.5%. In order to project the impact of any change in the way that the state pension is uprated it is necessary to make assumptions about future earnings growth and inflation (measured by the CPI).

Current assumptions about future rates of CPI and earnings growth suggest that, overall, projected earnings growth is greater than 2.5%, which is in turn greater than the expected future level of CPI. But this does not mean that the assumed growth in the triple lock should be the same as the projected levels of earnings growth. While in most years we might expect earnings growth to be the greater of the three components of the triple lock, this will not be the case every year. For example the basic state pension was uprated by CPI in April 2012 because CPI was greater than 2.5% and higher than earnings growth, and for the April 2013 increase it was the 2.5% floor that bit when both CPI and earnings growth were below 2.5%. The assumed level of the triple lock should therefore be slightly higher than the projected earnings growth assumption to allow for the years where earnings growth is not the higher of the three components.

The triple lock is assumed in the PPI assumptions to be on average around 0.26% a year more than earnings. This is the current standard PPI assumption in line with the previous notes in this series and the assumption made by the Office for Budget Responsibility in their Economic and Fiscal Outlook report prepared for Budget 2013.[1]

The impact of switching from the triple lock to earnings growth

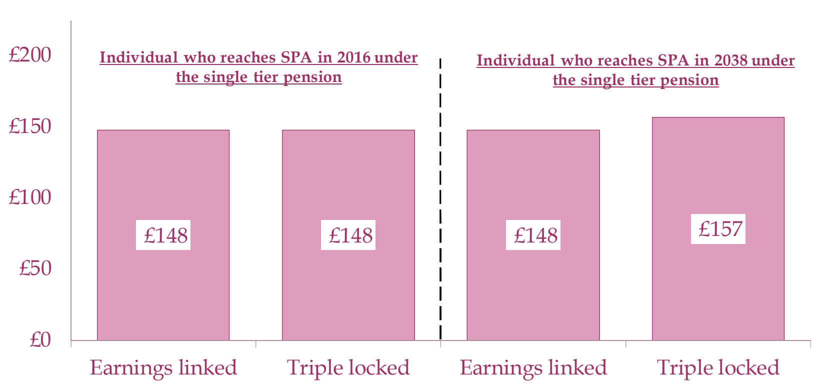
The triple lock has extra protection, compared to a link to earnings growth, in the form of the CPI and 2.5% underpin. This means that if the triple lock were to be removed at the end of the current parliament in 2015, then the future value of the single-tier may be reduced.[2]

Chart 1 sets out the initial rate of the single-tier pension to two people, the first reaching SPA in 2016 and the second reaching SPA in 2038. The results are presented under the earnings linked approach, as in legislation, and under a triple locked approach as under current practice.

For the person reaching SPA in 2016 the initial single -tier pension would be £148 in 2013 earnings terms whether pension increases are earnings linked or triple locked. This is because the assumed difference between the triple lock and earnings is small in a single given year. However, over a period of time the difference grows and is compounded.

Chart 1: An earnings linked single-tier pension may result in a lower pension than a triple locked pension

Comparison of the outcome of the state single -ier pension entitlement of an individual reaching SPA in 2038 if the pension is triple locked from 2015 compared to an earnings linked single-tier pension (£ per week, 2013 earnings terms)



For the person reaching SPA in 2038 under the triple lock, the pension would be around £157 a week, (in 2013 earnings terms) compared to £148 a week if the triple lock were to be replaced with an earnings link from 2015. This is a reduction in the state pension of around 5%.

Pension growth operates throughout retirement

The initial rate of pension does not tell the whole story. The state pension is payable until the death of the pensioner. It is uprated each year during the time in payment, so if the triple locked pension is subject to increases above the level of earnings increases during the time it is in payment, it would become progressively more valuable to the pensioner than the earnings linked pension.

Chart 2: A triple locked Single Tier pension may result in a higher pension than an earnings linked pension

Comparison of the outcome of the state single tier pension entitlement of an individual reaching SPA in 2016 if the pension is triple locked from 2015 compared to an earnings linked single tier pension (£ per week, 2013 earnings terms)

