Public Inquiry Response:
"Intergenerational Fairness"

To: Department for Work and Pensions Select Committee
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Date: 04 February 2016

The Intergenerational Foundation (www.if.org.uk) is an independent think tank researching fairness between generations. IF believes policy should be fair to all – the old, the young and those to come.

Executive Summary

- IF believes the intergenerational contract which underpins the welfare state is under increasing strain from rising longevity and the growing wealth imbalance between the Baby Boomers and the younger generation.
- The government's austerity agenda has clearly been intergenerationally unbalanced: younger generations have suffered large falls in income, while the full range of pensioner benefits has been protected.
- This is inequitable because of the long-term rise in pensioner incomes, which has seen them become the group within society with the lowest levels of poverty over the last 25 years.
- Young people are also being held back by high housing costs, the costs of higher education and declining wages, which are undermining their ability to save for their own old ages.
- The basic state pension "triple lock" is an unfair use of public money at a time when most forms of working-age welfare have been either means-tested or been indexed to below the rate of inflation.
- A vast wealth gap is emerging between the generations: people aged 25–34 would need to become five-and-a-half times wealthier over the next 30 years to match the current wealth levels of the typical Baby Boomer.
- IF strongly believes that the main flaw in the UK's welfare state is that it directs too many resources on the basis of *age*, when this is becoming an increasingly inaccurate proxy for *economic need*.
- IF recommends a series of possible reforms to help achieve this important shift, including levying National Insurance on people who work beyond state pension age, harmonising eligibility for all universal benefits with state pension age, and raising the state pension age more rapidly than is currently proposed.

Introduction:

The Intergenerational Foundation (IF) is pleased to have the opportunity to comment on intergenerational fairness in relation to government welfare policy. Since it was formed in 2011, IF can claim to have played an important role in leading the debate about intergenerational fairness in the UK, and we are regularly consulted by the media and policy-makers on these issues. Among our research projects, we publish an annual Intergenerational Fairness Index which shows that the socio-economic position of young people has suffered a cumulative 10% decline since 2010. Our responses to the questions posed by the select committee in their terms of reference are given below.

1) To what extent is intergenerational fairness a welfare issue?

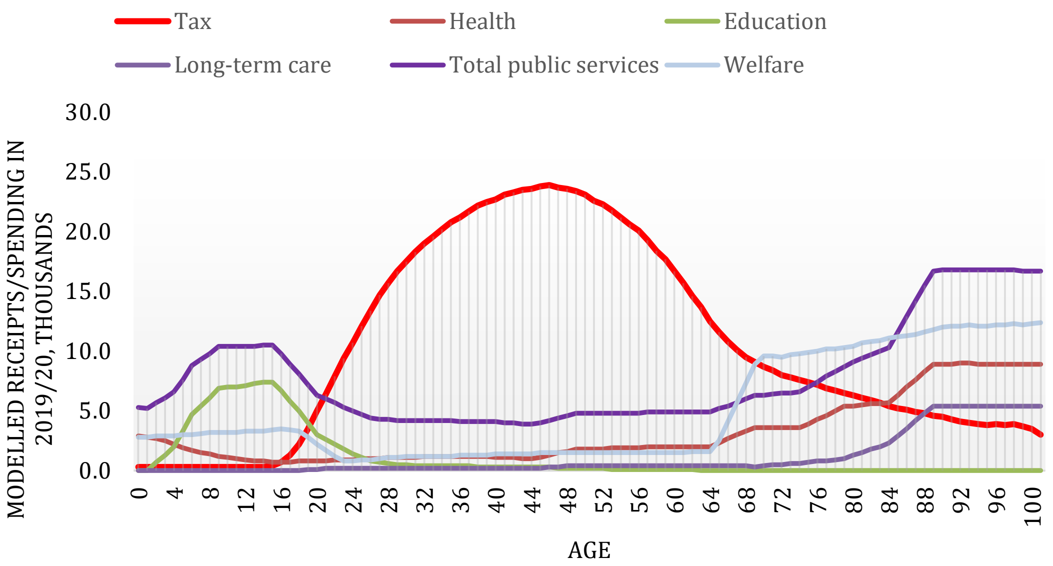

Fig.1 Modelled profiles of taxes and public service consumption over the life-course[1]

