Have we robbed our children?

... and, if so, how might they respond?

by Angus Hanton October 2010

In an article entitled "Drifting to disaster" published 4 years ago I argued that Britain was living beyond its means, that the country was over-borrowed, and that the pound was overvalued. These views were treated with some scepticism at the time, but they have been largely vindicated by recent events. Meanwhile, over the last 30 years, occurring almost unnoticed, there has been a huge shift in both wealth and entitlements in favour of older people at the expense of younger citizens. The recession of the last 2-3 years has made the issue much more acute and younger adults might at some point raise serious objections. How this has happened and what might result from it should be of concern to all of us.

In contrast to our own prosperity, our children face bleak economic prospects. We in the UK have consumed wealth where other countries have saved for future generations; our government has borrowed very heavily against hoped-for tax revenues and we have made over-generous pension promises that are likely to prove unaffordable. Longer life expectancies and the increasing ratio of retired to working adults are steadily increasing the burden on the younger working population. Righting this misallocation will be made harder because of the sales of industrial assets, which is illustrated by the recurrent pattern of large trade deficits. Successive governments have added to the challenges facing younger workers by making them take on borrowing to pay for their education, and recent pressure on the labour market has made it especially hard for them to find and retain employment.

The possibility of a growing inter-generational struggle has received very little attention. Perhaps this is because some of the tensions have only recently become pressing and the issues do not fit neatly into a single academic specialisation: pensions, public finance, inflation and housing policy are each very different disciplines, but in each of these areas the extent of the skewed distribution of wealth and entitlements is becoming apparent.

The cupboard is bare due to over-consumption

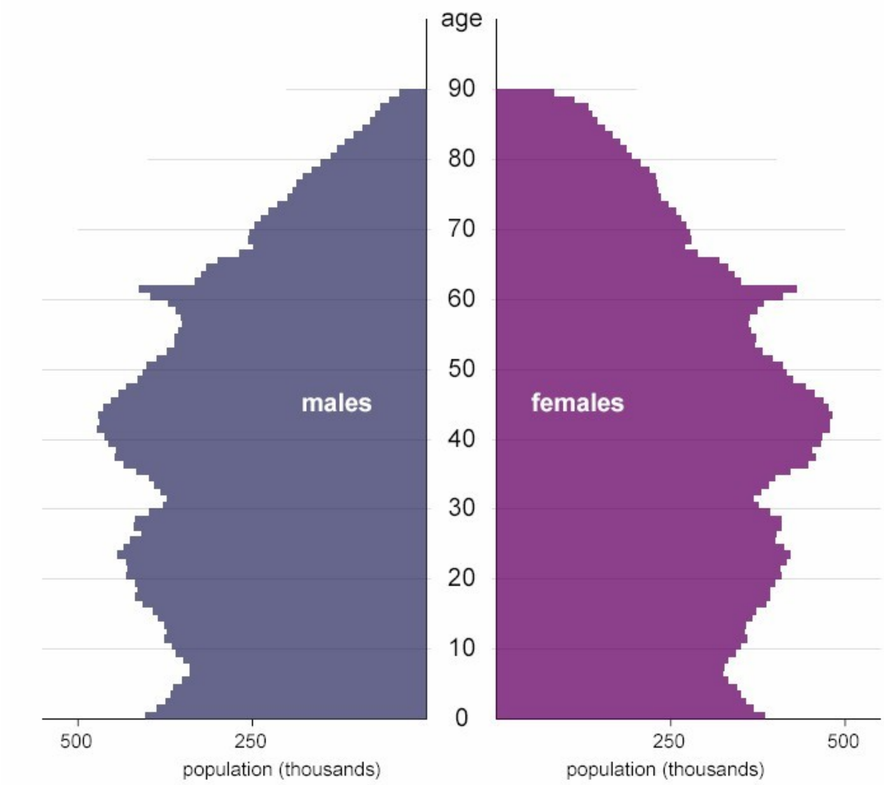
The financial squeeze that the government now faces is partly a result of having few reserves to meet its commitments. For example, Britain has always had a policy of extracting North Sea oil as fast as possible and spending all the revenues from oil field licensing and petrol taxation. Some countries have had policies to spread their oil windfalls between generations. One way this has been done is a depletion policy that limits the rate at which oil is extracted in order to allow future generations to benefit. Another way is to build up funds from the oil revenues with a view to looking after the aged and saving for the future. Norway, for example, has an oil fund that is now worth about £230 billion - equivalent to almost £50,000 of government savings for each Norwegian citizen. This fund has holdings of equities, bonds and property across the world. The contrast with the UK in how wealth has been shared between generations is striking. Some economists see the UK's discovery of natural resources as a “resources curse” similar to that which has afflicted developing nations where the extraction of the natural resources keeps the exchange rate artificially high and allows the running down of alternative manufacturing industry. If the North sea oil windfall has contributed to the reduction of Britain’s industrial base then this represents an extra cost for younger people and future generations.