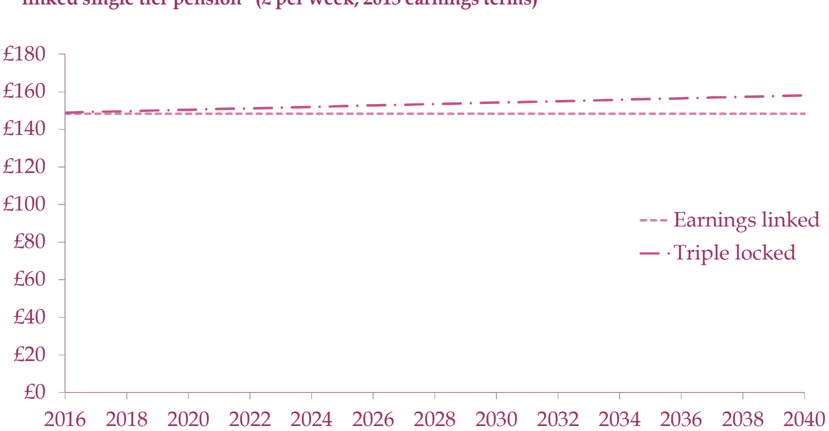


Chart 2 sets out the single-tier pension that a pensioner, reaching SPA in 2016 may receive throughout their retirement in 2013 earnings terms. The earnings linked single-tier pension is a constant £148 a week in current earnings terms. It is important to note that it is not losing value in earnings terms and is likely to be outpacing the rise in consumer prices. The triple locked pension increases faster than earnings, reaching around £158 a week in 2040 (expressed in 2013 earnings terms). That is around 7% higher than the earnings linked single-tier pension might be at that time.

The impact of a switch from the triple lock to uprating by earnings

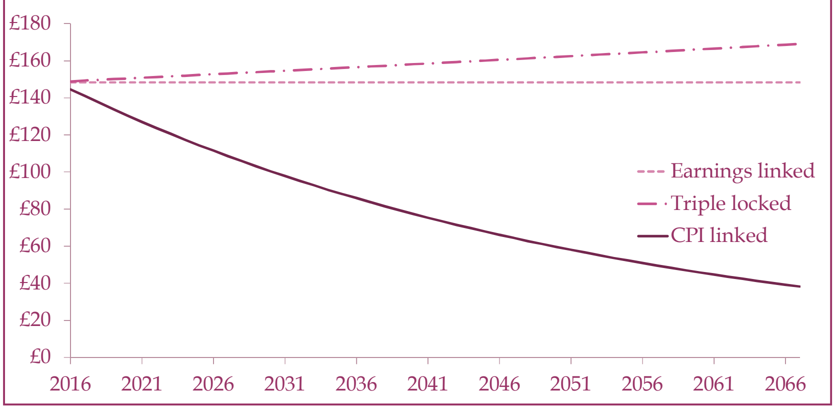
Earnings growth v triple lock in the longer term

The impact of the switch from the triple lock to earnings linked increases depends upon the duration it is in force. Historical data suggest that the earnings growth rate is likely to be the largest component of the triple lock, and therefore the triple lock growth might be the same as earnings growth. However, over the longer term there are likely to be instances when earnings growth is exceeded by either CPI or 2.5%.

Chart 3 sets out the level of the full single-tier pension from 2016 to 2066 in 2013 earnings terms. The earnings linked single-tier pension remains at a constant £148 a week in current earnings terms.

Chart 3: A Prices linked Single Tier pension is less valuable than an earnings linked or triple locked pension

Comparison of the level of the state single tier pension under earnings linking, triple locking and CPI linking (£ per week, 2013 earnings terms)



The triple locked single-tier pension reaches around £158 a week in 2040 (expressed in 2013 earnings terms). The level of the triple locked single-tier pension in 2065, could be around £168 a week (in 2013 earnings terms). This is around 14% higher than the earnings linked pension.

How earnings and triple lock increases compare with price inflation

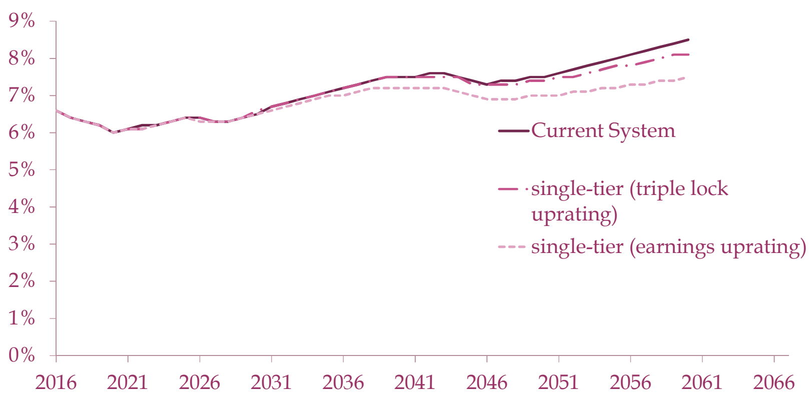
From 1979 until the introduction of the triple lock in 2011, the growth in the state pension was linked to the growth in prices. The current measure for price inflation for the indexation of benefits is the Consumer Price Index (CPI). In contrast, the current legislation requires the state pension to be increased by at least the growth in average earnings. For comparison purposes, Chart 3 also sets out the projected value of the single-tier pension in current earnings terms if it were linked to the CPI from 2015. The chart shows how much more valuable earnings growth and the triple lock are compared to CPI.

A CPI linked single-tier pension might be expected to fall in current earnings terms, being worth half of a triple locked single-tier pension by 2040, and around 25% of a triple locked single-tier pension by 2065.

