

Updating uprating: towards a fairer system

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Reform

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Executive summary

Each year, the Government increases – or ‘uprates’ – the value of social-security benefits. Fairness and sustainability have been at the forefront of policy in recent years, but the simplicity of these objectives obscures the trade-offs they entail. Welfare policy needs to protect the most vulnerable in society, while avoiding dependency. It must be fair to those in receipt of benefits, as well as those paying for them. Getting uprating policy right is an important part of satisfying the competing demands of a social-security system.

Historically, these goals have been pursued by uprating benefits in line with a measurement of price inflation: until 2010, this was Rossi, New Rossi or the Retail Price Index (RPI). Lately, however, Governments have upended this settlement. Against the backdrop of a significant budget deficit, the Coalition and then Conservative Government capped and then froze growth in the value of many working-age benefits. It was argued that at a time when inflation was outstripping wage growth this was a fair contribution to fiscal consolidation. This was a short-term measure, underpinned by a wholesale switch to the Consumer Price Index (CPI) as the default measurement of inflation. This, it was argued, was to more accurately reflect claimants’ experience of price changes. It cannot be overlooked that CPI typically returns a lower inflation reading than RPI. At the same time, since 2011, the State Pension has been uprated by the ‘triple lock’ – the highest of CPI inflation, average earnings or 2.5 per cent. The Government argues this policy protects pensioners’ standard of living, thereby rewarding them for a lifetime of labour.

This report evaluates the current approach to uprating policy and argues that these policies fail to achieve the central aims of sustainability and fairness. Improving economic conditions (with wages growth soon to return to pre-crisis levels) now render the freeze on working-age benefits superfluous. Rolling back this iniquitous measure should be a priority. But there is also a long-term issue. The use of CPI – a macroeconomic price indicator that persistently understates the price experiences of beneficiaries – to uprate benefits erodes the purchasing power of some of the poorest in society. The Government should therefore develop a new ‘Benefit Uprating Index’ (BUI), and use this measure to uprate the majority of working-age benefits as soon as this index has been quality assured.

These measures would, of course, come at a price. Uprating tax credits, Jobseeker’s Allowance, Employment Support Allowance, Disability Living Allowance, and Personal Independence Payments by BUI would cost HM Treasury an estimated £13 billion over the next five years. A considerable proportion of this expenditure, however, is derived from reversing the freeze. Indeed, if these payments were already CPI-linked, the additional cost would be £3 billion over five years.

Savings to fund this expenditure could be found by curtailing the future cost of the State Pension. As our population ages, expenditure on the State Pension as a proportion of GDP will inevitably grow. Yet by ensuring the State Pension grows faster than wages, the triple lock will increase government debt by 26 per cent of GDP over the next 50 years. The Government is right to want to both maintain an earnings link and protect pensioners against inflation. However these policy objectives could be achieved at less expense. The triple lock should be replaced with a relative earnings link, which pegs the State Pension to a proportion of wages in the medium term. By returning the State Pension to the proportion of earnings when the triple lock was first introduced, the Treasury could save £20.9 billion over the next five years.

This report argues that these policies should all be implemented together. If the Government does this, it is likely to make considerable savings. Over the course of the next five years, these policies would save a total £7.9 billion relative to the freeze, or £17.9 billion relative to a CPI-link. Not only are these considerable savings possible, but they represent the best way for the Government to meet the competing aims of uprating

policy. To ensure fairness and sustainability, the Government should implement these reforms as a matter of priority.

Recommendations

Recommendation 1: The Government should develop a new index, the Benefit Uprating Index, and use it to uprate income-replacement and income-supplement benefits.

Recommendation 2: The UK Statistics Authority and Office for National Statistics should investigate the degree to which there is variation between the price experiences of different beneficiary groups. If the variation is significant and the cost of implementation not prohibitive, consideration should be given to using sub-indices within the BUI.

Recommendation 3: All extra-cost benefits except Local Housing Allowance should be uprated by the Benefit Uprating Index. As part of its investigation into sub-indices, the UK Statistics Authority and Office for National Statistics should explore whether households with children, those with disabilities, or those in need of care experience price changes in a significantly different fashion as to warrant the introduction of sub-indices for these groups.

Recommendation 4: The Government should replace the triple lock with a relative earnings link, a mechanism that pegs the value of the State Pension to wage growth in the medium term but also protects pensioners from high inflation during periods of economic volatility.

Introduction

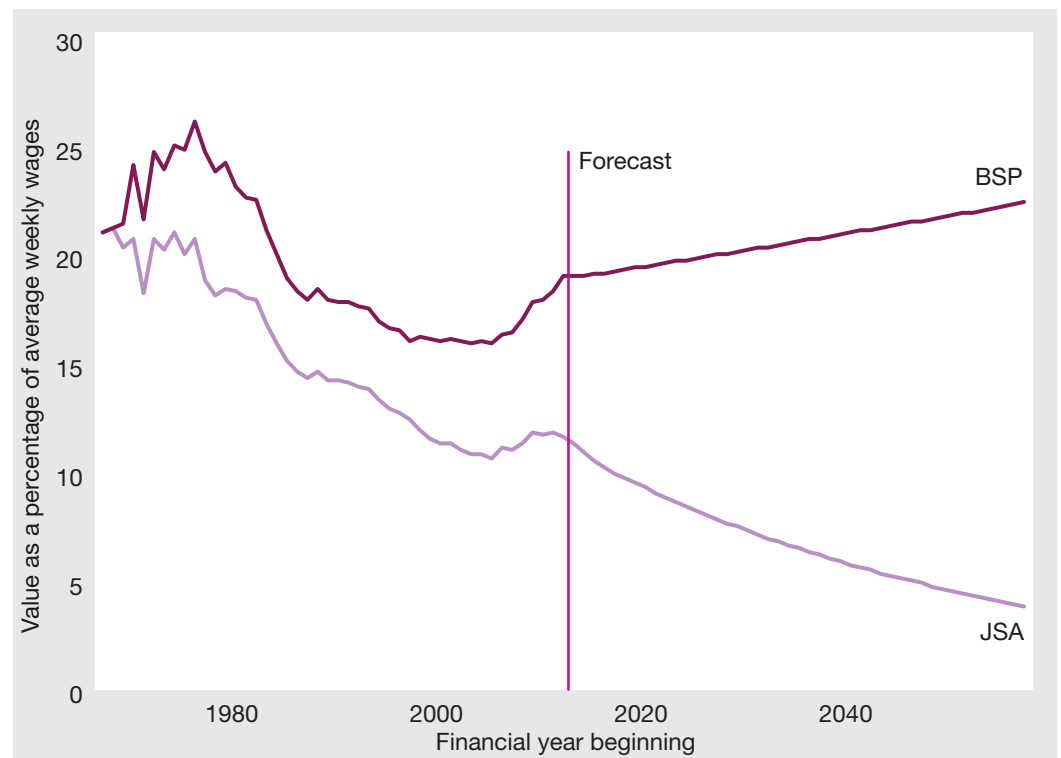
At its most basic level, the welfare state secures a minimum standard of living for UK citizens. It offers financial assistance to the unemployed, an income stream for those unable to work altogether and compensation for those with injuries or disabilities. It encourages labour-market participation, and helps individuals save for their retirement. At the same time, the welfare state must be fiscally sustainable, and fair to those not in receipt of transfers.

This collection of objectives and constraints creates trade-offs. The desire to alleviate out-of-work poverty, for example, can conflict with objectives relating to labour-market participation; increasing the value of transfers to pensioners may come at the expense of fiscal sustainability. There are no easy answers to these problems. Indeed, it may be the case that these conflicts are irreconcilable. Policymakers must therefore be clear about their priorities, and adjust the parameters of social-security payments accordingly: the conditionality, eligibility criteria or generosity of benefits.

A crucial, but often overlooked, lever is how the value of benefits is ‘uprated’ – that is, how they are adjusted in nominal terms each year to reflect changing economic circumstances, such as inflation, earnings growth or fluctuations in the cost of living.

As an example, in the 1970s, Jobseeker’s Allowance (JSA) and the Basic State Pension (BSP) were administered at the same level. Successive uprating decisions, however, have seen the value of these benefits diverge over time. If current practice is maintained, by the 2040s the BSP will be four times more generous than JSA and its successor component within Universal Credit (UC).

Figure 1: Long-run trajectory of JSA and BSP on current uprating mechanisms¹



Sources: Department for Work and Pensions, “Abstract of statistics 2014”, April 2015; Office for Budget Responsibility, *Fiscal Sustainability Report: July 2015*, 2015.

¹ Calculation based on ASHE wage data.

In the last five years a string of reforms have been announced to uprating policy, including the introduction of the 'triple lock' on the State Pension, the short-term cap and freeze on increases in the value of many working-age benefits and the transition to uprating the majority of benefits by the Consumer Price Index (CPI) once the freeze is reversed. At a time of fiscal consolidation, these decisions have reflected the Coalition and Conservative Governments' desire to protect the most vulnerable, create a more sustainable welfare system and uprate benefits in a way that best reflects the price experiences of beneficiaries.

Yet the priorities underpinning recent reforms are in tension with a number of elements of existing policy. The triple lock on the State Pension will, according to Chairman of the Office for Budget Responsibility (OBR) Robert Chote, drive the country back into deficit in the medium term.² CPI underreports the price experiences of beneficiaries because it was never designed to fulfill such a function.³ A four-year freeze on the value of many benefits will unjustly erode the purchasing power of beneficiaries in real terms. The emphasis placed on the priorities of sustainability and fairness means the Government should consider the case for reform carefully. This report recommends a new model for uprating, one that is better suited to delivering a fair and sustainable social-security system.

² Ben Riley-Smith, 'George Osborne's Pensions Triple Lock "Will Help Drive Britain into Deficit"', 11 June 2015, <http://www.telegraph.co.uk/news/politics/conservative/11669052/George-Osbornes-pensions-triple-lock-will-help-drive-Britain-into-deficit.html>.

³ John Astin and Jill Leyland, 'Towards a Household Inflation Index: Compiling a Consumer Price Index with Public Credibility', 14 May 2015.

1

A history of uprating

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1.1 Uprating mechanisms

Social-security payments in the UK are generally pegged to inflation indices – measures that track changes in the general price level of goods and services. While the concept of inflation is widely understood, the complexities in measuring it are considerable (see Figure 2). Inflation indices differ from each other in terms of ‘coverage’ (which goods and services are measured for price changes) and ‘weighting’ (how individual price fluctuations are aggregated into a headline figure).

Figure 2: Inflation metrics used for uprating explained

RPI (1956):

- Calculates price changes of a basket of hundreds of goods, which is altered each year to represent changes in purchasing patterns.
- Includes housing costs such as mortgage-interest payments and Council Tax. Excludes highest earners, foreign visitors, non-profit institutions that serve households (such as nursing homes) and pensioner households from calculation.
- Lost national statistic status in 2013 due to concerns about the Carli formula underpinning the measurement.

Rossi (1983):

- Uses the RPI basket of goods, minus housing costs (mortgage-interest payments, dwelling insurance and ground rent, local taxes, water charges, repairs and maintenance and DIY materials for repairs and decorations).

New Rossi (1992):

- A reformulation of Rossi, using the RPI basket of goods, less rent, local taxes and mortgage-interest payments.

CPI (1996):

- Macroeconomic measurement introduced in the wake of the Maastricht Treaty and used for inflation targeting.
- Excludes housing costs (Council Tax, buildings insurance and house purchase costs) and mortgage interest payments, but includes rent prices.
- Uses a ‘geometric’ average of prices sampled, reflecting the fact that when prices rise, some people will switch to lower-priced alternatives.

RPIJ (2013):

- Variant of RPI that resolves the ‘formula effect’ by using a Jevons formula.