IF believes that intergenerational fairness is one of the most pressing issues facing the welfare state in Britain and other advanced countries today. As the analysis undertaken by Sir John Hills of the LSE has demonstrated, the main function of the welfare state is to redistribute resources between different stages of the same individual's life, rather than between different individuals.[2] This is shown by modelling that the Office for Budgetary Responsibility has done on the representative profile of tax and spending over the life course (Fig.1), which compares the amount contributed in tax by the average person during different stages of their life with the value of the public services they consume

This system of lifetime redistribution only works if the social contract of the welfare state is underpinned by an "intergenerational contract", which relies upon each successive generation of workers being willing to support public services for the current generation of pensioners, in return for the next generation of workers doing the same for them when their time comes.

IF strongly believes that the ageing of the large post-war Baby Boomer generation is placing the intergenerational contract under increasing strain. The number of Baby Boomers and the unprecedented longevity which they are set to enjoy means they will require a bigger financial contribution from the next generation to support them in their old age than they provided for the generation which came before them, yet at the same time there is abundant evidence to suggest that today's young workers are enduring a lower standard of living than today's pensioners did when they were the same age, a trend for which government policy is partly responsible.

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[1] Office for Budgetary Responsibility (2015) *June 2015 Fiscal Sustainability Report* London: OBR
[2] Hills, J. (2014) *Good times, bad times: the welfare myth of them and us* Bristol: Policy Press

2) 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?

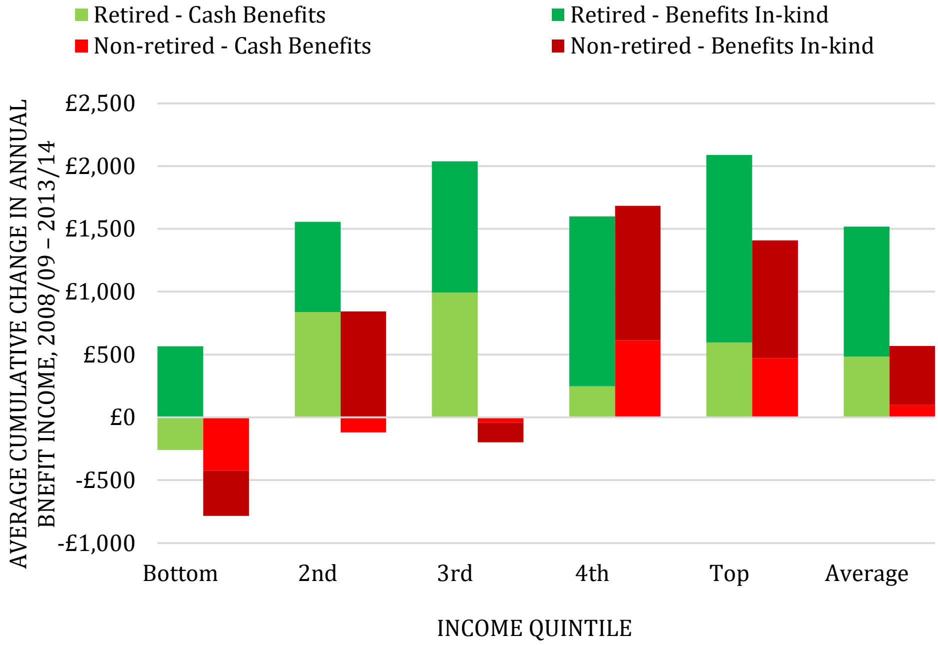

Fig.2 Changes in the cumulative annual value of benefits for retired and non-retired households between the 2008/09 and 2013/14 financial years, real terms[3]

It is clear that the implementation of the government's deficit-reduction agenda has had an unfairly disproportionate impact on young people compared with older generations. In relation to welfare expenditure, working-age households have been disproportionately affected by a number of austerity measures, including: the 1% cap in indexation on working-age benefits; the £3.9 billion worth of cuts to tax credits; the £1.9 billion worth of cuts to Child Benefit; and the £1.8 billion worth of cuts to private sector Housing Benefit.[4] By contrast, the full array of universal benefits has been protected for all pensioners, and the introduction of "triple lock" indexation means that the value of the basic state pension rose significantly during the same period (see points 5 & 6 below).