Chart 4: Triple locked single tier pension is largely cost neutral

Pensioner benefit expenditure as a proportion of GDP under different uprating assumptions for the single-tier pension

Figures provided by the Department of Work and Pensions



How much does the triple lock cost?

Chart 4 sets out the cost of pensioner benefit expenditure as a proportion of GDP. These figures were published by the Department for Work and Pensions in the single-tier impact assessment. The chart shows that under a triple locked Single Tier pension, spending on pensioner benefits is largely cost neutral until around 2040 at which point the projected spending on the triple locked single-tier falls in comparison with the current system. By 2060 there is a projected reduction in the expenditure from 8.5% of GDP to around 8.1% of GDP.

The impact of a switch from the triple lock to uprating by earnings

The primary reason for the cost saving is that while the single-tier pension is more generous to low earners, it provides an income of less than might otherwise be built up by some earners through the State Second Pension on top of the Basic State Pension.

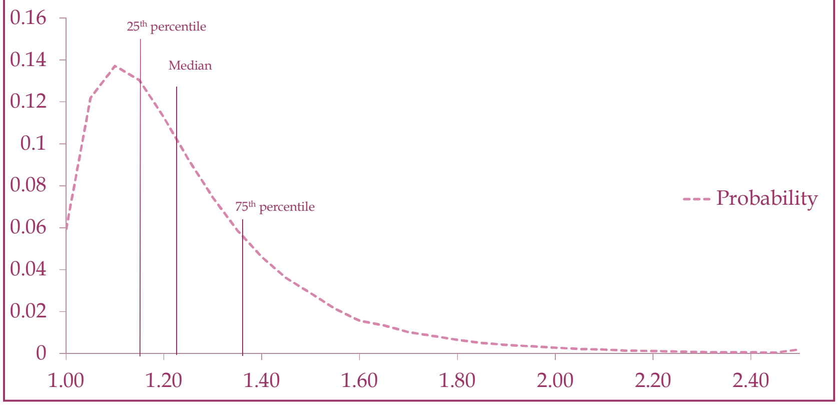
Removing the triple lock on the single-tier and instead linking pension increases to the rate of average earnings growth reduces the cost further, to around 7.5% of GDP in 2060 according to DWP projections.

Variability of the Triple Lock

Research carried out by the PPI has suggested that, following Auto Enrolment, it may be easier for people to obtain an adequate income in retirement if there is a triple locked single-tier pension rather than an earnings linked pension.

Chart 5: A triple locked single-tier pension may result in a higher pension than an earnings linked pension

Probability density of the difference between an earnings linked and triple locked single-tier pension by 2060. Expressed in terms of the triple locked pension as a multiple of the earnings linked pension.



The triple lock is dependent on the relative level of earnings growth, consumer price inflation and the flat rate of 2.5%. Chart 5 sets out the distribution of the difference between the triple locked and earnings linked single-tier pension by 2060. The area under the line is the probability that the triple locked single-tier pension is that much higher than the earnings linked pension would be by 2060. Due to the way the triple lock operates, the triple locked pension is always at least as high as the earnings linked pension.[3]

In three-quarters of the 100,000 simulations undertaken for the research, by 2060 the triple locked pension was at least 13% higher than an earnings linked pension. In half of the simulations, the triple locked pension was at least 22% higher than an earnings linked pension, and in one-quarter on simulations the triple locked pension was more than 37% higher than the earnings linked pension. The simulated median annual difference between the growth of an earnings linked pension and a triple locked pension is around 0.4%.

Conclusion

Significant savings are likely to be made in the future as a result of switching from the current state pension system to the single tier pension. The triple lock is more expensive than earnings indexation, but it has a large impact on the level of the single-tier state pension that individuals will receive in the future, and makes it more likely that individuals will achieve an adequate retirement income.

1. The OBR have since revised their triple lock assumption to be 0.3% above earnings growth, however for consistency with earlier notes in this series a triple-lock assumption of 0.26% over earnings has been maintained in this paper.

2. The following assumptions were made in the deterministic modelling underlying charts 1, 2, 3 and 4: Earnings growth 4.7%; CPI 2.0%; Triple lock 4.96%.

3. The modelling underlying this analysis was undertaken in collaboration with Kings College for the PPI report *What level of pension contribution is needed to obtain an adequate retirement income.* The analysis in that report found that under the triple lock the median earner has a 49% chance of achieving an adequate income, but with earnings indexation this falls to 30%

For more information on this topic, please contact
John Adams
020 7848 3675
www.pensionspolicyinstitute.org.uk

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This analysis has been funded by a grant from the Nuffield Foundation, an endowed charitable trust that aims to improve social well-being in the widest sense. It funds research and innovation in education and social policy and also works to build capacity in education, science and social science research. The Nuffield Foundation has funded this project, but the views expressed are those of the authors and not necessarily those of the Foundation. More information is available at www.nuffieldfoundation.org.