These difficulties explain both recent interest in inflation indices as well as the array of measures policymakers can, and have, used to uprate benefits. The Retail Price Index (RPI) was the dominant headline measure in the twentieth century, although the CPI has now taken that mantle. Variants on these headline measures have also been used: in the 1980s and 1990s, means-tested benefits were pegged to Rossi and New Rossi, which exclude the housing costs included in RPI to different degrees.⁴ The methodological and coverage differences between these measures have implications for the rate of inflation they return and, in the uprating context, the pace at which benefits increase in nominal terms.

More recently, there has been domestic and overseas interest in the adoption of ‘sub-indices’ for uprating purposes.⁵ Rather than adjusting coverage (as per Rossi and other headline variants such as RPIX (RPI excluding mortgage-interest payments) or CPIH (CPI including some owner-occupied housing costs)), sub-indices are constructed by adjusting the weights accorded to the ‘consumption bundles’ that compose any inflation index. Headline indicators reflect the consumption pattern of the average individual; sub-indices

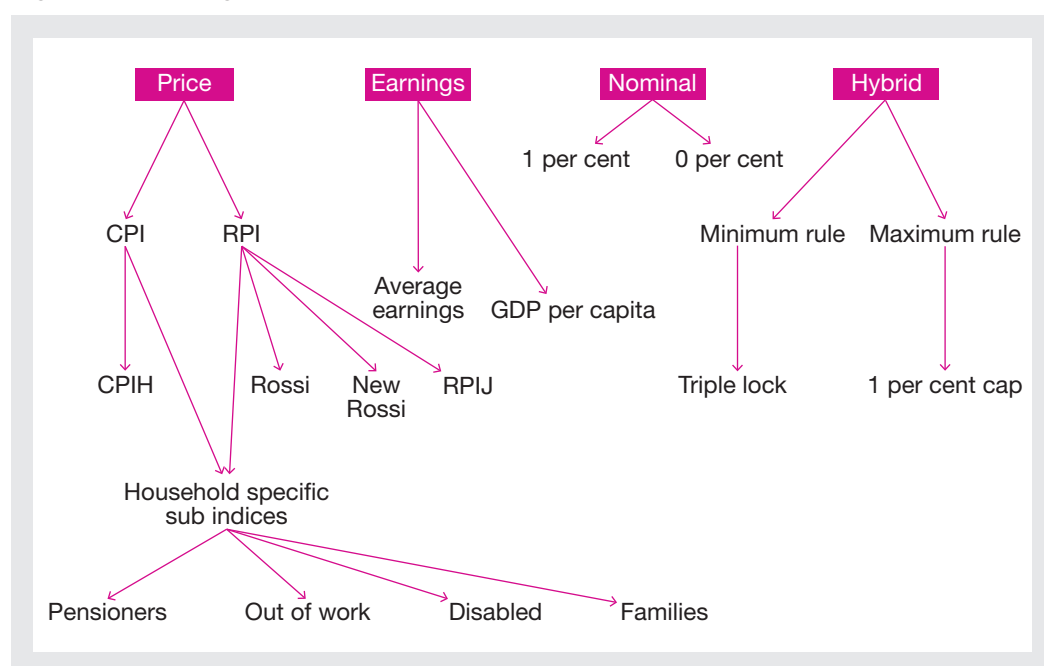
⁴ CPIH, a variant of CPI that includes mortgage interest repayments, has recently been mooted for uprating purposes.

⁵ Paul Johnson, *UK Consumer Price Statistics: A Review*, 2015; Australian Bureau of Statistics, ‘Explanatory Notes – Selected Living Cost Indexes, Australia’, March 2015, <http://www.abs.gov.au/ausstats/abs@.nsf/Products/6467.0-Mar+2015-Explanatory+Notes-Explanatory+Notes?OpenDocument#2718121728189953>; Astin and Leyland, ‘Towards a Household Inflation Index: Compiling a Consumer Price Index with Public Credibility’.

can weight these bundles of goods and services in a way that reflects the expenditure patterns of groups of individuals such as pensioners or those in receipt of social-security transfers.

Yet price indices are by no means the only way of uprating benefits. Pensions have been pegged to earnings in the UK and abroad.⁶ There are also choices to be made here: in the UK, average weekly earnings (AWE) is the standard measure, although GDP per capita could also be used as a proxy for living standards. Additionally, the UK has recently seen the adoption of nominal uprating (for example, the freezing of many working-age benefits). These rules can also form part of a hybrid mechanism, one which uprates benefits by the highest or lowest out of a bundle of metrics (see Figure 3).

Figure 3: Uprating mechanisms



1.2 Historical trends

This array of uprating mechanisms means policymakers can ensure benefits respond appropriately to changes in the general price level, wages or the cost of specific items. Uprating decisions have been made in light of the public-policy objectives of the payment in question. These, of course, are numerous and often conflicting. Nonetheless, benefits can be broadly arranged into three categories:

- **Income replacement:** payments made to those with low or no income to provide recipients with subsistence-level support. These can be divided into short-term income replacements, which provide support for those temporarily out of work, and long-term income replacement, for those deemed unable to work.
- **Income supplement:** payments aimed at supporting those in low-paid work, primarily through the tax-credits system.
- **Extra cost:** payments that contribute to additional costs, such as those incurred due to a disability or by having children.

6 Ive Marx and Kenneth Nelson, *Minimum Income Protection in Flux*, 2012.

Figure 4: Uprating policy since 1973-74

	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20		
Income replacement																																																	
Basic State Pension																																																	
ESA (WRAG)																																																	
ESA (SG)																																																	
Income support																																																	
Unemployment Benefit/USA																																																	
Income supplement																																																	
Working Tax Credit																																																	
Extra cost																																																	
Child Tax Credit																																																	
Local Housing Allowance																																																	
Child Benefit																																																	
DLA/PIP/ Attendance Allowance/ Carer's Allowance																																																	

Sources: Steven Kennedy, Richard Cracknell, and Roderick McInnes, *Welfare Benefits Uprating Bill*, (House of Commons Library, 2013); Kim Greener, and Richard Cracknell, *Child Benefit*, (House of Commons Library, 1998); Roderick McInnes, *2015 Benefit Uprating*, (House of Commons Library, 2014); Tania Burchardt, *The Evolution of Disability Benefits in the UK: Re-weighting the Basket*, 1999; HM Treasury, *June Budget 2010*; HM Treasury, *Autumn Statement 2012*; HM Treasury, *Summer Budget 2015*.

Systematic uprating commenced after the *Social Security Act 1973* (see Figure 4).⁷ Long-term income replacements – including the BSP and long-term incapacity-related benefits – have historically enjoyed the most generous uprating treatment. These benefits were pegged to wages during the 1970s, ensuring recipients shared “the increased standards of living of the country as a whole.”⁸ The earnings link was eventually broken in 1980, following concerns regarding fiscal sustainability.⁹

Short-term income replacements, such as JSA and Income Support, moved from RPI to Rossi and then New Rossi, reflecting the fact that many recipients did not face housing costs due to Housing Benefit. Extra-cost benefits avoided this transition, underscoring their function as compensation for costs unrelated to the coverage issues that spawned these offshoots of RPI. The history of Tax Credits, and their antecedent payments, is less coherent, cycling through RPI, Rossi and New Rossi, until the Labour Government unveiled a series of reforms in 2003-04. Local Housing Allowance (LHA), which assists those struggling to afford private rents, has also seen a number of different uprating approaches, including by a mechanism that pegged increases to growth in the cost of rents for low-value properties. The uprating of non-LHA Housing Benefit – which covers those in the social-rented sector – falls outside the purview of this paper since benefits are linked to price levers controlled by the Government.

⁷ *Social Security Act 1973*, sec. 39; the main legislation used to uprate pensions and benefits is now: *Social Security Administration Act 1992*.

⁸ HC Deb 13 June 1979 Vol 968 c439

⁹ *Social Security Act 1980*.

2

Current policy

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The programme of reform unveiled by the Coalition Government and continued by the current Government has upended the pre-2010 settlement. Three reforms in particular stand out. In 2013, a 1 per cent cap on increases in the value of many working-age benefits was implemented. This will be effective until 2016, when benefits will be frozen in nominal terms. Longer-term reforms were also introduced. In 2010, the chancellor announced that CPI indexation would be used for all price-pegged benefits. The triple lock on the BSP was also implemented, which uprates by the highest of prices, 2.5 per cent or earnings growth.

Recent reforms were motivated by a number of key themes (see Figure 5). In the short term, uprating policy has been used to bear down on the deficit and discourage welfare dependency. Long-term priorities for the Government have included protecting vulnerable claimants and more accurately reflecting the price experiences of beneficiaries. These changes were built on a shifting landscape thanks to the introduction of UC, which rolls six individual benefits (income-based JSA, income-related Employment and Support Allowance (ESA), Income Support, Child Tax Credit, Working Tax Credit and Housing Benefit) into one payment.

Figure 5: Existing policy rationale

		Short term		Long term	
Current regime	New regime	Uprating mechanism	Rationale	Uprating mechanism	Rationale
Income replacement					
State Pension	Single Tier Pension	Triple lock	Protect recipients from inflation, track earnings growth and ensure meaningful yearly rises	Prioritise those who have worked hard	Protect recipients from inflation, track earnings growth and ensure meaningful yearly rises
JSA	UC: Standard Allowance	Cap / Freeze	Strengthen work incentives by ensuring wage growth overtakes growth in the value of benefits	Save the Exchequer money	Prioritise those who have worked hard
Income Support	UC: Work Capability Element	CPI	Protect recipients against inflation risk by uprating in line with a measure that accurately reflects their price experiences	Prioritise those who are most vulnerable	Save the Exchequer money
ESA (SG)					
Income supplement					
Working Tax Credit		Cap / Freeze	Save the Exchequer money		
Working Tax Credit (disability element)	UC: Standard Allowance	CPI	Protect recipients against inflation risk by uprating in line with a measure that accurately reflects their price experiences	Prioritise those who are most vulnerable	Protect recipients against inflation risk by uprating in line with a measure that accurately reflects their price experiences
Extra cost					
LHA	UC: Housing Element	Cap / Freeze	Exert downward pressure on private-sector rents		
Working Tax Credit (Child element)	UC: Child Element	Cap / Freeze	Protect the fairness of the Welfare State by ensuring wage growth overtakes growth in the value of benefits	Save the Exchequer money	
Child Benefit	UC: Child Element				
Attendance Allowance	UC: Attendance Element				
Carer's Allowance	UC: Carer Element				
DLA/PIP	PIP				

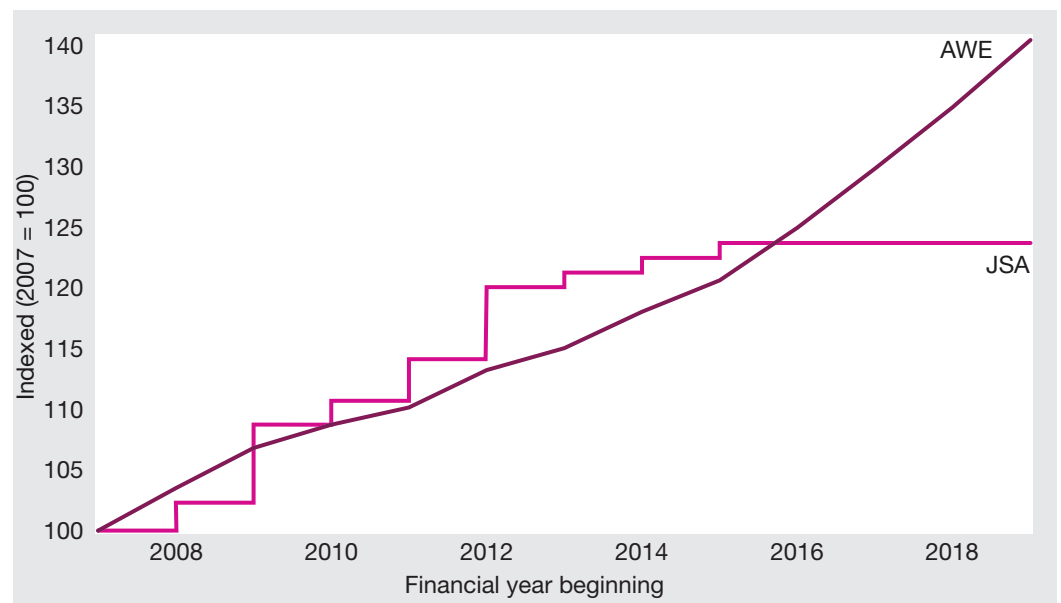
Sources: Department for Work and Pensions, *Housing Benefit – Uprating Local Housing Allowance Rates by CPI from April 2013: Impact Assessment, 2012*; HC Deb 8 January 2013 Vol 556; HL Deb 20 June 2011; HM Treasury, *Autumn Statement 2012*; HM Treasury, *Summer Budget 2015*; Tim Ross, “David Cameron: Tories Will Keep Pension ‘Triple Lock’ Guarantee,” *Daily Telegraph*, January 4, 2014.