In addition to having spent the large North Sea windfall, the UK government has borrowed very heavily: it now predicts that total national debt will shortly rise above £1,000 billion (one trillion pounds) and is likely to rise significantly further. The borrowing is so large that in June 2009 the Bank of England Governor, Mervyn King, raised the possibility of national bankruptcy as he warned that, without a credible plan, Britain could struggle to finance its ‘extraordinary’ deficit. He warned that a recovery was ‘more uncertain than ever’ and the nation faced a ‘long, hard slog’ to get back on its feet. Even with the planned cuts, the government accepts that its debt will shortly exceed 80% of GDP. However, it could rise significantly higher than this - as the economy shrinks the same debt will represent a higher percentage of GDP. Putting the government’s debt in per-household terms, and assuming a debt of “only” £1 trillion divided by about 17 million families gives a national debt on a per-family basis of about £60,000. However, the projected total taxpayer liabilities are much higher if one includes the loans to banks and unfunded pension liabilities. Taking into account the unfunded pension liabilities the total “national debt” is over £2,000 billion, or about £120,000 per household.

Residential property - the silent partner for many older Britons

While the UK government has been getting into debt, older Britons as a class have been getting wealthier. One major source of this wealth is private housing where owners have gained from a long-term shortage and from favourable tax treatment. A shortage of permissions for new house building and a rise in the value of housing assets has led to the average house rising in price to about £160,000 being at least three times the cost of building a new home. The high value of building plots has been created by strict rationing of planning permissions and the beneficiaries are the incumbent owners. With a housing stock valued at about £4.0 trillion and associated debt of about £1.2 trillion, this suggests a net housing asset per UK adult of about £58,000, and ownership of housing assets is obviously heavily skewed to the older population. By contrast the bulk of housing debt is naturally associated with borrowings by younger owners. In effect the current generation of owners is saying to those younger workers who need housing that they must pay a heavy cross-generational premium to acquire their houses and flats. Whilst the older generation have the lion’s share of the equity in the housing stock, they also benefit from favourable tax treatment: when they do sell they pay no capital gains tax and the transaction tax (stamp duty) is paid by the buyer. The financial benefit of home ownership includes low property taxes even including a reduction for single occupants which can be seen to subsidise “hoarding” of housing by older single people.

The housing imbalance is made worse by the aging of the population so that older people hold on to their houses longer and absorb more of the limited stock. This is happening in two different ways which combine to squeeze the young: people are living much longer but there are also fewer young people because of lower birth rates in recent years, as the population graph shows. On top of this, we have now started to see the effect of the baby-boomers retiring in large numbers – people refer to the demographics looking like a pig passing through a python but this analogy implies a problem that will soon pass, whereas in fact we are seeing a permanent shift to an older population.