The cumulative distributive impact of this unequal treatment is demonstrated by Fig.2, which shows the change in real average annual benefit income experienced by both retired and non-retired households in different income quintiles between the 2008/09 and 2013/14 financial years. This analysis indicates that there was a clear divide below the 4th income quintile, particularly in relation to cash benefit transfers, which decreased in value the most for the poorest non-retired households. It also demonstrates how the value of benefits-in-kind rose dramatically for all retired households, which was principally due to the decision to protect departmental spending on the NHS.

[3] Based on IF's analysis of data taken from: ONS (2015) *Effects of Taxes and Benefits on Household Income, 1977 to Financial Year Ending 2014* Newport: ONS

[4] All figures are quoted from: Hood, A. and Phillips, D. (2015) *Observations: Substantial cuts made, but biggest changes to the benefit system yet to come* London: Institute for Fiscal Studies

3) What effects are these changes projected to have over time? Are they sustainable? What have the long-term trends been?

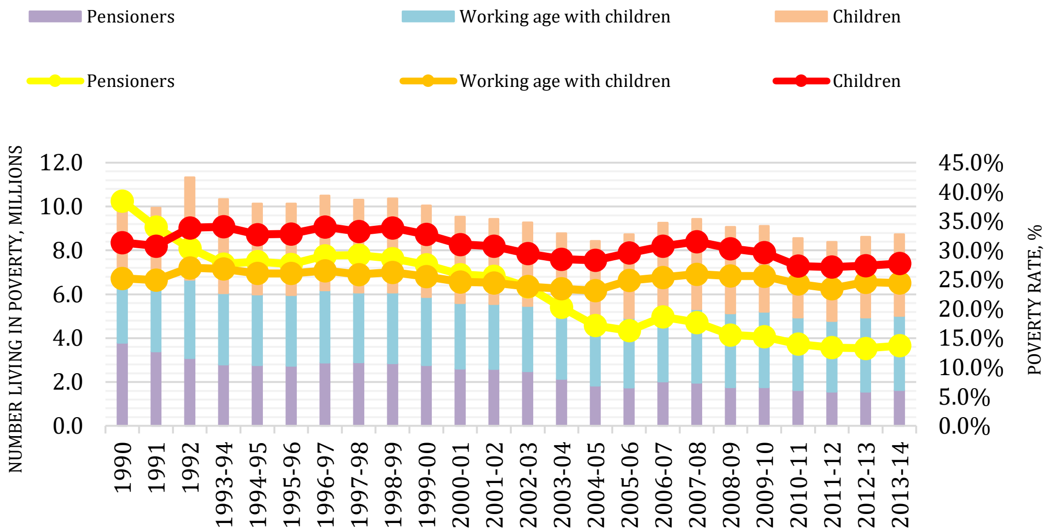

Fig.3 Number and proportion of households living on less than 60% of median household income, 1990–2013/14[5]

The distributional impact of government austerity measures cannot be understood in a vacuum. Fig. 3 demonstrates the remarkable changes which have occurred during the last 25 years to the profile of poverty in the UK: using the government's official threshold of 60% of median household income, pensioner households have gone from being the group which had both the largest number and highest rate of people living in poverty to the one which has the fewest on both measures. As Fig.4 shows, this is largely because the relative incomes of pensioner households have accelerated beyond those of non-pensioner households throughout this period. While the reduction in pensioner poverty represents tremendous social progress, it also calls into question the fairness of expecting today's struggling generation of working-age families to support the current generational contract.