2.1 Cap and freeze: sustainability and fairness

The last two Governments have been clear about the financial motivations for limiting increases in the value of working-age benefits. Commenting on the legislation that delivered the 1 per cent cap, the work and pensions secretary, Iain Duncan Smith, argued “this Bill is about finding savings.”¹⁰ The policy was forecast to avoid £11 billion of expenditure by 2014-15, although the eventual figure was £7.6 billion.¹¹ The freeze on working-age benefits – a “historically unprecedented” measure, almost unheard of in international practice¹² – was also framed in terms of cost saving. The Government has recently emphasised the transformative impact this measure will have, helping the UK move “from a low wage, high tax, high welfare economy, to a higher wage, lower tax, lower welfare society.”¹³

Fairness has also been at the heart of these reforms. Thanks to the anaemic wage growth the UK experienced in the aftermath of the financial crisis, the value of benefits grew proportionately more than earnings.¹⁴ Concerns were raised about the effect this would have on work incentives, and the legitimacy of a system that saw the relative economic position of welfare recipients improve while non-beneficiary working families were struggling.¹⁵ The Government’s policy response is designed to ensure the value of benefits relative to earnings will decline in the short to medium-term (see Figure 6).

Figure 6: Growth in the value of JSA (2007 to 2020)



Sources: Kennedy, Cracknell, and McInnes, *Welfare Benefits Uprating Bill*; Office for Budget Responsibility, *Economic and Fiscal Outlook, July 2015*; HM Treasury, *Autumn Statement 2012*; HM Treasury, *Summer Budget 2015*.

¹⁰ HC Deb 8 January 2013 Vol 556 cc193-4.

¹¹ Andrew Hood and David Phillips, *Benefit Spending and Reforms: The Coalition Government's Record*, 2015.

¹² Steven Kennedy, Richard Cracknell, and Roderick McInnes, *Welfare Benefits Uprating Bill*, 2013. An exception was a freeze in the Netherlands in the late eighties and early nineties (Tony Eardley et al., *Social Assistance in OECD Countries*, 1996).

¹³ HM Treasury, *Summer Budget 2015*, 2015.

¹⁴ In 2012, the Coalition identified that average earnings had increased by around 10 per cent between 2007-08 and 2012-13, while out-of-work benefits had increased by 20 per cent over the same period. (George Osborne, 'Speech to Conservative Party Conference 2014', 29 September 2014, <http://press.conservatives.com/post/98719492085/george-osborne-speech-to-conservative-party>).

¹⁵ HM Treasury, *Autumn Statement 2012*, 2012.

2.2 Switch to CPI: getting the index right

In 2013, RPI lost its national statistic status due to concerns about its approach to aggregating price changes. Prior to this, the Coalition Government had already taken the decision to the switch to CPI indexation in 2010, a move that was justified on the grounds that “CPI provides a more appropriate measure of benefit and pension recipients’ inflation experiences than RPI”.¹⁶ The availability of Housing Benefit, the Coalition argued, means beneficiaries are unlikely to face the housing costs represented in RPI. However the mothballing of New Rossi, which excluded rent and mortgage interest repayments, raises questions about the persuasiveness of this position, as does the application of CPI to universal benefits. More compelling was the suggestion that CPI better reflects consumer behaviour.¹⁷ Unlike the now discredited RPI and its variants, CPI accounts for a consumer’s ability to transfer to relatively cheaper goods during periods of price change.¹⁸ This argument applies particularly well to low-income benefit recipients, who are more likely to be price sensitive.

The Coalition’s reforms also aligned UK policy with current international practice. Many EU member states use CPI or their equivalent for uprating purposes, as do the United States and Canada.¹⁹ In the context of the UK’s yawning budget deficit, the savings delivered by transitioning to CPI uprating were also a factor. CPI returns a considerably lower level of inflation compared to RPI (see Figure 7), so reform was forecast to reduce expenditure by £7.8 billion.²⁰ Due to a global food and oil price spike in 2011 and 2012 – that narrowed the gap normally observed between RPI and CPI – savings on this scale did not materialise.²¹

¹⁶ HM Treasury, *June Budget 2010*, 2010.

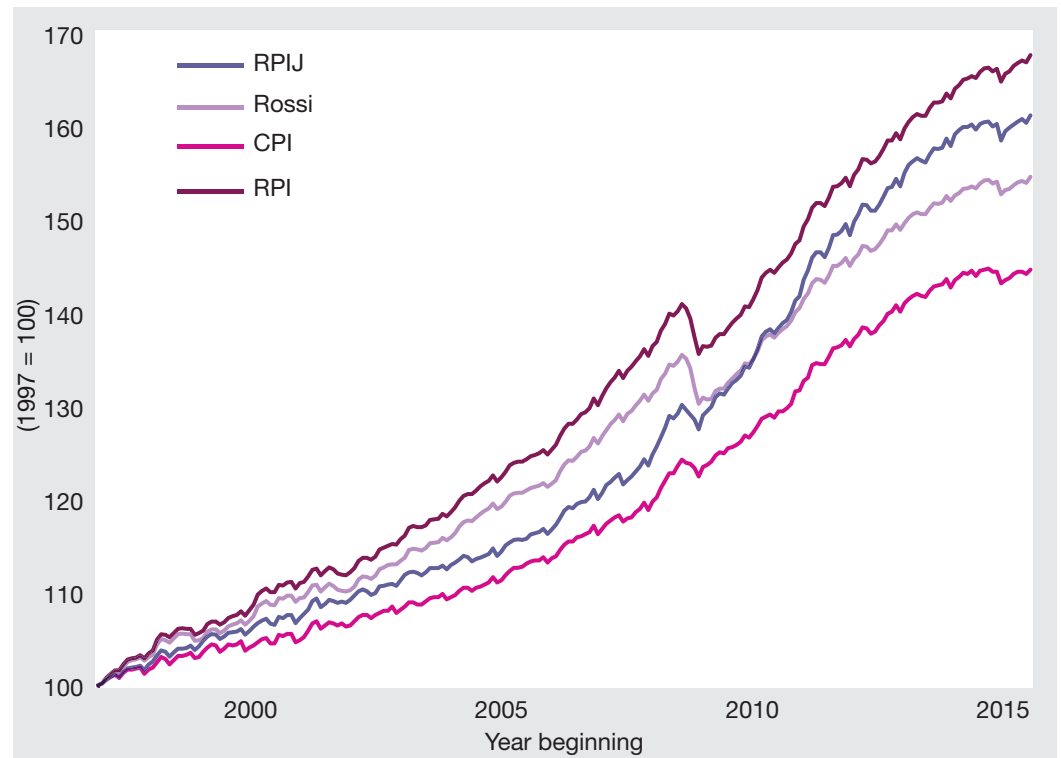
¹⁷ Ibid.

¹⁸ James Browne and Peter Levell, *The Distributional Effect of Tax and Benefit Reforms to Be Introduced Between June 2010 and April 2014: A Revised Assessment* (Institute for Fiscal Studies, 2010).

¹⁹ Martin Feldstein and Horst Siebert, *Social Security Pension Reform in Europe* (University of Chicago Press, 2009); Marx and Nelson, *Minimum Income Protection in Flux*; Holly Sutherland et al., *The Impact of Benefit and Tax Uprating on Incomes and Poverty* (Joseph Rowntree Foundation, 2008).

²⁰ Hood and Phillips, *Benefit Spending and Reforms: The Coalition Government’s Record*.

²¹ Office for Budget Responsibility, *Welfare Trends Report*, 2015.

Figure 7: Growth in price indices

Sources: Kennedy, Cracknell, and McInnes, *Welfare Benefits Uprating Bill*; Office for Budget Responsibility, *Economic and Fiscal Outlook*, July 2015.

2.3 Triple lock: protecting the vulnerable

Fairness and sustainability were also at the heart of the introduction of the triple lock. By pegging the BSP to the highest of earnings, wages or 2.5 per cent, the triple lock ensures pensioners share in the prosperity of the working population, are protected against inflation risk and will receive meaningful rises in their income each year. In 2014, the prime minister, David Cameron, argued it was right to reward those who have worked hard by protecting their standard of living, and suggested the Conservatives were only able to keep their commitment to the triple lock because decisions to address the deficit had been taken elsewhere.²²

A similar story can be told about Pension Credit, which 'tops up' the BSP for some recipients. The Government had committed to uprating the Pension Credit Standard Minimum Guarantee at least in line with average earnings – and indeed, beyond this in 2011, 2012 and 2013, when it was uprated in line with the cash rise in the full BSP.²³ However the introduction of the single-tier pension (the New State Pension) in April 2016 above the minimum guarantee, combined with the forthcoming abolition of the Saving Credit, will see the significance of the Pension Credit wane in future years.²⁴

²² Tim Ross, 'David Cameron: Tories Will Keep Pension "Triple Lock" Guarantee', *Daily Telegraph*, 4 January 2014, <http://www.telegraph.co.uk/finance/personalfinance/pensions/10551113/David-Cameron-Tories-will-keep-pension-triple-lock-guarantee.html>.

²³ Kennedy, Cracknell, and McInnes, *Welfare Benefits Uprating Bill*.

²⁴ Djuna Thurley, *The New 'Single-Tier' State Pension* (House of Commons Library, 2015). The single-tier pension will only be paid to those who reach State Pension age after 6 April 2016 and so will be rolled out slowly in the coming decades.

3

Price indices

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Historically, policymakers' rationale for uprating income-replacement and income-supplement benefits in line with prices was clear: to maintain the living standards of welfare recipients. By increasing the nominal value of benefits in line with inflation each year, the purchasing power of social-security beneficiaries is maintained. Indeed, this approach is a minimum requirement for a number of benefits, written into law by the *Social Security Administration Act 1992*.

The question for policymakers is how to ensure the price experience of beneficiaries is adequately reflected. The Coalition was probably right to argue that "CPI provides a more appropriate measure of benefit and pension recipients' inflation experiences than RPI".²⁵ Yet this does not mean indexing the majority of benefits to CPI is the most appropriate approach to uprating. At least two other options exist. The first is to use another headline indicator to better reflect the price experiences of beneficiaries. The second is to employ more bespoke solutions such as the creation of sub-indices, or uprating benefits in line with growth in the value of certain goods and services. If the Government wishes to use an indicator that truly reflects the prices experienced by claimants, it might opt for one of these.

3.1 Benefit Uprating Index

CPI was never designed to reflect the price changes that individual households experience. It is an inflation index: a macroeconomic tool – developed to assess economic convergence between European countries – to measure general changes in prices. This history explains some of the coverage choices the developers of CPI made. Rather than measuring the changing average outlay experienced by households, CPI excludes certain costs because of their relationship with central-bank interest rates – mortgage-interest repayments and non-mortgage loans are two such examples. Of course, there may be very strong reasons to exclude housing from a price index used to uprate benefits, as the Government argued in 2010. Nonetheless this question serves to highlight the fact that CPI was not designed to replicate the changing costs that households face.

