PPI Briefing Note Number 123

What does COVID-19 mean for the triple lock and State Pension inflation?

PPI Briefing Notes clarify topical issues in pensions policy.

Introduction

COVID-19 has increased Government expenditure while also significantly reducing price and earnings inflation in 2020. The Government may be considering changing the triple lock State Pension inflation mechanism to a double lock as a way of helping reduce government expenditure. However, potential spikes in earnings inflation in 2021 could mean that both a double and a triple lock would significantly increase the cost of the State Pension next year.
This Briefing Note explores the potential impact on the Government and on pensioners of moving from a triple lock to a double lock. The Note also explores the impact of a potential short-term smoothing mechanism which would reduce the level paid out on State Pensions in 2021 and help ensure that any spikes in inflation following economic recovery do not result in a dramatic increase in the State Pensions Bill.

Summary of conclusions:

- Dropping the triple lock in favour of a double lock will not necessarily save money on State Pension costs in the short-term.

- A smoothing mechanism could ensure the cost of State Pensions does not rise significantly in 2021, saving up to 0.6% of GDP (around £15bn).

- A smoothing mechanism may require changes to legislation, or to the definition of earnings.

- The Government would need to weigh up the potential political consequences of breaking a manifesto promise, to drop the triple lock, with the potential savings.

- Changing the State Pension inflation mechanism would mean that pensioner incomes do not increase as quickly. Under a triple lock, average pensioner incomes could reach up 31% of national average earnings by 2040, compared to up to 30% under a double lock and up to 29% under smoothing for one year, followed by the triple lock.

- The future cost of the State Pension is uncertain as changes in the economy and health trends are unpredictable.

There have been recent discussions regarding re-moving the triple lock to help fund the COVID-19 Bill

Since the election, the economy has undergone significant upheaval as the result of the COVID-19 pandemic which began to significantly affect the UK from March 2020. The pandemic has both reduced tax intake, due to increases in unemployment and furloughing, and resulted in an increase in Government spending on the NHS and care, grants, loans and tax reductions for businesses and individuals. The Office for Budget Responsibility (OBR) estimates that in 2020/2021 the UK will have spent £192bn on COVID-19 related spending and tax reductions, bringing the UK budget deficit to £322bn (16% of GDP) during 2020/2021.[1]
In May 2020, there were reports that HM Treasury was considering moving from the triple lock State Pension inflation measure to a double lock, which would in-crease the level of the State Pension by the higher of prices (CPI) or earnings, as a way of reducing the im-pact on the budget arising from the pandemic.[2]
While changing the inflation mechanism will reduce Gov-ernment spending in the short and long-term, it will also slow down the increase in pensioner income relative to earnings, resulting in future pensioners experiencing low-er standards of living than they would have if the triple lock were maintained. The potential for a significant in-crease in earnings inflation in 2021, could also mean that a move to a double lock would not result in a reduction in the State Pensions Bill.

This Note:

- Sets out the history of State Pension inflation.

- Outlines uncertainties around State Pension costs.

- Sets out how the triple lock, double lock and a smoothing mechanism work.

- Explores the potential impact of changing inflation mechanisms on the cost of the State Pension and on pensioners.