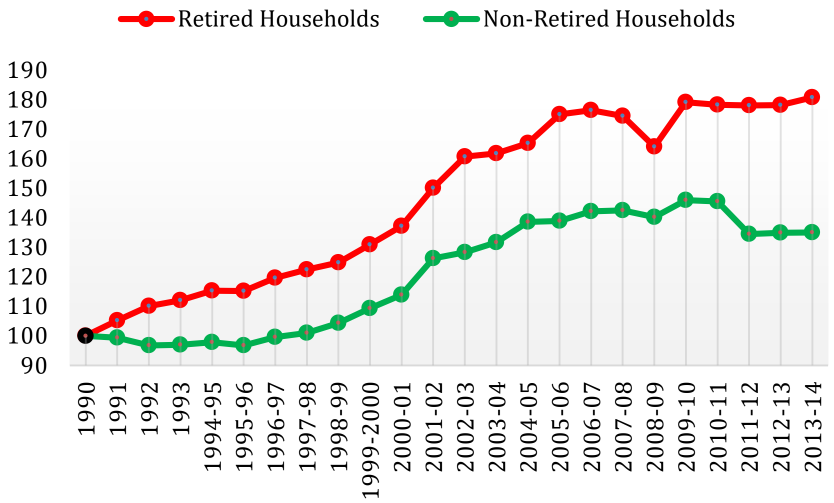

Fig.4 Comparison between relative changes in real net household income for retired and non-retired households, 1990–2013/14 (1990=100)[6]

[5] Institute for Fiscal Studies (2015) *Incomes in the UK* London: IFS
[6] Source as for Fig.3.

4) 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?

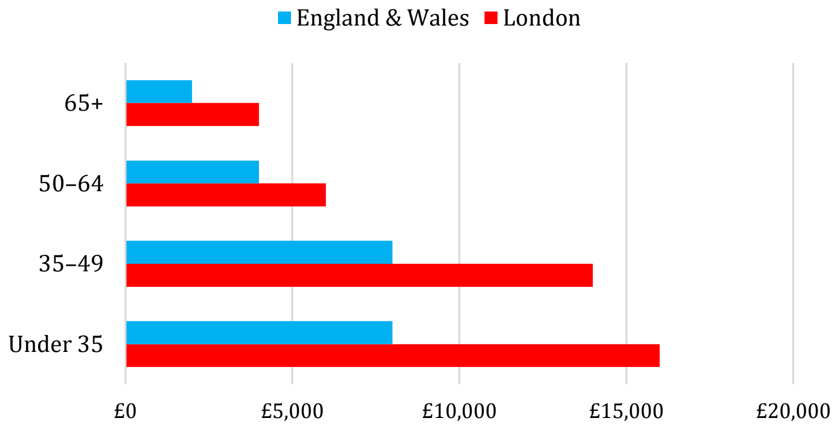

Fig.5 Average annual housing costs by age group[7]

Housing costs for today's young people have become far less affordable they were for members of previous generations at the same stage in life. Survey evidence clearly indicates that the majority of the UK's young people still desire to become homeowners, but many are finding that achieving this goal is beyond their economic capabilities, especially if they trying to save up for a housing deposit while also paying rent. Forecasts suggest that a significant proportion of these would-be first-time buyers will never get on the housing ladder, which will have long-term negative implications for the welfare state if this leads to more people needing to claim Housing Benefit, the cost of which has reached £25 billion in recent years. It will also lead to worsening social inequality, as housing wealth trickles down the generations to those who are fortunate enough to have wealthy families. IF strongly advocates increasing the supply of housing to address this situation, as well as measures to encourage a more efficient allocation of our existing homes.

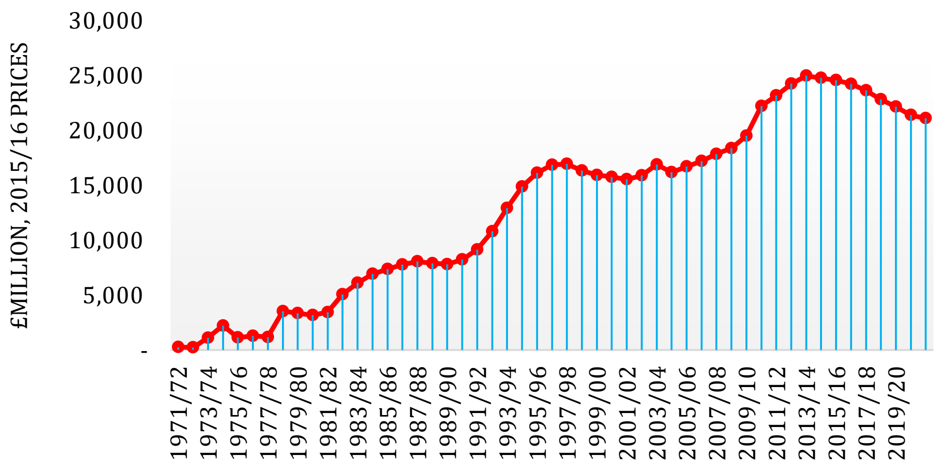

Fig.6 Total annual expenditure on Housing Benefit, 1971/2–2019/20 (forecast)[8]