This point is underscored elsewhere. CPI is an 'expenditure-weighted' measure, balancing the relative importance of price changes in accordance with the volume of money spent on the good or service in question. This aggregation method is considered generally appropriate for macroeconomic indicators, but less so when an index is used for uprating.²⁶ By aggregating price changes in accordance with expenditure volume, the price experiences of wealthier households – because they spend more – are overrepresented at the expense of less income-rich ones.²⁷ Clearly this is undesirable if policymakers want to peg benefits to price changes experienced by the many, and not just the few.

These concerns have recently led academics John Astin and Jill Leyland to call for the development of a Household Inflation Index (HII) which measures the costs "experienced by households in their role as consumers."²⁸ Unlike CPI, HII would include interest repayments, the cost of owner-occupied housing and insurance. Such a measure would also be 'household weighted', giving equal importance to the price experiences of all households. Astin and Leyland argue the HII – because it specifically tracks changes in the cost of household expenditure, rather than the macroeconomic variable 'inflation' – would be a natural index by which to uprate benefits.

An alternative approach would be to develop an index aimed specifically at tracking the costs faced by beneficiary households. A Benefit Uprating Index (BUI) could differ from the HII conceived by Astin and Leyland in terms of both coverage and weighting. The

25 Irrespective of the merits of the Coalition's argument, the loss of RPI's national statistic status in 2013 means a return to the previous system is impossible.

26 International Labour Office, ed., *Consumer Price Index Manual: Theory and Practice* (International Labour Office, 2004).

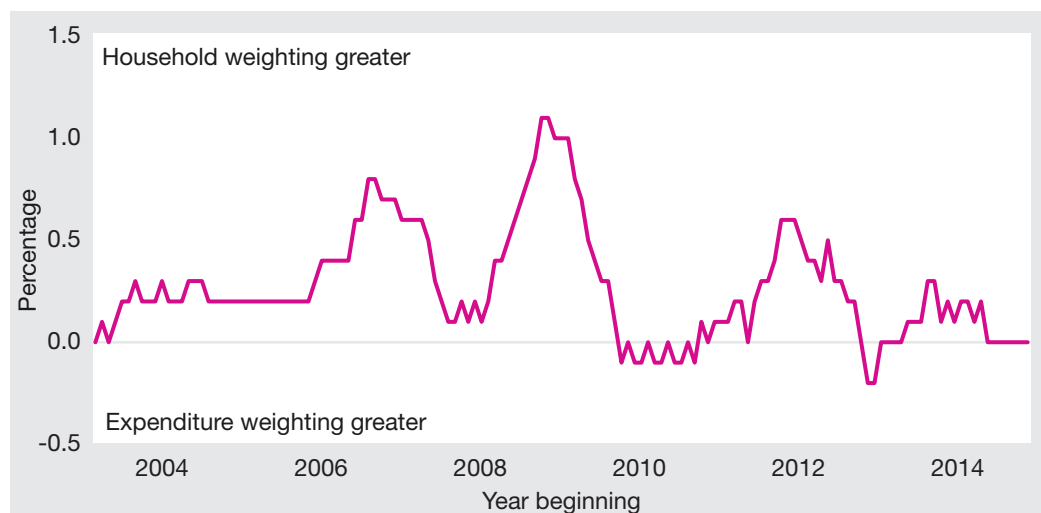
27 Tanya Flower and Philip Wales, *Variation in the Inflation Experience of UK Households: 2003 – 2014*, 2014.

28 Astin and Leyland, 'Towards a Household Inflation Index: Compiling a Consumer Price Index with Public Credibility'.

inclusion of mortgage-interest payments (MIPs) in an index developed to measure the price experiences of the average household may be sensible. It is not, however, so relevant for an index geared towards beneficiaries, since many are less likely to bear such costs.²⁹ Similarly, the weighting of BUI must reflect the consumption patterns of beneficiary groups, who consume proportionately more of their income on goods such as food and energy than the average household. In recent years this has resulted in CPI underreporting the level of inflation experienced by beneficiary groups.

Since BUI would aim to gauge the price changes experienced by beneficiaries, it would, like the HII, adopt a household-weighted approach. This technical adjustment would likely mean the BUI registers a persistently higher level of inflation than CPI. As Tanya Flowers and Philip Wales explain, expenditure-weighted price measures underestimate the level of inflation since “low-expenditure households have typically experienced higher rates of inflation than high-expenditure households over the last decade.”³⁰ For example, if CPI was household – rather than expenditure – weighted, the measure would have returned a rate of inflation 0.3 per cent higher each year between January 2013 and October 2014 (see Figure 8).³¹ Of course, by focusing specifically on low-income households, the BUI already addresses this problematic aspect of CPI. Nonetheless, the development of BUI should be guided by the international Consumer Price Manual, which deems household-weighted indices more appropriate for benefit indexation.³²

Figure 8: Difference between expenditure-weighted CPI and household-weighted CPI



Source: Tanya Flower and Philip Wales, *Variation in the Inflation Experience of UK Households: 2003 – 2014*, 2014.

²⁹ Just under three-quarters of pensioners own their own home outright. (Department for Work and Pensions, 'Households Below Average Income', June 2015, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/437246/households-below-average-income-1994-95-to-2013-14.pdf).

³⁰ Flower and Wales, *Variation in the Inflation Experience of UK Households: 2003 – 2014*.

³¹ Ibid.

³² 'As pointed out in the international Consumer Price Index Manual (ILO, 2004), household-weighted indices are generally considered more appropriate for consumer price indices which are designed for use in indexation.' (Astin and Leyland, 'Towards a Household Inflation Index: Compiling a Consumer Price Index with Public Credibility').

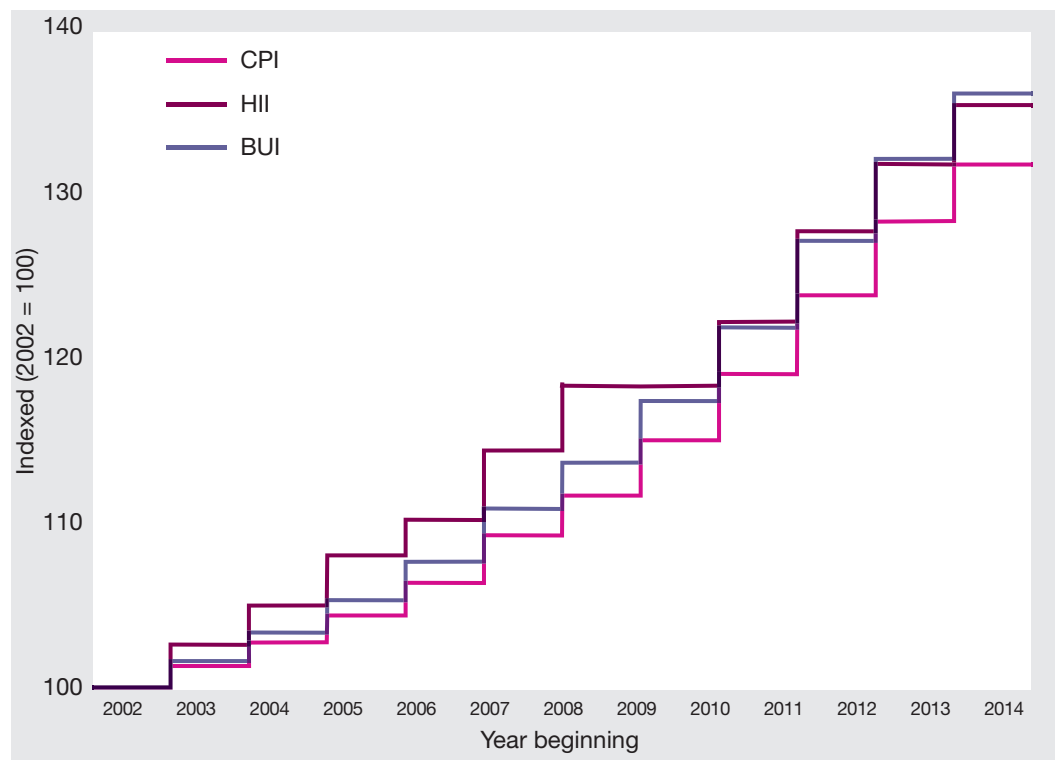
Figure 9: Modelling BUI and HII

Rough calculations of how BUI and HII would uprate benefits can be gleaned from existing data.

- As per Astin Leyland, RPIJ is used as a proxy for HII.³³
- A household-weighted CPI is used as a proxy for BUI. As per Flower and Wales, this is calculated by $CPI + 0.3$ per cent.³⁴

In practice, uprating benefits by BUI would likely increase their future value at a faster pace than CPI. By way of an example, between 2002-03 and 2013-14, BUI indexation would have returned a benefit 4.3 per cent more generous than under CPI pegging (see Figure 10). In other words, because CPI does not reflect the price experiences of beneficiaries, uprating social-security transfers by this measure erodes the purchasing power of some of the most vulnerable people in our society.

Figure 10: CPI, BUI and HII uprating, 2002-03 to 2013-14



Source: Office for National Statistics, “Consumer Price Inflation, August 2015”.

To be clear, the BUI would have a specific and narrow role in the uprating of benefits. This measure would neither compete with, nor replace, CPI as the Bank of England’s main macroeconomic measure for inflation. If the Government is concerned about maintaining the purchasing power of those on income-replacement and income-supplement benefits, it should uprate these benefits by an index developed specifically to model the general price experiences of beneficiaries. The UK Statistics Authority and ONS should therefore develop and quality assure a new price index, the BUI, as a matter of priority.

Indeed, the BUI should be used by the Government to uprate income-replacement and income-supplement benefits as soon as it has been developed. This would replace an iniquitous freeze that goes beyond short-term crisis policy. The aim of the freeze is to tackle the deficit (it is forecast to save £4 billion a year by 2019-20) and ensure that benefit inflation does not outstrip wage growth, as it has since 2008.³⁵ However, as Figure

³³ Modelling BUI in this way assumes BUI would take the same coverage and weighting decisions as CPI. As already explained, this may not necessarily be the case. (Ibid).

³⁴ Ibid.

³⁵ HM Treasury, *Summer Budget 2015*.

6 shows, this is quickly changing, as wage growth returns to its pre-crisis level. Even with low inflation, freezing benefits will also erode the standard of living for beneficiaries who are unable to smooth their consumption. Relative to CPI, benefits stand to lose 8.6 per cent of their value as a result of the freeze – income which affected beneficiaries are unable to recuperate.³⁶

Recommendation 1

The Government should develop a new index, the Benefit Uprating Index, and use it to uprate income-replacement and income-supplement benefits.

3.2 Sub-indices

The adoption of BUI indexation would be a significant improvement on the current direction of policy. Some people, however, have suggested that this does not go far enough. International policymakers and academics are increasingly calling into question the use of headline price indicators. Their concern is that groups of people – such as pensioners, the unemployed and the long-term sick – experience price changes in drastically different ways. This has led to calls for the introduction of price sub-indices: measures that better reflect the price experiences of groups of individuals by reweighting a headline price index in accordance with the expenditure pattern of the group in question.³⁷ Some overseas governments are building the infrastructure to do just this. Australia publishes the Analytical Living Costs Indices (ALCIs), which include sub-indices for welfare dependents, workers, state pensioners and self-funded retirees.³⁸ New Zealand is currently developing a similar measurement.³⁹

Since BUI already focuses on a particular cross-section of the population (beneficiaries) this question is less potent than for those proposing CPI uprating. Nonetheless, there could be merit in developing BUI sub-indices that correspond to specific beneficiary groups (pensioners, the long-term sick and the unemployed) if these groups experience price changes in significantly different ways.

Section 3.1 shows that, as a whole, beneficiaries experience price changes differently to the rest of the population. But might different groups of beneficiaries experience price changes dissimilarly? Take the example of pensioners in the UK. A 2014 study by the ONS found pensioners experienced price rises 0.25 percentage points higher than the rest of the population – over a 12 year period, these disparities amounted to a 3.5 percentage point difference (see Figure 11).⁴⁰ The ONS does not produce figures for other beneficiary groups, although the experiences of those in lower-income deciles could roughly proxy some social-security recipients such as the unemployed. The divergence here is larger – 0.34 per cent annually, culminating in a 4.8 percentage point gap.⁴¹

³⁶ Reform calculation based on OBR and DWP figures. (Office for Budget Responsibility, *Economic and Fiscal Outlook: July 2015*, 2015; Department for Work and Pensions, *The Annual Abstract of Statistics for Benefits, National Insurance Contributions, and Indices of Prices and Earnings*, 2014).