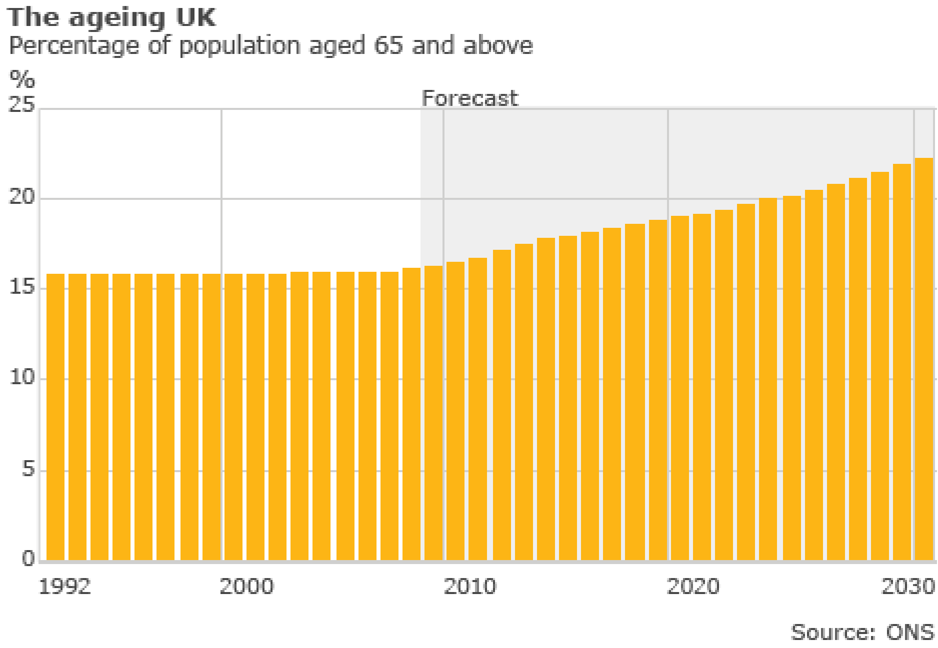


Age structure of the UK population, mid 2008, from statistics.gov.uk

The IMF has highlighted how critical these demographic changes are and has said recently, "in spite of the large fiscal costs of the crisis, the major threat to long-term fiscal solvency is still represented, at least in advanced countries, by unfavourable demographic trends".

Pensions - paradise or fantasy?

When the old age pension was introduced in 1911 the pension age was 70 and the average life expectancy was 68. Retirement ages have been reduced since then, whilst those retiring can expect much longer, and more expensive, retirements. Someone retiring in 1970 might have had a life expectancy of just a few years, whereas a man retiring at 65 today has a life expectancy of over 20 years and it is projected that someone born today will have a life expectancy of over 92. The percentage of the population over 65 will rise, according to the OECD, from about 15% today to about 22% over the next 20 years and will move towards 25% of the population after that. Moves to increase the retirement age are slow and small. It looks probable that it will be increased to 67, after much debate and delay, but life expectancies are running well ahead of such increases.



Retired people are not just living longer, they are also costing more, particularly the costs of their healthcare and nursing care. Almost 20% of Government spending is on health and an increasing proportion of that is on medical costs geared towards the older generation. With the current downturn, the likelihood is that this percentage will increase as it has done in previous downturns according to a recent report by the OECD. We know that the National Health Service finds older people disproportionately expensive to look after and many treatments aimed at exending life are particularly expensive to deliver.

The pensions that have been promised to many of those in the older generation are very generous. Retirement ages and levels of pension were mostly set when life expectancies were much lower and when people generally started work at a younger age. Typically these pensions are final salary schemes, which means an entitlement to a large proportion of final salary for the remainder of the retiree's life, often as much as 2/3 of the highest salary earned. These pensions are usually index-linked and are often transferable to spouses. Both private sector employees and civil service employees have these generous entitlements, but one can get a feel for the economic impact if one considers that there are currently about 5.2 million civil servants out of a working population of about 29 million. The pensions of these workers are often shared between couples and are transferable to surviving spouses, so the number of likely beneficiaries is much larger even than the combined numbers of current and retired civil servants. There is a final twist to this picture: those with these generous pensions are likely to live longer than average as they are in groups with longer life expectancies – civil servants and the middle classes in general – so society's current pension and healthcare commitment is bigger than it might seem.

Pulling up the ladder behind us

In the private sector these final salary pensions are now being rapidly phased out and replaced with money-purchase pensions that will be far less valuable. When the workers without final salary schemes see what has happened they may come to resent that they will not be getting these pensions but also that they are paying for many others in their companies to enjoy them. In due course when the government reduces pension entitlements for civil servants, as it must surely do, both new government employees and taxpayers may object to the sheer cost of pensions to which the government is committed. The most worrying figures on government indebtedness relate not to the borrowing required for a particular year but the gap between the present value of the government's commitments and the present value of its likely assets and future income.

