CSFI
Centre for the Study of
Financial Innovation

## Work and Pensions Committee
## Intergenerational fairness inquiry

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**Submission from:**
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## Introduction

The Centre for the Study of Financial Innovation is an independent, not-for-profit think-tank based in London. It provides a forum for debate and research about the future of the financial services industry.

Jane Fuller, co-director, is responding to this inquiry in her role as pensions fellow. She is the author of *The Death of Retirement,* published in July 2015, and has contributed to HM Treasury's consultation: *Strengthening the incentive to save: a consultation on pensions tax relief.* For more information about the CSFI's pensions programme, see:
http://www.csfi.org/pensions

The main reasons for contributing to the work and pensions committee's inquiry are
a) the CSFI's pensions programme has addressed several of the issues being considered in the inquiry into intergenerational fairness;
b) to argue that recent pension reforms have laid the foundations for a fair and sustainable approach to the state pension and will provide appropriate incentives for work-based long-term saving;
c) to question the argument that the baby boomer generation has unfair access to a large share of the state's resources, at the expense of younger generations, and has created an unaffordable fiscal burden.

The questions raised by the inquiry are in the detailed section of this response, in bold type. I have altered the order of a few of the questions in a way that I hope is clear.

# Executive summary

## Recommendations are marked in bold type

## The state pension

- The UK government was slow to respond to increased life expectancy by raising the state pension age. Changes to the SPA for women and then for all are being implemented in this parliament. **Further increases are planned, with a target of 70, and should be accelerated** by the review that was launched in March 2016.
- **The policy principle that people should receive a state pension for a third of their adult life should be dropped.**
- The UK's state pension is not (and will not be) generous by international standards. The increases now in train are addressing historic inadequacy.
- While total spending on state pensions is rising, the twin aims are to lift pensioners off means-tested benefits and to provide a non-means-tested platform for private saving, removing a disincentive.
- **As the state pension rises, the cost of other benefits claimed by pensioners will fall and the case for pensioner-specific benefits, such as the winter fuel allowance, withers away.**
- **There should be a target for the state pension of 60-67% of the national living wage. The triple lock is one way to get there but should be abandoned once the target is reached. Then the state pension should generally rise in line with the NLW.**

## Interaction with other areas of public spending

- **Health:** people cost the NHS more as they near the end of their life – this is not an issue of intergenerational fairness. The issue is the bulge in the ageing population created by the baby boomers.
- To tackle the disjuncture between free hospital/local authority services and expensive nursing home/domestic care, **some charges could be considered for hospital stays** eg for food. In the home, robotics and other forms of **automation could reduce care costs and enable more people to stay in their homes**.
- The care of many older people is being funded by their savings, including the wealth stored in their homes. The Care Act, which addressed the perceived unfairness of this open-ended liability, has been postponed.
- A rational debate is needed on the decisions being made about hospital interventions, palliative care and assisted suicide.

- **Education:** spending on schools has been protected.
- A substantial part of the cost of a big expansion in higher education is being borne by today's students. While it should be remembered that a much smaller proportion of baby boomers went to university, the current position is unfair – **a graduate tax would be fairer.**
- If the cost of higher education needs to be curbed, **limiting access needs to be considered**. Young people will, in any case, respond by

finding less expensive (to the state) forms of training, such as apprenticeships.

## Welfare policy

- The barometer should be tackling poverty and removing disincentives to work and save, not comparisons that suggest the government could rob Peter (pensioners) to pay Paul (younger people).
- Apart from the state pension, **all adults should be treated equally by the benefit system. This means that pensioner-specific benefits (other than the SP) should be phased out.**
- To control the overall cost of welfare, the government is rightly aiming to reduce state subsidies to the private sector, eg through the NLW and by capping payments for housing. The new universal credit system is designed to tackle disincentives to work and to earn more.