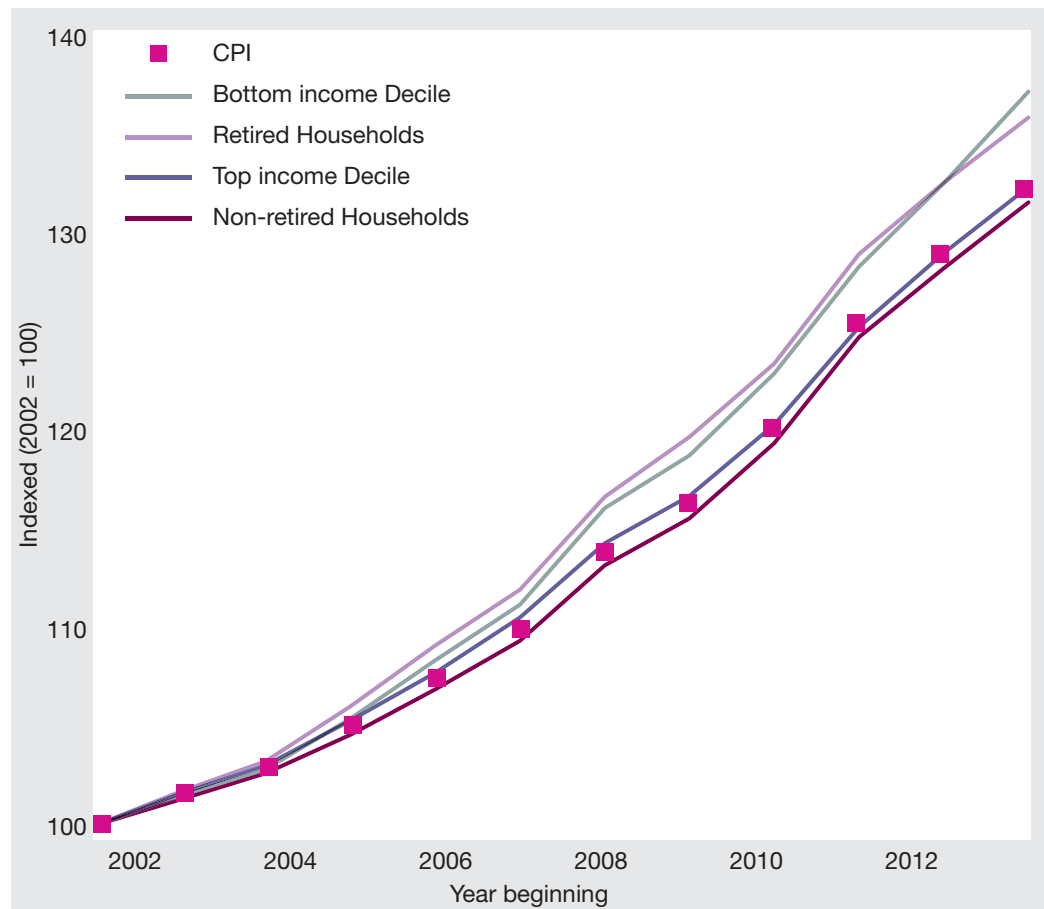
³⁷ Johnson, *UK Consumer Price Statistics: A Review*.

³⁸ Australian Bureau of Statistics, 'Overview of the Analytical Living Cost Indexes', July 2012, <http://www.abs.gov.au/ausstats/abs@nsf/exnote/6463.0>.

³⁹ Statistics New Zealand Tatauranga Aotearoa, *Decision on 2013 CPI Advisory Committee Recommendations*, 2014.

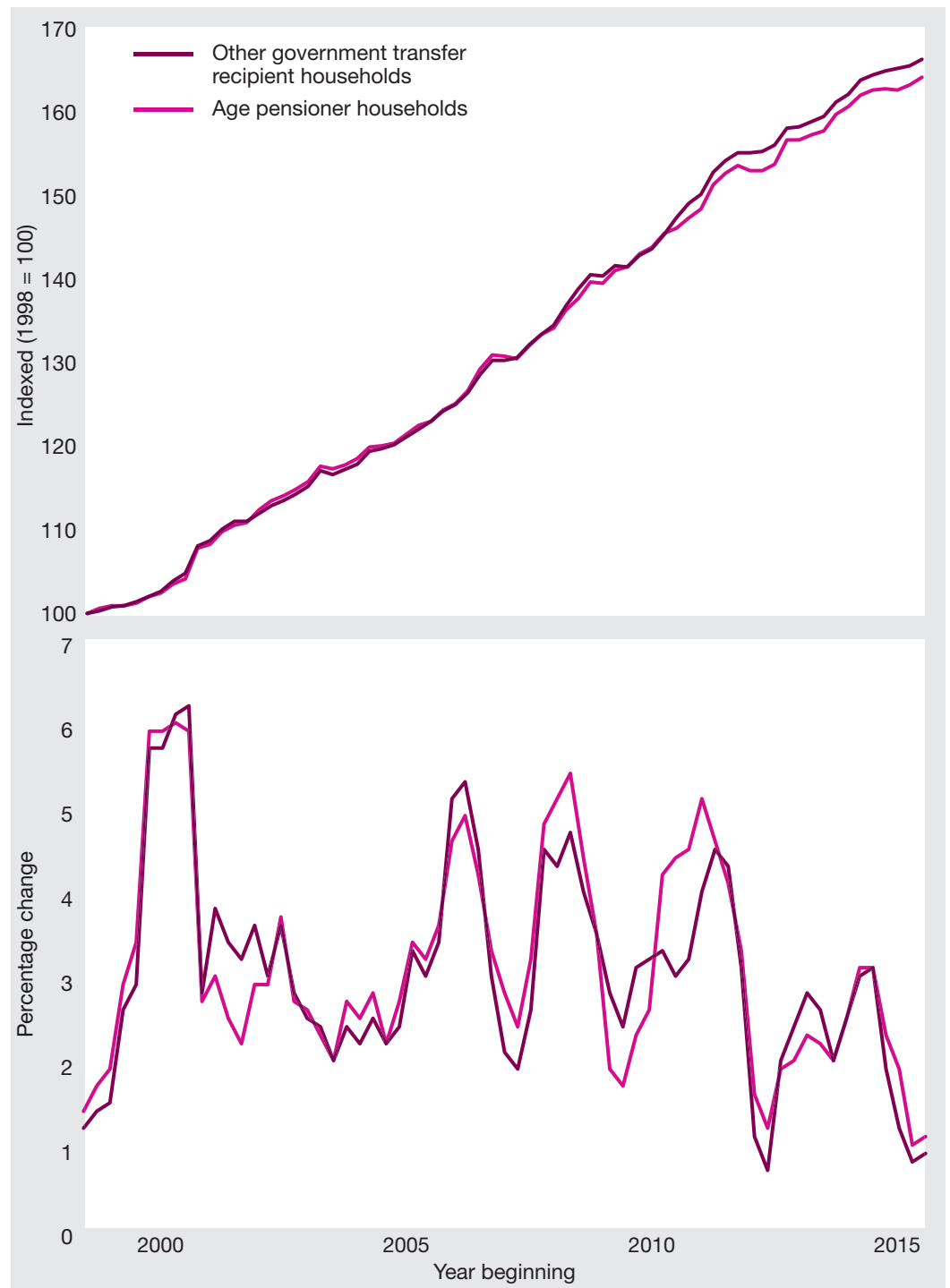
⁴⁰ Flower and Wales, *Variation in the Inflation Experience of UK Households: 2003 – 2014*.

⁴¹ Ibid.

Figure 11: Price experiences by household type

Source: Tanya Flower and Philip Wales, *Variation in the Inflation Experience of UK Households: 2003 – 2014*, 2014.

While the divergence between headline CPI and pensioner and low-income households is clear, there appears to be no systematic departure between the price experiences of pensioners and low-income households. In part this is because of the overlap between these two groups – some pensioners will fall into the bottom income decile group. This picture is partially supported by data from Australia (see Figure 12). There, the price experiences of pensioner households were almost identical to that of other government transfer recipient households until the global financial crisis. Since then, a 0.2 percentage point gap in the average annual inflation rate experienced by these groups has opened up.

Figure 12: Annual inflation rates in Australia by household type

Source: Australian Bureau of Statistics, *Selected Living Cost Indices, Australia, June 2015, June 2015*.

Existing evidence, therefore, does not conclusively show beneficiaries experience price changes in significantly different ways. It should also be recognised that organising sub-indices by beneficiary groups would entail costs, particularly since social-security beneficiaries are underrepresented in existing survey data sets such as the Living Cost and Foods Survey. The ONS would need to administer and quality assure these new indicators.

Added to these problems is the more significant question of how using different uprating mechanisms could affect the interactions between benefits, a problem that will be

exacerbated by the planned introduction of UC for all new claimants by 2017.⁴² The example of JSA and ESA is instructive: a more generous uprating mechanism for the latter could strengthen incentives for those out of work to try to move onto ESA. Uniform uprating would circumvent these concerns, but if historical evidence indicates the divergence between beneficiary groups is significant, the introduction of BUI sub-indices should at least be considered.

To be clear, the key priority for the UK Statistics Authority and the ONS should be to develop the Benefit Uprating Index in preparation for the Government to uprate benefits by this measurement. Simultaneously, however, the ONS should build on its recent work into varying experiences of price changes, and investigate whether the expenditure patterns of the unemployed and long-term sick differ considerably from one another. As it stands, the little evidence that exists indicates there may be no significant divergence. This dearth of information, however, suggests that investigations into sub-indices by the UK Statistics Authority and the ONS would provide the Government with much-needed data about the inflationary experiences of different beneficiary groups, thereby giving future policymakers the tools to uprate benefits by the most appropriate measurement.

Recommendation 2

The UK Statistics Authority and Office for National Statistics should investigate the degree to which there is variation between the price experiences of different beneficiary groups. If the variation is significant and the cost of implementation not prohibitive, consideration should be given to using sub-indices within the BUI.

3.3 Extra-cost benefits

The logic of uprating extra-cost benefits ought to be straightforward. Since these benefits refer to particular costs, their value should track price changes in the relevant good or service. However, because beneficiaries can spend these cash payments in whatever manner they see fit, the reality is rather more complicated. Disability Living Allowance (DLA), and its successor Personal Independence Payment (PIP), is used for items ranging from food and clothing, to travel or social expenses.⁴³ Only 25 per cent of recipients of Attendance Allowance – a benefit for those over 65 with physical and mental disabilities to help with the cost of social care – actually use their benefits to fund care services.⁴⁴ Child Benefit, which goes to heads of households with children, is disproportionately spent on ‘adult goods’.⁴⁵

With expenditure derived from extra-cost benefits going on such an unfocused collection of goods and services, the space for the ONS to develop indices specific to extra-cost benefits is limited. This process would be further complicated by the lack of iterative, government-backed data on how these extra cost benefits are actually spent. Indeed, for a number of extra-cost benefits, such as Carer’s Allowance, there appears to be no data at all. In light of these difficulties, the BUI, rather than CPI, would provide the most applicable uprating mechanism. The ONS should also explore whether households with children, those with disabilities, or those in need of care experience price changes differently to the average beneficiary group. Again, if significant divergences are revealed, the introduction of sub-indices may be necessary.

⁴² Department for Work and Pensions, *Universal Credit at Work*, 2014, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/368805/uc-at-work.pdf.

⁴³ ‘What Disability Living Allowance Means to Me – in Pictures’, *The Guardian*, 9 February 2011, <http://www.theguardian.com/society/gallery/2011/feb/09/disability-living-allowance-reform-scope-in-pictures>.