The recent rise in higher education costs is also extremely harmful to the current generation of young workers, many of whom will have student loan repayments acting as an extra drain on their incomes throughout their working lives.

[7] Cook, L. (2015) *Market Examination*, Presentation delivered during the 2015 RESI conference at Celtic Manor, Newport, 8 September 2015

[8] DWP (2015) *Benefit expenditure and caseload tables 2015* London: DWP

5) Is the triple-lock necessary to prevent future increases in pensioner poverty? & 6) What would be the effects of reforming the triple lock and how might the worst of these be mitigated?

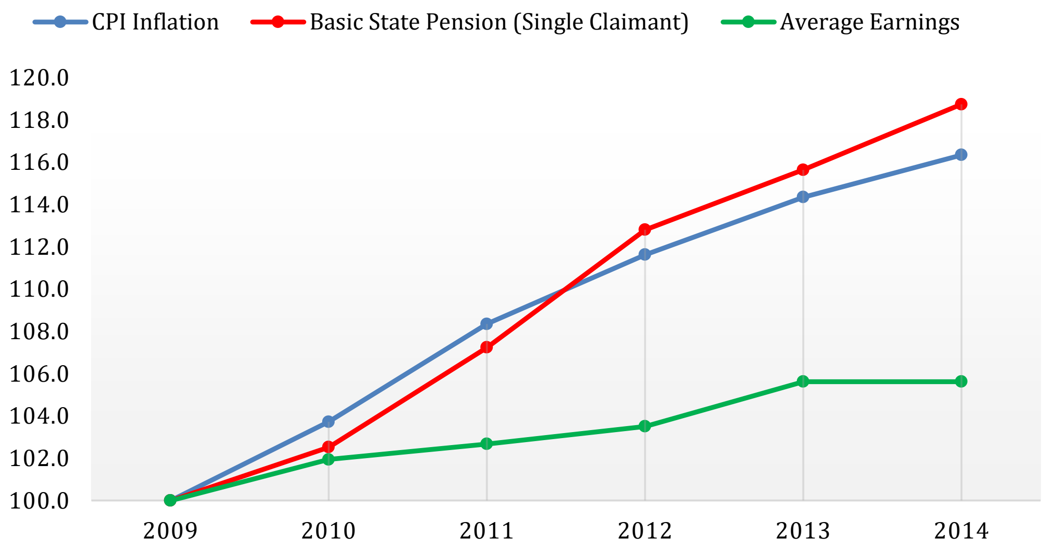

Fig.7 Relative changes in the Basic State Pension compared to CPI and average earnings, 2009–2014 (2009=100)[9]

IF takes the view that the state pension "triple lock" guarantee is unfair on younger generations who have to pay for it, while it is not a particularly effective means of addressing pensioner poverty because of broader flaws with the UK's state pension system.

As Fig.3 demonstrates, the profile of modern-day poverty is such that poverty is less common among pensioners than either children or working-age families, because of the long-term trend towards rising incomes for retired households. Research by the Institute for Fiscal Studies indicates that pensioner incomes are likely to continue rising throughout the next decade, as retiring Baby Boomers consume their housing and pension wealth.[10] Therefore, given this long-term shift in the distribution of wealth and income in the UK, IF does not consider it equitable to uprate the Basic State Pension (BSP) more generously than other benefits which go to working-age claimants. Fig.7 demonstrates the special treatment which pensioners have received: the value of the BSP has increased by almost 19% in real terms since 2009, whereas CPI growth has been only 16% and average wages increased by just 5.6% over the same period. From an equity standpoint, it makes sense to uprate the BSP in line with either inflation (to maintain its purchasing power) or earnings (so that it increases at the same rate as the working population's capacity to pay for it), but increasing it by more than either of these measures is unfair, especially at a time when many working-age benefits have been either frozen or indexed by less than the value of inflation. If the goal of the triple lock policy was specifically to ameliorate pensioner poverty, then there are potentially better-targeted methods of doing this, as we argue below in response to Question 9.