## Non-welfare issues

- **House prices:** luck with market timing is not an issue of intergenerational unfairness. Some older people who have benefited from house price rises in recent decades suffered negative equity in the late 1980s/early 1990s.
- Current high prices look unfair to younger people as they make home ownership difficult to afford. **The key remedy is to increase supply**.
- **Debt:** see above on student debt, which is a source of intergenerational unfairness.
- However, high prices are linked to the falling cost of credit, which has benefited borrowers and disadvantaged savers. The latter tend to be older people. Very low annuity rates are one example of the way their interests have been damaged.

## Tax and incentives to work and save

- Older people are working in ever-increasing numbers, helped by the abolition of a default retirement age and in response to increased life expectancy, less generous occupational pensions and poor annuity rates.
- Pensioners pay tax: £13bn on personal (non-state) pension income in 2014-15 (PEN 6 Table on the cost of pension scheme tax relief). The number of people over 65 paying tax has risen from 4.91m in 2010-11 to an estimated 5.75m in 2015-16 (HMRC Survey of Personal Incomes). The above points cast doubt on the usefulness of the “dependency ratio”.
- Incentives are needed if people are to save for the long-term, giving up access to the funds for decades. Recent reforms, notably auto-enrolment into work-based schemes, rightly target low to moderate earners.
- Reductions in tax allowances for annual and lifetime pension contributions have only affected the better off. **If the rate of tax relief were equalised at about 30% (between the standard rate of 20% and the higher rate of 40%), it would enhance incentives for the vast majority.**

- **The government can both improve tax incentives for most workers and reduce the overall cost of income tax and national insurance exemptions.**

## Answers to specific questions

**What has been the collective impact on different generations of policies in recent years, including welfare reform and deficit reduction with areas of protected spending?**

The state pension age

1. When the UK brought in the Old Age Pensions Act in 1908, the state pension age (SPA) was set at 70 – an age only about one in four people reached. Since then, life expectancy for men at 65 has risen from less than 11 years to 19 years, and for women from 12 to 21 years. Is it “unfair” that the UK government was slow to react to increased longevity by raising the SPA? If the answer is yes, how quickly can it be corrected without being unfair to people approaching retirement?

2. The problem is aggravated by retiring baby boomers (born 1944-63), According to the ONS, the number of people above the SPA is forecast to rise to more than 13m by 2025, nearly 14m by 2030 and 16.6m by 2040. The best way to tackle this is by accelerating the rise in the SPA.

3. Lifting the SPA for women and then for all by 2020 limits the number of people above SPA to just over 12m during this parliament and is forecast to save about £5bn in 2020-21 (Pensions Act 2011, Impacts – Annex A). A review of the SPA was launched in March 2016. A crucial step is to abandon the policy principle that people should spend a third of their adult life receiving a state pension. This would clear the way for a much more rapid rise in the SPA towards 70.

**Areas of protected spending**

Pensions

4. An earlier policy to mitigate pension costs was to reduce its value per head: the basic state pension fell from 26% of average weekly earnings in 1979 to less than 16% in 2008, according to DWP figures. Compared with other developed nations, the UK is economical in its pensions spending. According to the OECD, “On average pension expenditure is forecast to grow from around 9.0% of gross domestic product (GDP) in 2010-15 to 10.1% of GDP in 2050”. The UK is projected to peak at 8.4% in 2040.

5. Current reforms to the state pension system both correct the historic unfairness of a low state pension and remove a disincentive to save. The policy goal of lifting pensioners off means-tested benefits is a worthy one. The quid pro quo is that other pensioner-specific benefits will either fall

automatically (eg pension credit) or should be withdrawn as no longer necessary (eg winter fuel allowance). The following table shows that this process has started:

**DWP: expenditure directed at pensioners, march budget 2016 [updated 7 April 2016]**
(selected numbers)

| 2015-16 | | Forecast 2020-21 |
|---|---|---|
| State pension | £89.3bn | 103.3bn |
| Pension credit | 6.08bn | 5.28 |
| Housing benefit | 6.52 | 5.35 |
| Attendance allowance | 5.49 | 6.36 |
| Disability living all'ce | 4.76 | 2.9 |
| Winter fuel | 2.08 | 1.96 |
| TV licence | .62 | - |
| Personal Indep pay't | .28 | 2.18 |
| … | | |
| Total | 116.2bn | 128.5 |

6. As the state pension becomes more generous, pensioners are lifted off other benefits, saving a net £1.7bn a year by 2020-21 (the controversy over savings on personal independence payments has limited the offsetting savings.) Further falls in pension credit might be expected. The case for the winter fuel allowance (**cost £2bn**) and free TV licences (already tackled by switching responsibility to the BBC **saving £620m**) also withers away.

**Is the triple-lock necessary to prevent future increases in pensioner poverty What would be the effects of reforming the triple lock and how might the worst of these be mitigated?**

7. No. The triple-lock is one way of raising the state pension to an acceptable level. The more important policy point is to have a goal eg 60-67% of the national living wage. Once reached, the state pension should generally rise in line with the NLW.

8. The new single-tier pension (£155.65 per week) is 54% of the NLW (£7.20 per hour) on the basis of a 40-hour working week. It is already nearly 62% on the basis of a 35-hour week. So, by some measures, a target of at least 60% of the NLW is in sight. However, with the NLW set to rise by 4-5% a year, if it is to exceed £9 by 2020, even the triple lock will not ensure that the state pension keeps up.

9. It should also be borne in mind that the reason for not targeting 100% of the NLW is that the retired are deemed to have fewer expenses eg many own their homes outright. If they are paying rent, they will still be entitled to housing benefit, for instance.

**How might other benefits such as Winter Fuel Payments be reformed?**

10. As mentioned above, the need for pensioner-specific benefits should wither away as the state pension is increased. This is consistent with the overall policy of lifting as many adults as possible off benefits and encouraging them to be independent.

**How does the welfare system interact with other areas of public expenditure and income and wealth in the wider economy, including issues of health, education and housing**

Health

11. Spending on health is not only protected but is being allowed to rise by £10bn in real terms by 2020. This will help to cover the cost of care for the elderly. According to some estimates, an 85-year-old receives five times as much NHS spending as a 40-year-old. This is not a source of unfairness for individuals since young people will one day be old. But is the burden of supporting a large cohort of ageing baby boomers unreasonable? Rationing healthcare is a sensitive issue and includes issues such as assisted suicide.

12. There are a number of ways in which the cost can be, and is being, mitigated. First, the issue of free hospital care but expensive home and nursing home care needs to be tackled. It should be remembered that the care of many older people is being funded by their savings, including the wealth stored in their homes. The Dilnot report, feeding into the (postponed) Care Act, treated this as a source of unfairness to the elderly. It may be that some charges can be levied on people in hospital, eg for food. Similarly, prescription charges could be reviewed.

13. Ways need to be found to make better use of robotics and other forms of automation to care for the chronically sick, with the aim of keeping them in their own homes for longer.

14. A policy debate should be had on rationing care for those approaching the end of their lives: whether to provide hospital treatment that will only extend life temporarily or to shift the emphasis towards palliative care elsewhere.

Education, including student loans

15. At the other end of the generational spectrum, spending on schools has been protected and access to higher education has been greatly expanded. According to the OECD, the percentage of the UK population aged 25-34 with tertiary education rose from less than 20% in 1970 to nearly 50% in 2013.It can be argued that it is unfair that previous generations (albeit a much smaller proportion of them) enjoyed free tuition in higher education. Now the cost is up to £9,000 a year and, once a salary threshold of £21,000 is reached, 9% of salary is deducted in debt repayments.