⁴⁴ Jill Papworth, ‘Attendance Allowance: The £200-plus a Month Many Elderly People Miss out on’, *The Guardian*, 30 September 2011, <http://www.theguardian.com/money/2011/sep/30/attendance-allowance-elderly-miss-out>.

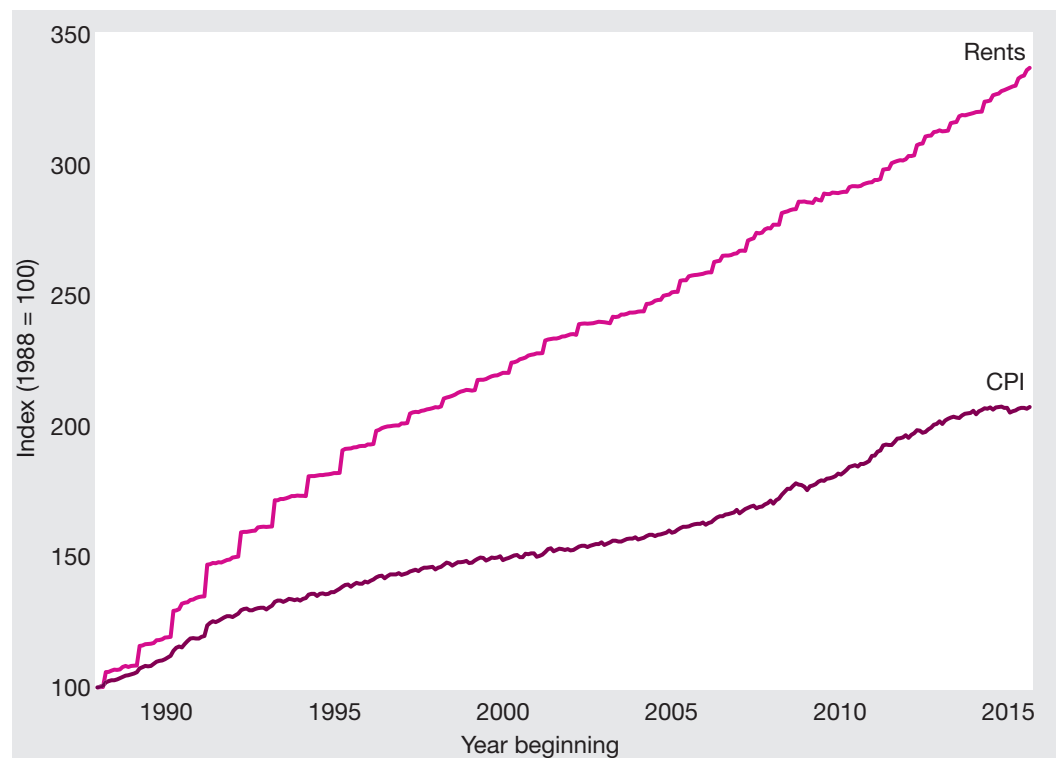
⁴⁵ Laura Blow, Ian Walker, and Yu Zhu, ‘Who Benefits from Child Benefit?’, 2006, <http://wrap.warwick.ac.uk/1446/>.

Recommendation 3

All extra-cost benefits except Local Housing Allowance should be uprated by the Benefit Uprating Index. As part of its investigation into sub-indices, the UK Statistics Authority and Office for National Statistics should explore whether households with children, those with disabilities, or those in need of care experience price changes in a significantly different fashion as to warrant the introduction of sub-indices for these groups.

The case of Local Housing Allowance (LHA) is more complex. First, unlike other extra-cost benefits, LHA can only be spent on housing costs.⁴⁶ Second, housing costs have outstripped CPI by nearly an average of 2 percentage points each year (see Figure 13). As a result, pegging LHA to a more general measure of inflation would see the purchasing power of recipients erode over time. Third, unlike other extra-cost benefits, governments have the ability to uprate LHA in line with the actual change in the cost of low-value accommodation. Indeed, this was the case from 2008-09 to 2011-12, when LHA was uprated in line with data on local rents collected by Rent Officers, and prior to the introduction of LHA, when private-sector housing benefit entitlement was tied to growth in rents rather than the overall price level.⁴⁷

Figure 13: CPI and rental costs



Source: Office for National Statistics, "Consumer Price Inflation, August 2015".

Yet uprating policy also needs to take into account the competing objectives of housing support. The Coalition Government's reforms to LHA uprating policy – first the move to the lower of CPI indexation or rents, then a 1 per cent cap with exemptions for high rent areas, and finally a freeze – were driven by the spiralling cost of the Housing Benefit bill.

⁴⁶ For example, see Plymouth City Council, 'Local Housing Allowance Frequently Asked Questions', FAQ, n.d., <http://www.plymouth.gov.uk/homepage/benefits/localhousingallowance/lhafaqs.htm>.

⁴⁷ Department for Work and Pensions, *Housing Benefit – Uprating Local Housing Allowance Rates by CPI from April 2013: Impact Assessment*, 26 March 2012, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220180/hb-lha-cpi-uprating-wr2011-ia.pdf.

Thirty-seven per cent of all private renters now receive LHA;⁴⁸ in some areas, the figure is two-thirds.⁴⁹ With the Government subsidising such a significant proportion of the private rental sector, concerns were growing that increases in Housing Benefit were fuelling, rather than responding to, the cost of renting.

The Government has not been clear whether it intends to link LHA to CPI when the freeze is removed (as it currently does in areas outside the cap) or whether it will revert to its previous policy of pegging increases to the cost of rents in the bottom 30 per cent of housing. Recent history indicates CPI uprating of LHA would significantly erode the purchasing power of recipients. This would be an unwelcome development. The Government must recognise that LHA is distinct from other extra-cost benefits because the benefit is used by claimants to pay for housing costs; it should therefore uprate LHA by a measurement that more closely measures the rising prices of private rents. This would be a continuation of the rationale behind the indexation used before the short-term cap and freeze.

3.4 Costings

Of course, the introduction of a more generous uprating mechanism would have cost implications. Taking the example of tax credits, JSA, ESA and DLA and PIP, the introduction of BUI uprating in the next financial year would cost £13 billion. A considerable proportion of this expenditure, however, is derived from reversing the freeze on working-age benefits, particularly tax credits. Indeed, on the assumption that caseloads hold constant, the difference between CPI and BUI uprating these benefits over the next five financial years would stand at £3 billion.

Figure 14: The cost of BUI indexation, £ millions (2015-16 prices)

	2016-17	2017-18	2018-19	2019-20	2020-21	Total
Cost of implementing BUI now	695	1,605	2,563	3,536	4,582	12,980
Cost of BUI over all uprated by CPI	199	398	601	804	1,017	3,019

Source: Department for Work and Pensions, *Summer Budget 2015 Expenditure and Caseload forecasts*, July 2015

The gains for beneficiaries will be significant. If BUI uprating replaced existing policy (the freeze) as of the next financial year, recipients of JSA and ESA Work Related Activity Group would be £193 a year better off by 2021. The difference between BUI-uprating and CPI-uprating would be smaller – £60 pounds a year by 2021 – but even this modest improvement would be welcome. As ONS research recently noted, the wellbeing of those on low incomes are most positively affected by increases in cash.⁵⁰

48 Christina Beatty and Department for Work and Pensions, *The Impact of Recent Reforms to Local Housing Allowances: Summary of Key Findings*, 2014.

49 Ian Cole et al., *Monitoring the Impact of Recent Measures Affecting Housing Benefit and Local Housing Allowances in the Private Rented Sector: The Response of Landlords*, 2014.

50 James Lewis, *Income, Expenditure and Personal Well-Being, 2011/12* (Office for National Statistics, 2014), <http://www.ons.gov.uk/ons/rel/wellbeing/measuring-national-well-being/income--expenditure-and-personal-well-being/art--income--expenditure-and-personal-well-being.html>.

4

Earnings indexation

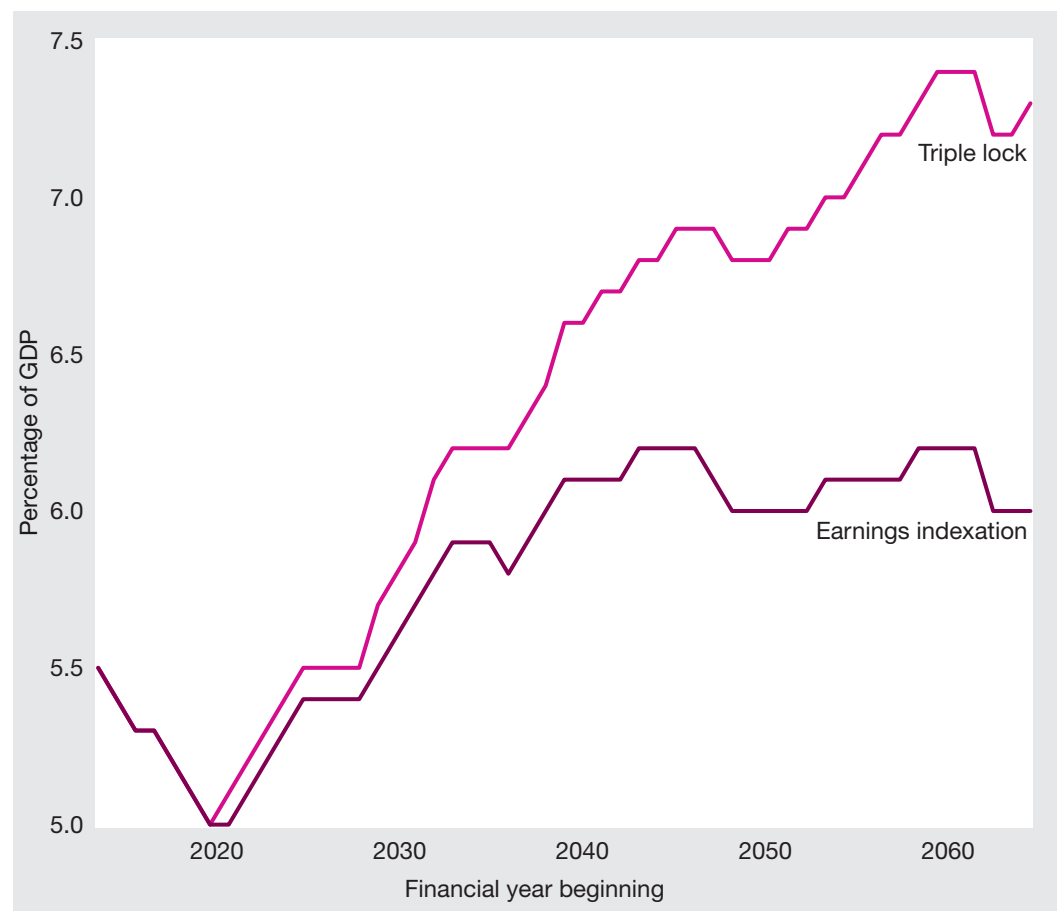
4.1	The State Pension	31
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4.1 The State Pension

The fiscal burden of welfare has remained at the forefront of the new Conservative Government's mind, with both the chancellor and the work and pensions secretary characterising the country's approach as "unsustainable" in the long run.⁵¹

The Government is right to be concerned about long-term fiscal sustainability: in each year since it was created in 2010, the OBR has judged the public finances to be unsustainable.⁵² However the issue is not so much the future cost of working-age welfare as the triple lock on the existing State Pension system as well as the forthcoming single tier (which will merge the BSP and the State Second Pension). By increasing payments in line with CPI or 2.5 per cent whenever earnings growth falls below these measures, the triple lock creates a ratchet effect on the cost of the State Pension. Chairman of the OBR, Robert Chote, has argued the triple lock will put "systematic upward pressure on pensions spending as a share of GDP" (see Figure 15).⁵³ Indeed, the triple lock is the primary driver of long-term spending growth on the State Pension, accounting for more than 70 per cent of its increased expenditure over the next 50 years.⁵⁴

Figure 15: Expenditure on the State Pension as a percentage of GDP: earnings indexation compared to the triple lock



Source: Office for Budget Responsibility, *Fiscal Sustainability Report: July 2015*, 2015.