Whilst government employees and those in private pension schemes have these generous pensions, those who only receive the basic state pension are being particularly hard hit, so that pensioners are rapidly dividing into two classes – those with occupational pension schemes and those dependent on a state pension. At only 30% of average earnings, the British state pension is the lowest in the OECD and contrasts with countries such as Holland and Spain where the government pays over 80% of average earnings (figures from "Pensions at a glance", OECD Paris 2007). So the retired population will be far from uniformly well-off. Already many of those who reach retirement age and are dependent on the state pension need to continue in work. They are often well positioned to get work as they are experienced, but the impact on the labour market is significant. In the recent downturn younger workers have lost out to older workers: redundancy rates for young people have already experienced relatively large increases – in the year to March 2009 unemployment rates for 18-24 year olds increased by a third from about 12% to 16%. At the other end of the scale employment rates for the over 65s have actually increased. Some younger people may feel that not only have the older generation as a group taken a disproportionate share of national wealth but that they are now also taking or keeping too many of the jobs.

Pensions under-funded or unfunded?

In the case of the private sector many pension schemes are already heavily under-funded, with schemes in deficit being under-funded by about £130 billion, which means that the current and future workers in these companies will have to make significantly increased contributions to make up this shortfall if the old pension promises are to be honoured. The state sector is in an even worse position and has sometimes been referred to as an official "Ponzi Scheme" because it has no actual fund to pay the pensions of retired civil servants or the basic state pension but it depends completely on money from new entrants to pay out to those who are already retired. Those pensions will have to be paid from general taxation and inevitably largely from those in work.

These pension promises can be seen as promises the older generation has made to itself on the assumption that the younger workers will be willing and able to deliver on them. When combined with higher life expectancies and a manifestly weak economy, such generous pensions arguably represent a breaking of an implicit social contract between older and younger members of society. Retired people will not give up their entitlements willingly, so renegotiation will be very difficult and at some point the government may be forced to find a way of breaking the pension commitments. This could be done by changing the law but, given the contractual nature of pension entitlements, it would almost certainly face legal challenge. If these promises cannot be afforded some will argue that they are better broken sooner rather than later before the current imbalance becomes worse. Pressure on government spending may also require large reductions in health expenditure which would disproportionately impact the elderly.

The government have calculated their pension liabilities at about £2.2 trillion but this is based on using a discount rate for working out the present value of future liabilities of 3.5% plus inflation which some people believe is too high. Such is the sensitivity of these liabilities to different discount rate assumptions that a more realistic and lower rate would increase the liability by at least one trillion pounds.

One way in which older Britons have enjoyed their wealth since the early 2000s is by employing immigrant labour from Poland and other Eastern European countries. During the boom years of high employment this hasn't mattered too much to younger British workers whilst there has been fairly full employment, but as the downturn continues tension over jobs could increase. The wealthy middle classes benefit enormously from cheaper domestic labour and services, whereas for younger workers this immigration keeps often wages down and they may feel that Eastern Europeans have taken their jobs. The number of new immigrant workers is estimated to be well over 1 million in a workforce of about 29 million. This addition to the labour market, combined with the downturn, has clearly driven down real wages in many sectors.

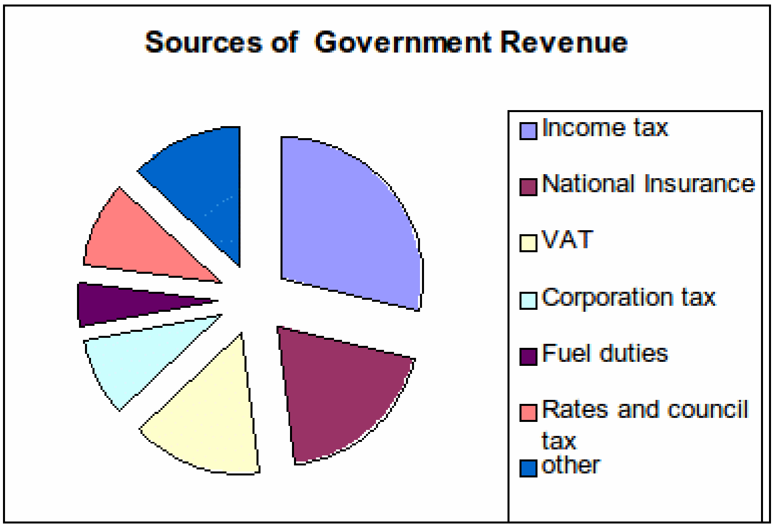
About 50% of teenagers now take up tertiary education and on leaving college they have average debts of about £15,000 – which their parents didn't have. Seeing the relative wealth of their parents' generation may concentrate their minds on the intergenerational wealth issue.