16. A fairer way to raise money to fund higher education would be a graduate tax, since the argument is that graduates enjoy higher earnings. The overall cost could also be reduced by curbing access. Raising fees may have this impact, although it is a poor filter for academic talent. Tuition fees may prompt young people to look at the cost-benefit trade-off and instead seek apprenticeships (for which a levy has been introduced), or other in-work training. Some firms, including in accountancy and insurance, have increased recruitment of school leavers.

17. The overall point is that the position is very different for the current generation of students and recent graduates to the one prevailing when the baby boomers went to university.

**To what extent is intergenerational fairness a welfare issue?**

Welfare policy

18. The barometer here should be tackling poverty and removing disincentives to work and save, not comparisons that suggest the government could rob Peter (pensioners) to pay Paul (younger people). Raising the state pension to a level above means-tested basic income support is a fair way to tackle pensioner poverty.

19. Access to benefits that are not pensioner specific, such as housing benefit, should be on an even footing. As mentioned above, pensioner-specific benefits will either fall automatically or should be phased out. Apart from the state pension, all adults should be treated the same by the welfare system.

20. Separately from pensions-related reforms, the government is acting to control spending on welfare. For instance, the new national living wage will reduce subsidies to employers who are paying low wages, and capping housing benefit will curb subsidies of private-sector rents. Raising the income tax threshold and implementation of the universal credit system are tackling disincentives to work and earn more.

**Non-welfare issues:**

House prices

21. Is good luck with market timing unfair? Some older people who have enjoyed rising prices since the early 1990s had experienced negative equity before that. The remedy is to increase the supply of houses, as has often been pointed out. If this finally happens over the next decade, younger people will have better access to affordable housing. Every suggested reform – eg speedier planning consent, releasing publicly owned land, denser construction on brownfield sites, redrawing the green belt – should be pursued.

22. There is a case for taxing windfall gains. While taxing capital gains on the sale of the primary residence is a logical option, stamp duty is serving as a semi-progressive tax on house prices. The freezing of the IHT threshold has also captured some of the gains. Even with the additional nil-rate band of up to £175,000, IHT receipts are forecast to rise from £4.4bn in 2015-16 to £5.8bn 2020-21.

Debt and falling interest rates

23. Interest rates have fallen dramatically since 1980 (UK benchmark government bonds yielded 14-16% in 1980-82 and are now below 2%). This means that that although the house price:earnings ratio is relatively high, mortgage affordability as a percentage of pay is less stretched and remains below peaks before the financial crisis and in 1988-1990.

24. While the rise in house prices fuelled by a lack of supply is a policy failing, all borrowers have benefited from the falling cost of credit. This helps younger generations because average household debt tends to peak between the ages of 25 and 40 (British Household Panel Survey/Bank of England). The absolute level of average debt roughly doubled for this cohort between 1995 and 2005, but the survey nevertheless showed average debt dwindling to very little by the age of 65 for both dates. However, with mortgage terms lengthening there is concern about mortgage debt lasting into old age.

25. Another consideration is that low interest rates have badly affected savers. Take annuity rates: for a 65-year-old with £100,000 to invest in February 2016, the annual income with no inflation proofing was less than £5,400, which means if he died on cue 19 years later, he would just have got his money back – without interest or compensation for lack of access to the funds. This helped to make the case for freedom of choice in the use of retirement savings.

26. Pensioners tend to be savers rather than borrowers and so have been disproportionately affected by low interest rates in all savings accounts.

27. Student loans are dealt with above (pars 15-17)

**To what extent will existing policies encouraging work and savings ensure a more sustainable system?**

Pensioners pay tax

28. Since 2010-11, the number of people aged 65-plus paying tax has risen from 4.91m to an estimated 5.75m in 2015-16 (HMRC's survey of personal incomes); and tax liable on pension payments amounted to £13bn in 2014-15, up from £11.3bn in 2010-11 (HMRC's PEN 6 table).

29. A rising SPA and the end of the default retirement age of 65 have boosted the number of people aged 65+ in work. Fewer than 800,000 were in work at

the start of 2010; by late 2015, there were more than 1.2m (ONS UK Labour Market, January 2016).