51 Rowena Mason and Alberto Nardelli, 'Britain Responsible for "Unsustainable" 7% of World's Welfare Spend – Osborne', 17 June 2015, <http://www.theguardian.com/politics/2015/jun/17/britain-responsible-unsustainable-worlds-welfare-spend-osborne>.

52 Richard Harries and James Zuccollo, *A Framework for Fiscal Sustainability* (Reform, 2015).

53 Ben Riley-Smith, 'George Osborne's Pensions Triple Lock "Will Help Drive Britain into Deficit"', 11 June 2015, <http://www.telegraph.co.uk/news/politics/conservative/11669052/George-Osbornes-pensions-triple-lock-will-help-drive-Britain-into-deficit.html>.

54 Office for Budget Responsibility, *Fiscal Sustainability Report: June 2015*, 2015.

Historically there may have been a rationale for increasing the generosity of the State Pension: pensioner poverty was a considerable public-policy problem until the early 2000s.⁵⁵ However this is no longer the case. Once housing costs are taken into account, median pensioner incomes are now higher than non-pensioner incomes.⁵⁶ This is not to say all pensioners are well off, but it does mean that a Government that has emphasised the importance of sustainability should look to develop a more tenable mechanism by which to uprate the State Pension.

The Government could achieve this by pegging the value of the State Pension to medium-term earnings growth. This would give governments the ability to protect pensioners against inflation in the short term and ensure pensioner incomes grow in line with earnings – thereby rewarding retirees for years of hard work, as the prime minister proposed.

This policy has been pioneered in Australia. There, the State Pension is uprated in line with prices, but if this mechanism sees pensioners fall behind 25 per cent of wages, the State Pension is topped up to this level.⁵⁷ Pensioners receive inflation-pegged payments when real wages are falling, but this generosity is clawed back when the economy recovers.

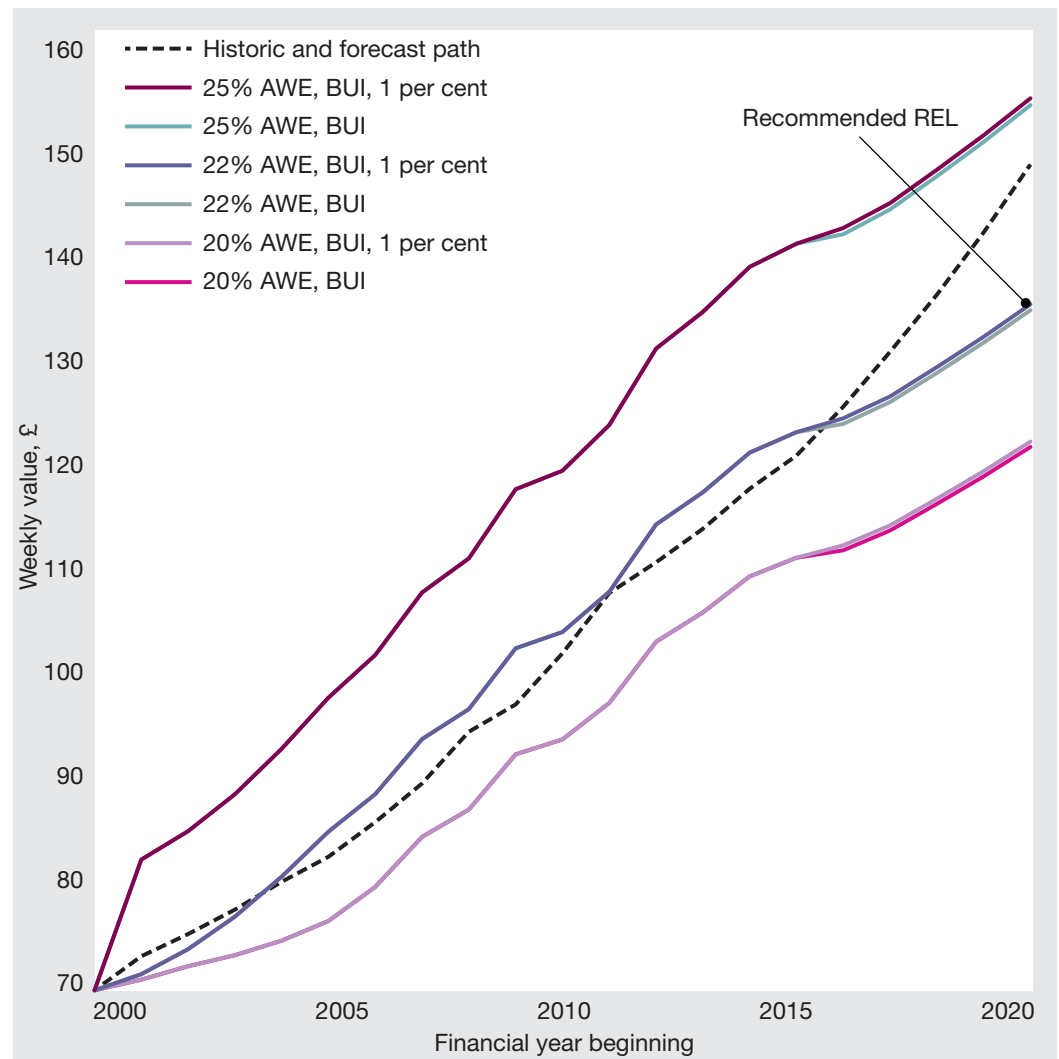
The exact dimensions of this ‘relative earnings link’ can vary. The choice of price indicator, as well as the inclusion of a constant (much like the triple lock) would produce variations, although relatively minor ones.⁵⁸ The primary determinant of the mechanism’s generosity is the benchmark at which the State Pension is set (see Figure 16). In 2010, the BSP was roughly 22 per cent of the value of average weekly wages (AWE), but policymakers might want to set this figure higher or lower.

⁵⁵ Tom McInnes et al., *Monitoring Poverty and Social Exclusion 2014* (Joseph Rowntree Foundation, 2014).

⁵⁶ Department for Work and Pensions, *The Pensioners’ Incomes Series*, 2014.

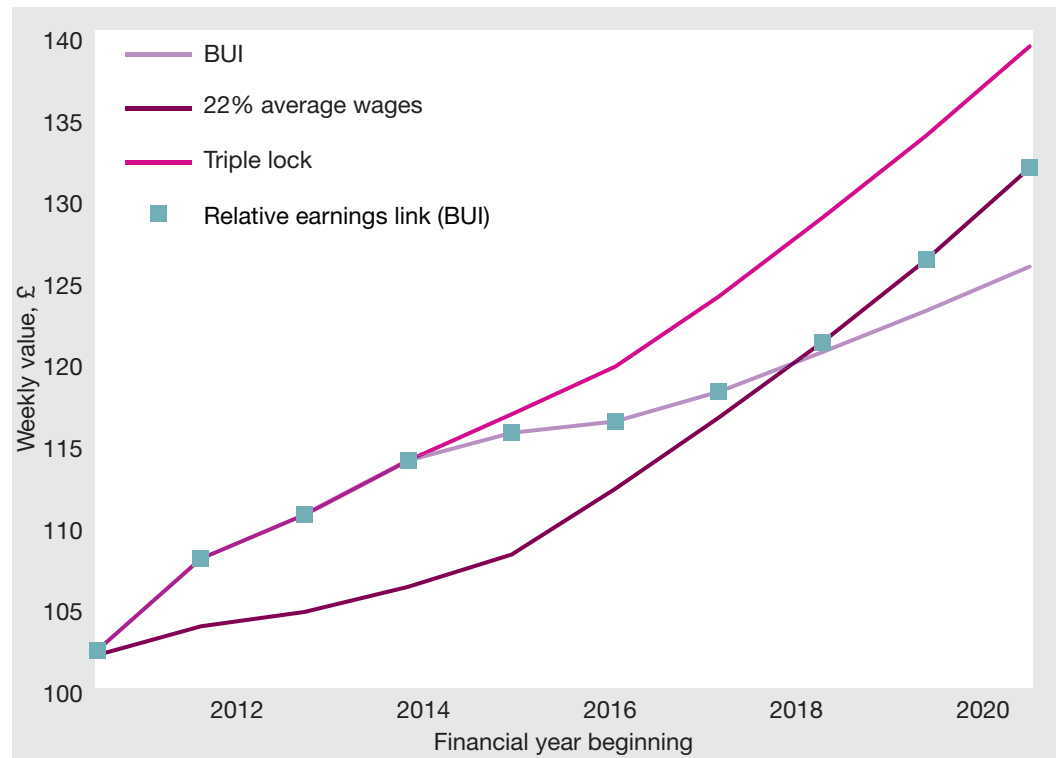
⁵⁷ Australian Government, ‘Common Provisions Affecting Indexation of Pensions’, May 2015, <http://guides.dss.gov.au/guide-social-security-law/5/1/8/50>.

⁵⁸ RPIJ would have actually reduced further the value of the State Pension over the last few years, thanks to the exposure of RPIJ to housing costs.

Figure 16: Value of the BSP, variations on the relative earnings link

Sources: Office for National Statistics, “Consumer Price Inflation, August 2015”; Office for National Statistics, “Average Weekly Earnings Dataset, August 2015”; Office for Budget Responsibility, *Economic and Fiscal Outlook: July 2015*.

A relative earnings link could save the Government significant sums of money while simultaneously satisfying the public-policy objectives of the triple lock. Take the example of a mechanism that benchmarks earnings to 22 per cent of weekly wages, uses the BUI as its price indicator, and does not employ a constant. During periods of sustained growth and recessions, this relative earnings link would function very similarly to the triple lock. It is in the recovery phase where the difference lies (see Figure 17). With real wage growth returning in 2015, the relative earnings link would have uprated in line with prices until the BSP drops down to the benchmark in 2017.

Figure 17: Effect on the BSP – relative earnings link, triple lock and average wages⁵⁹

Sources: Department for Work and Pensions, “Abstract of statistics 2014”; Office for National Statistics, “Consumer Price Inflation, August 2015”; Office for National Statistics, “Average Weekly Earnings Dataset, August 2015”; Office for Budget Responsibility, *Economic and Fiscal Outlook: July 2015*.

The short-term savings of this reform would be considerable. At the same time as protecting pensioners against inflation and maintaining the value of the State Pension in proportion to wages, this relative earnings link would reduce the cost of the State Pension by 5.7 per cent by 2020-21. If this policy was implemented in the next financial year, the cumulative saving by the end of the Parliament is forecast to be £20.9 billion in today's money.⁶⁰

The long-run gains would be far greater. A relative earnings link could reduce the government debt by up to 26 per cent of GDP over the next 50 years.⁶¹ This would be a significant step towards the long-term fiscal sustainability the chancellor has been championing since he entered Number 11.

Recommendation 4

The Government should replace the triple lock with a relative earnings link, a mechanism that pegs the value of the State Pension to wage growth in the medium term but also protects pensioners from high inflation during periods of economic volatility.

⁵⁹ Calculation based on State Pension level for man or woman under 80 with own National Insurance Contributions.

⁶⁰ Calculation based on figures from: Carl Emmerson, Paul Johnson, and Robert Joyce, eds., *The IFS Green Budget 2015* (Institute for Fiscal Studies, 2015); Office for Budget Responsibility, *Economic and Fiscal Outlook: July 2015*, 2015; ‘GDP Deflators at Market Prices, and Money GDP: July 2015 (Summer Budget 2015)’, <https://www.gov.uk/government/statistics/gdp-deflators-at-market-prices-and-money-gdp-july-2015-summer-budget-2015>.

⁶¹ Modelling based on the assumption that a relative earnings linked State Pension would perform similarly to earnings indexation. (Office for Budget Responsibility, *Fiscal Sustainability Report: June 2015*).

