3. Economics, Wealth and Debt

Economic analysis is usually concerned with how wealth is generated and how resources are shared between different groups within society, often focussing on the gap between rich and poor. However, the division of resources within society can also be thought of across time, in other words looking at how they are spread between the members of different generations. This approach is at the heart of "intergenerational accounting", a novel way of understanding economics which changes how we might think about the UK economy and the economic policies which have been pursued by recent UK governments.

It can easily be argued that over the last several decades the UK economy has been run with an outlook which is excessively short-term. In particular, huge liabilities have been built up in order to achieve short-term growth and to avoid having to deal with difficult political decisions, such as reforming pensions.

The UK economy is still one of the largest in the world, with total economic activity (Gross Domestic Product, GDP) of about £1.5 trillion, which is equivalent to about £25,000 for each UK citizen. Of this the government takes almost £600 billion in taxes (roughly 40%), which are used to finance its spending. However, it currently spends more money than it gets in by a margin of about £80 billion each year, and this gap between income and expenditure represents the "deficit" which is often quoted in the media. This gap has to be plugged using additional borrowing, further increasing the official national debt which is now just over £1 trillion, or about £40,000 for each UK household. Such borrowings have to be paid by future taxpayers, and so in intergenerational terms they are a burden which we are passing on to them, while most of this government spending will only directly benefit those who are around today.

Age has a very big impact on people's economic circumstances. The majority of younger people are borrowers (to pay for university education, for instance, or to buy a flat), whilst older people are more likely to be savers. This means that the same economic policies are likely to have a different impact depending on how old you are. This is especially true of interest rates. While many older people want higher interest rates because it means they get a bigger return on their savings, younger people would usually prefer to have lower interest rates because it makes their borrowing costs cheaper – they have to pay less interest each month. Younger people have benefited from the fact that during the last five years interest rates have been kept very low by historical standards, while older people who have cash savings are finding they get very low returns, and when you take account of inflation the value of their cash is actually falling.

Part of the reason why young borrowers are so indebted is that over the last 30 years house prices have grown on an unprecedented scale (see Fig. 1), especially in London and the South East of England. Several factors lie behind this trend: lower borrowing costs, the shortage of new house building, overall population growth, smaller households, and the favourable tax treatment of housing etc. Rents have also increased steeply because more young people have to rent for longer as they cannot afford to buy property at today's prices.

House-price increases and higher rents have generally been beneficial to older people, who own most of the UK's property – between them the over-45s own 87% of all the UK's asset wealth, which includes property, pensions and investments. Yet higher costs have made it harder for younger people to gain access to

property, placing them at a disadvantage. Part of the problem is that current property owners form a powerful lobby group, making it less likely that the government would implement policies which act against their interests, such as making it easier to build more housing.

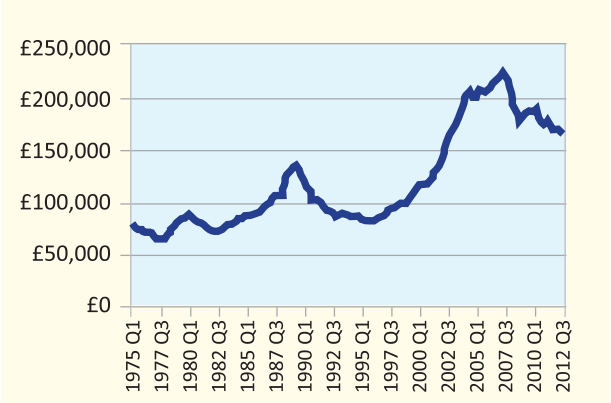

Fig. 1 Quarterly changes in UK real average house prices, 1975–2012 (Nationwide Building Society)

A clear example of short-termism has been the very large pension promises made by the government which are "unfunded" – that is to say, no actual money has been put aside to pay for them. Instead, these have to be paid out of general taxation, meaning they represent a transfer of wealth largely from young workers to older retirees. This was less of a problem in the past when people lived shorter lives, but the longevity of the current older generation means this will become an increasingly significant burden for younger taxpayers over the coming years. These pension promises already amount to over £5 trillion if you include the liabilities for both the state pension, which nearly everyone gets when they reach a certain age, and pensions for former public sector employees. Altogether, these liabilities amount to almost £200,000 for each UK household.

Tax policy also affects people of different ages differently. Of the £600 billion of tax raised, the biggest chunk is from earned income in the form of payroll taxes, which means income tax and national insurance. This falls more heavily on younger people because they are more dependent on earned income, compared with older people who are more likely to be living off unearned income, such as from rent or pension income, or asset wealth. Unearned income and asset wealth are both relatively lightly taxed.

For a long time there has been an assumption that the liabilities which we are building up for future taxpayers to pay – including pensions and the national debt – would be manageable because long-term economic growth would mean that future people will be wealthier. However, sluggish growth since the start of the recession has brought this assumption into question: growth was projected to be 2–3% per year but has been almost flat since 2008. The result is that these financial commitments are in danger of burdening future generations unsustainably, and may have to be renegotiated if they turn out to be unaffordable.

Sources:

- "UK House Prices Adjusted for Inflation", Nationwide Building Society
- "Deficit, national debt and government borrowing - how has it changed since 1946?" The Guardian Datablog

Recommended Reading:

- Willetts, D. (2010) *The Pinch.* London: Atlantic Books
- Howker, E. and Malik, S. (2010) *Jilted Generation: How Britain has Bankrupted its Youth.* London: Icon Books