30. This calls into question the use of the "dependency ratio" as a barometer of the burden placed by (presumed) inactive older people on the younger working population. According to Prof Les Mayhew, of Cass Business School, London, the ratio of 20-64-year-olds to those aged 65-plus was 3.7 times from 1980 to 2006, when it started to turn down, potentially reaching about 2.3 times in 2040. Action already taken to raise the SPA keeps the recalculated ratio above 3 times. There is clearly scope for further participation in the workforce by older people. Baroness (Ros) Altmann, the pensions minister, suggested several ways to do this in a 2015 report entitled: *A New Vision for Older Workers: Retain, Retrain, Recruit.*

32. Another objection to an age-based measure of dependency is that it portrays a negative stereotype of older people. It is, in any case, misleading since not all people aged 0-19, 20-64 and 65+ are either working or not working. Economic activity is a more useful concept. Between 1984 and 2013 the number of economically active people in the UK rose by 8m to 31m, nearly two thirds of the adult population, as more women entered the workforce.

33. To capture the increased economic activity of older people and to equalise tax treatment, there is a case for continuing to collect NI contributions from those over the SPA. Carl Emmerson, at the Institute for Fiscal Studies (*IFS Green Budget 2014),* has suggested that this could initially be levied at a low rate. A previous IFS paper had calculated that each percentage point charged would raise £350m. One way to justify this would be to link it to funding health and social care for an ageing population.

**Incentives to work and save**

34. The CSFI report, *The Death of Retirement* (2015), argued that the idea of a common retirement age followed by a lengthy period of inactivity was both out of date and unaffordable – to individuals and the state. Instead, there is a transition from full-time work to ceasing to work, just as there is from borrowing to saving and from accumulating wealth to drawing on it.

35. Incentives for people to work longer include: a recognition that they are going to live longer; the decline of final salary pensions; the ending of compulsory retirement; more job opportunities; the inadequacy of the state pension; a desire to keep accumulating wealth to pass on to their children.

36. Incentives to save have been improved by recent reforms, including the provision of a non-means-tested state pension as a platform on which to build private savings; auto-enrolment into occupational schemes, with the employers and the government (via a tax rebate) matching the individual's contribution; freer access to savings from 55. The reduction in tax allowances for annual and lifetime contributions have so far only affected the better off.

**A more sustainable system**

37. The government has many options for reducing tax relief on pensions saving, some of which – cutting annual and lifetime allowances – are already in hand. A switch to a flat rate of tax relief of 28-30% and a cap on the tax-free lump sum that can be withdrawn from 55, added to planned cuts, would nearly halve the £21.1bn net cost of income tax relief referred to in HM Treasury's consultation. Assume rising tax revenues from pensioners, who are staying in work in larger numbers, and a cut in the annual allowance to £30,000 and it could be more than halved.

38. Considerable savings, amounting to about £15bn, are also in hand and could be added to by removing relief on or exemptions to National Insurance Contributions. (See Jane Fuller's submission to HM Treasury: *Pension costs, benefits and tax incentives* http://www.csfi.org/pensions/ )

39. As pensioner incomes improve, through a higher basic state pension (see pars 5-10) and through working (pars 28-29), they will claim less in benefits and pay more in tax.

40. It should also be borne in mind that the structural problem of retiring baby boomers will recede from about 2040; so will the transitional costs of raising the basic state pension while phasing out legacy entitlements to a higher second state pension.

Intergenerational transfer

41. Some members of generations X, Y and Z will enjoy intergenerational transfers through inheritance on which tax is paid (see par 22). Before death, baby boomer parents may be giving more support to their children than they received from their parents (anecdotally known as the "bank of mum and dad). This is a reminder that the perennial issue is intra-generational unfairness, related to wealth inequality. A progressive tax regime tackles this to some extent, but it is impossible to redistribute parental support – and by no means all of this comes in cash.