The break-up of consensus over inflation, housing and taxation

The interests of the young and old are in conflict over some critical economic and fiscal questions. Where there has previously been consensus this is now in danger of breaking up. Keeping inflation down as a primary policy objective has achieved widespread agreement, such that the Bank of England's monetary committee strives to keep inflation low as its main objective in setting interest rates – and it is even bound by law to do so. Yet some inflation, for all its disadvantages, may actually be an effective way of redistributing wealth back to the young. In an inflationary environment wages should move up with prices whereas most stores of capital are reduced in real value. Inflation would both erode the debts of younger workers and severely reduce the value of savings. Looked at another way, assets held by the older generation can be seen ultimately as a right to demand work from the younger generation and the right to charge rent in various forms (such as charges for the use of capital and housing). Inflation will reduce the relative strength of the claims of the holders of capital, being in effect a tax on capital. It may also lead to a period of negative real interest rates creating a subsidy to borrowers. Inflation has the additional advantage to government of reducing the real burden of its own debts and actually increasing taxation through mechanisms such as fiscal drag.

Rapidly rising prices confiscate wealth from savers without the bother of taxing them. Illustratively, in a non-inflationary situation, if people earning a 5% return on their savings are taxed 40% on the interest they will probably grumble a little. However, consider the same people earning 5% “tax free” where the background level of inflation is 10%. The real rate of tax they are facing on their interest is 200% - in effect they are losing all their interest and some of their capital, yet they appear at first glance to be earning a tax-free return. Inflation is, in this way, a hidden tax on savings and, despite the disruption it causes, would be a crude but powerful tool for inter-generational wealth redistribution.

In order to address the housing shortage and high house prices, the government may be pushed into allowing more building, relaxing planning controls and freeing up building land on a much larger scale than it has done recently. Younger voters wanting homes may push for the freeing up of planning controls and they may push for the reduction in the favourable tax treatment of housing which is redistributive towards the older generation.



from HM Treasury “Current Receipts” Budget 2008

As this diagram shows, almost half of the £600bn which the Government currently spends is raised through employment taxes (income tax and NI). The consensus that extra revenue has to be raised from employment taxes is breaking up and some politicians are advocating a wealth tax (tax on higher value houses). The question of where taxes fall (as between employment taxes and other taxes) risks dividing the retired and working populations. If employment taxes are to be kept down, consumption taxes and various capital taxes might have to be increased to levels not seen before.

Assessing the impact of new policies in terms of intergenerational wealth

If policymakers are concerned about these issues they need to start systematically measuring the impact of new measures on the intergenerational wealth problem. At present any budget measures require that the Treasury work out the likely impact on Government revenues. Perhaps a new requirement should be that any new law should be assessed as to what impact it will have on intergenerational wealth. This will not solve the immediate structural problem but it should stop measures being enacted that inadvertently make these conflicts more acute and further transfer wealth and entitlements from the young to the old.

Why does all this matter?

Apart from any questions of fairness, many will ask whether it matters that wealth shifts towards the older generation. It will certainly matter to today's politicians and their contemporaries if, in due course, a new generation of policy makers decides to cut healthcare for the elderly and choose economic policies that lead to inflation. It would matter even more to them if successors choose not to honour current pension arrangements. George Magnus, in his book "The Age of Aging", outlines a further way in which younger workers may react to high taxes, expensive housing and generally poor prospects: they may emigrate in large numbers, making life harder for those remaining. Such emigrations are worse for the economy than mere numbers suggest because those leaving are typically young, able and energetic.

Ultimately the danger is that younger workers may react with anger, and maybe force, to the withdrawal of final salary pension schemes (whilst keeping old ones in place), the difficulty of finding jobs, high employment taxes, and the difficulty of finding affordable housing. Whilst economic downturns tend to bring out divisions in society, this downturn also risks increasing tensions between young and old. It may be that policy-makers will start taking more account of the distorted distribution of wealth between generations and make adjustments less painful. The danger, if they do not, is that we may come to realise that, as Keynes said, "civilisation is a thin and precarious crust."

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