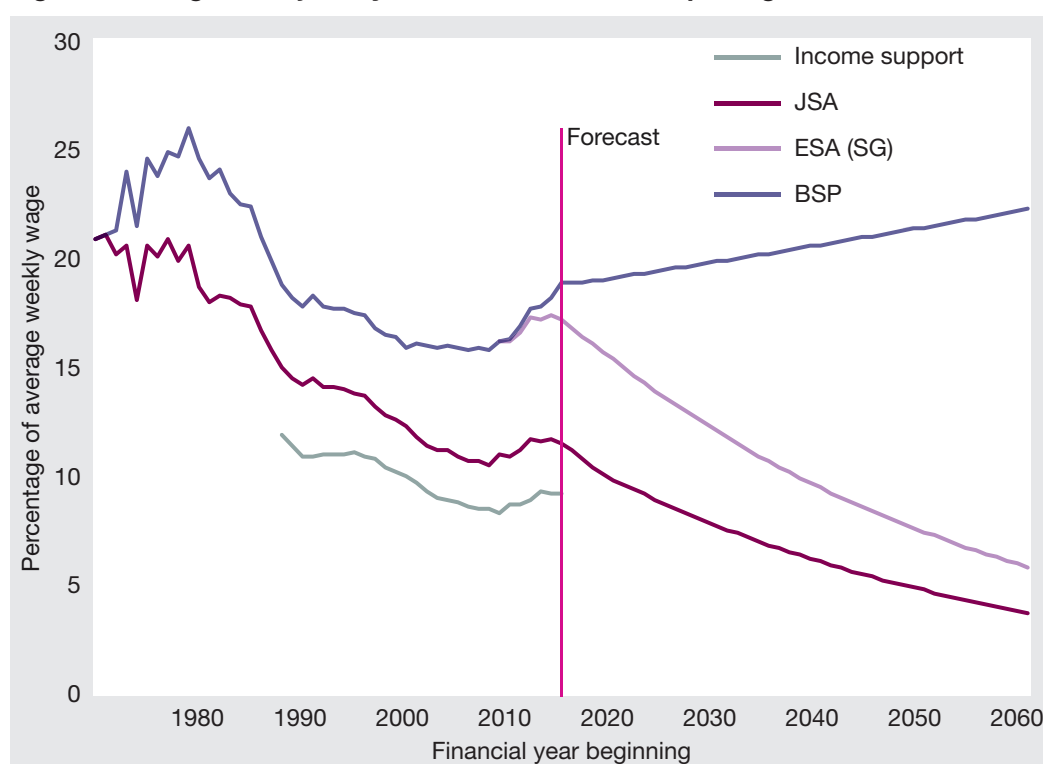
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Long-term considerations

Within the current political climate, the implementation of BUI uprating for the majority of benefits, and introduction of a relative earnings link on the State Pension would be natural developments of the Government's welfare-reform agenda. This approach continues the long-adopted practice of price indexing the majority of benefits, with additional generosity given to those on long-term income replacements.

These decisions have created (and will exacerbate) a schism between the value of BSP and other social-security transfers. In the 1970s, the BSP was administered at the same level as unemployment benefit. By 2040, the cumulative impact of uprating decisions would see the JSA component of UC administered at a quarter of the value of the BSP (see Figure 18). The future path of ESA is equally dramatic: it will halve as a proportion of wages by the late 2040s.

Figure 18: Long-run trajectory of benefits on current uprating mechanisms⁶²

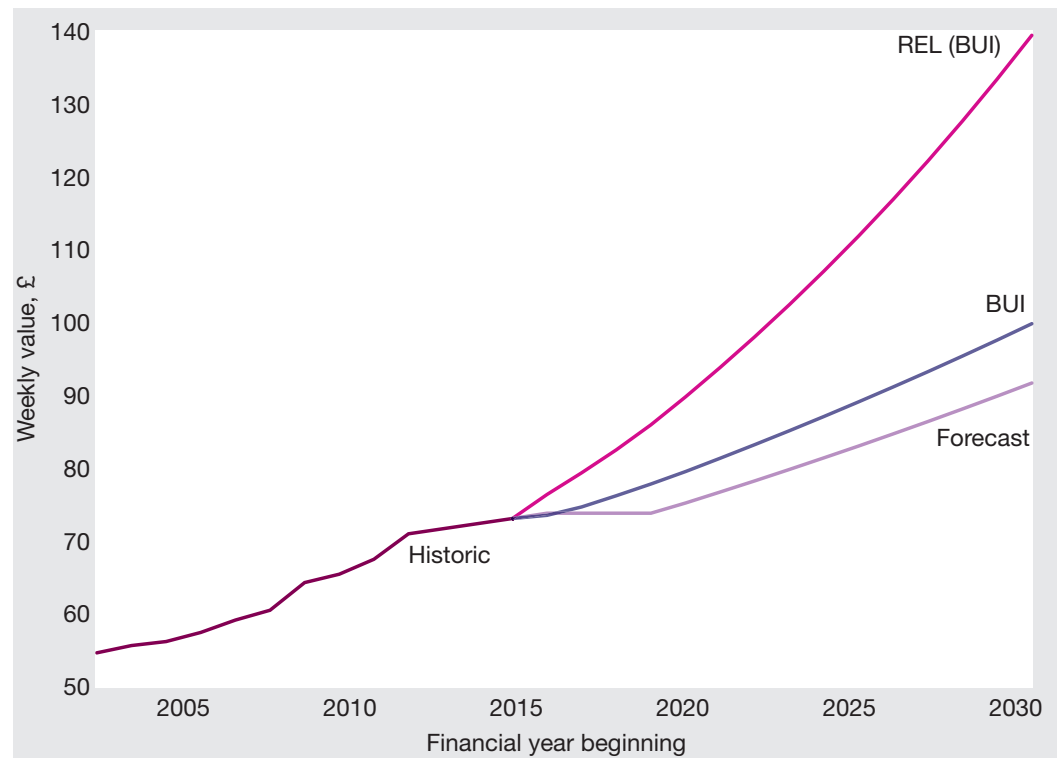


Sources: Department for Work and Pensions, “Abstract of statistics 2014”, April 2015; Office for Budget Responsibility, *Fiscal Sustainability Report: July 2015*.

The long-term divergence in the relative value of different benefits should make the Government think twice about the equity of the current policy. The case for earnings indexation would be strongest for income supplements. Tax Credits are structured to encourage employment; if they are uprated by inflation rather than earnings over the long run, the strength of this incentive will erode. A case for earnings-linking income-replacement benefits could also be made. These payments replace the function of an income for those temporarily, or permanently, out of work. An inclusive society would see these individuals share in the prosperity of those able to reap the higher returns of wage labour.

Clearly earnings-linking social-security transfers that are currently inflation pegged would have a significant impact on future value (see Figure 19). By 2030, an earnings-linked JSA component of UC would be 40 per cent more generous than on existing trend. Crucially, such a move would see beneficiary income hold constant relative to wage earners over the medium term.

⁶² Calculation based on ASHE wage data.

Figure 19: JSA, different uprating mechanisms

Sources: Department for Work and Pensions, “Abstract of statistics 2014”; Office for Budget Responsibility, *Economic and Fiscal Outlook: July 2015*; Office for Budget Responsibility, *Fiscal Sustainability Report: July 2015*; Office for National Statistics, “Consumer Price Inflation, August 2015”; Office for National Statistics, “Average Weekly Earnings Dataset, August 2015”.

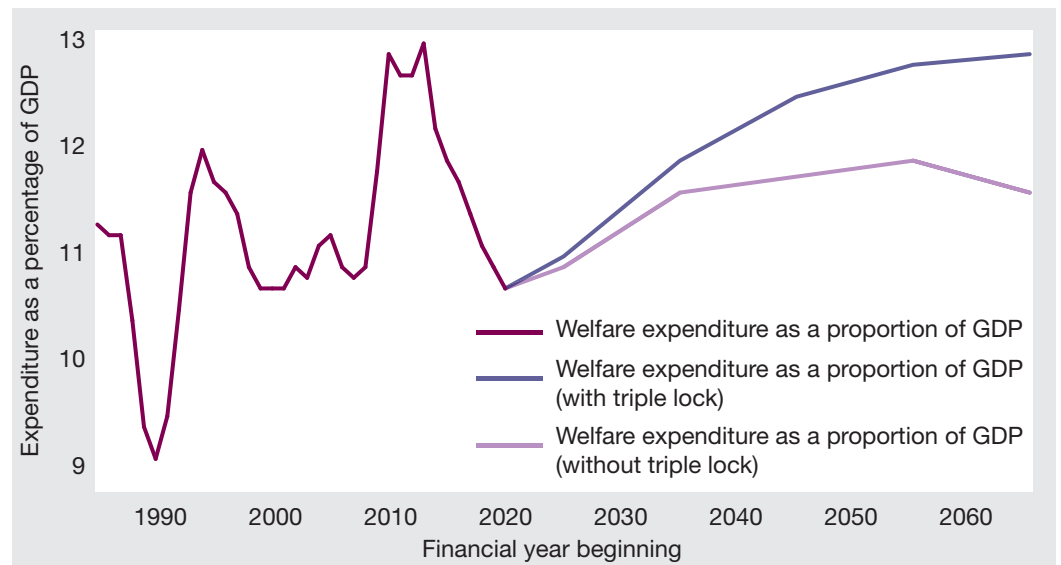
There are, however, strong counter arguments to such a proposal. The Government has repeatedly stressed the need to restructure the welfare system around work. This principle lies at the heart of UC; so too does it underpin the capping and freezing of many working-age benefits. This emphasis is well placed. Employment status has a substantial impact on individual wellbeing: for the vast majority of people, being in work is good, and being out of work is bad.⁶³ While there is ample evidence to suggest financial incentives are an important driver of labour market participation, less is known about the effect uprating policy has on employment.⁶⁴ Against this, the introduction of the ‘National Living Wage’, which will raise the level of the minimum wage to £9 in 2020, will further increase the gap between the value of benefits and wage labour, sharpening the incentive for those out of work to return to the labour-market.

A more significant concern is the effect earnings indexation might have on the public finances. This question is equally hard to unpick. Despite the persistent price uprating of benefits, the OBR assumes the value of social-security transfers will grow in line with earnings, meaning welfare spending does not fall in the long run “due to an ever-widening divergence between the living standards of those in work and those receiving income from the welfare state.”⁶⁵ Of course, this does not tally with the reality of past uprating decisions – as is clear from Chapter 2, benefits have generally been uprated by prices. The OBR’s model makes clear that uprating policy only bears on the future sustainability of the country’s fiscal position when tax receipts (which grow in line with earnings) are outpaced by the value of social-security transfers. This is exactly why the triple lock poses such a threat to the UK’s long-term fiscal position (see Figure 20).

⁶³ A review of the evidence on wellbeing and employment can be found in Gordon Waddell and A Kim Burton, *Is Work Good for Your Health and Well-Being?* (Department for Work and Pensions, 2006).

⁶⁴ James Mirrlees et al., *Tax by Design: The Mirrlees Review* (Oxford University Press, 2011).

⁶⁵ Office for Budget Responsibility, *Welfare Trends Report*.

Figure 20: A sustainable welfare state?

Source: Office for Budget Responsibility, *Fiscal Sustainability Report: July 2015*.

Removing the triple lock will create fiscal space to extend earnings indexation to income-replacement and income-supplement benefits – provided the Government holds benefit caseloads constant in the medium term. While the effect of such a move on work incentives is unknown, it is clear that by maintaining the status quo, the relative living standards of welfare recipients will continue to decline.

The Government has spoken forcefully about the need to ensure welfare spending is sustainable.⁶⁶ This is eminently attainable; but the Government should be prepared to radically reform the current uprating system to achieve this in a manner that is fair to all claimants.

⁶⁶ George Osborne, 'Chancellor George Osborne's Summer Budget 2015 Speech', 8 July 2015, <https://www.gov.uk/government/speeches/chancellor-george-osbornes-summer-budget-2015-speech>.

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