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[9] DWP (2015) *Abstract of statistics* London: DWP
[10] Johnson, P. (2015) *Press release: High levels of income for current retirees shouldn't blind us to future challenges* London: IFS

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

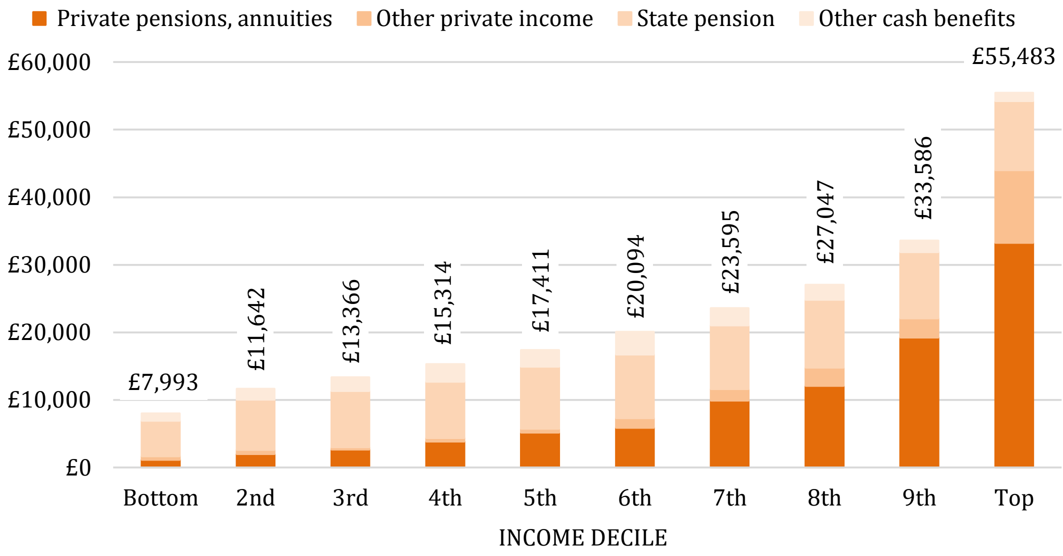

Fig.8 Distribution and sources of median gross household incomes of retired households by decile, 2013/14[11]

The main criticism of the UK's current welfare state from an intergenerational perspective is that it redistributes too many resources purely on the basis of *age*, when the evidence presented in previous sections on the changing demographics of poverty have demonstrated that this is an increasingly inaccurate proxy measure for economic *need*. IF strongly believes that redistributing according to economic need ought to be the guiding principle of any equitable welfare system, so remedying this flaw should be the main focus of future reforms. Achieving maximal value for money is clearly one of the current government's greatest priorities in relation to all areas of government expenditure, so it should be of concern to them that the current mismatch between age and need within the welfare state is inefficient as well as unfair. This is shown by Fig.8, which provides a snapshot of the current income distribution of retired households by income decile, including the sources of income. Clearly, pensioner households are highly unequal: the poorest 10% have a gross household income of less than £8,000 per year, while the wealthiest 10% receive over £55,000. However, the most important finding from Fig.8 is that average households in the top 20% have private incomes which are in excess of £22,000 per year, yet they still receive an average of £11,500 in state benefits. These figures are also unadjusted for household size, which is significant because retired households typically require a lower income to enjoy the same standard of living than younger ones as they usually don't have dependents living with them. The figures also don't provide any indication of household wealth, although older households hold most of the UK's assets. Total spending on state pensions and pensioner benefits is expected to rise from 6.3% of GDP in the current financial year to 7% in two decades' time.[12] Given the additional expense which this will create for government, and the unfairness of exempting all pensioner benefits from austerity measures while squeezing the remainder of the welfare benefit ever more tightly, IF's main proposal for reforming pensioner benefits is that they should become means-tested, with pensioners who have private incomes above the levels of the national average salary being subject to a gradual reduction of their entitlements. Failure to address this will result in increasing unfairness and inefficiency as the wealthy members of the baby boomer generation retire.

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[11] Source as for Fig.3.
[12] Source as for Fig.1.

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

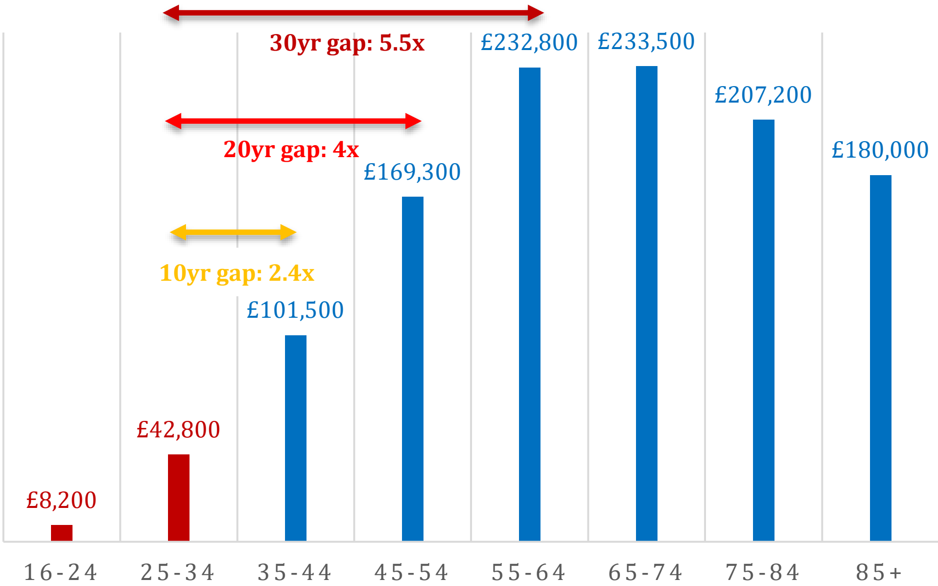

Fig.9 Median non-pension household wealth by age group in the UK, 2010/12[13]

IF is deeply concerned that the government's current policies will prove inadequate to mitigate the growing savings gaps which have emerged between the different generations. Fig.9 shows the median level of non-pension wealth for each age group in British society, taken from the most recent wave of the Wealth and Assets Survey. Although wealth will always vary by age group because of life-cycle effects, the scale of the current contrast between different birth cohorts is alarming; in order for the average person aged 25–34 to match the wealth of today's typical person aged 55–64, they would need to become five-and-a-half times as wealthy over the next 30 years. Professor John Hills, whose research has shown that people in their twenties suffered the largest falls in both income and wealth of any age group during the course of the recent recession, has expressed scepticism that this is realistic: *"…what's now striking is how big that age wealth gap is in relation to people's incomes. To close the gap you've got to save £12,000 a year, and that's pretty difficult when you're talking about households with incomes of £24,000 for all their expenses."*[14] This conclusion is supported by research from the IFS, which found that each birth cohort born since the 1940s has had a lower savings rate at the same stages in life.[15] The data in Fig.9 specifically exclude pension saving, which if included would make these disparities look even bigger. As mentioned above, inadequate savings by young people are likely to result in higher inequality and the welfare budget coming under ever-increasing strain. Of the two main initiatives which have been launched to try and combat this situation, IF is cautiously optimistic about the potential of auto-enrolment to encourage pension saving, but we are critical of Help to Buy, Starter Homes and other government attempts to encourage home-ownership, which we fear will use public money to help a relatively small number of young people who are already fairly well-off while increasing prices for the rest of their peers.

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[13] Hills et al. (2015) *Falling Behind, Getting Ahead: The Changing Structure of Inequality in the UK, 2007-2013* London: Centre for the Analysis of Social Exclusion, LSE

[14] Quoted in: "Young people 'unlikely to attain wealth of parents' generation' – study" *The Guardian*, 12 March 2015

[15] Hood, A. and Joyce, R. (2013) *The Economic Circumstances of Cohorts Born between the 1940s and the 1970s* London: IFS

9) What are the options for reform?

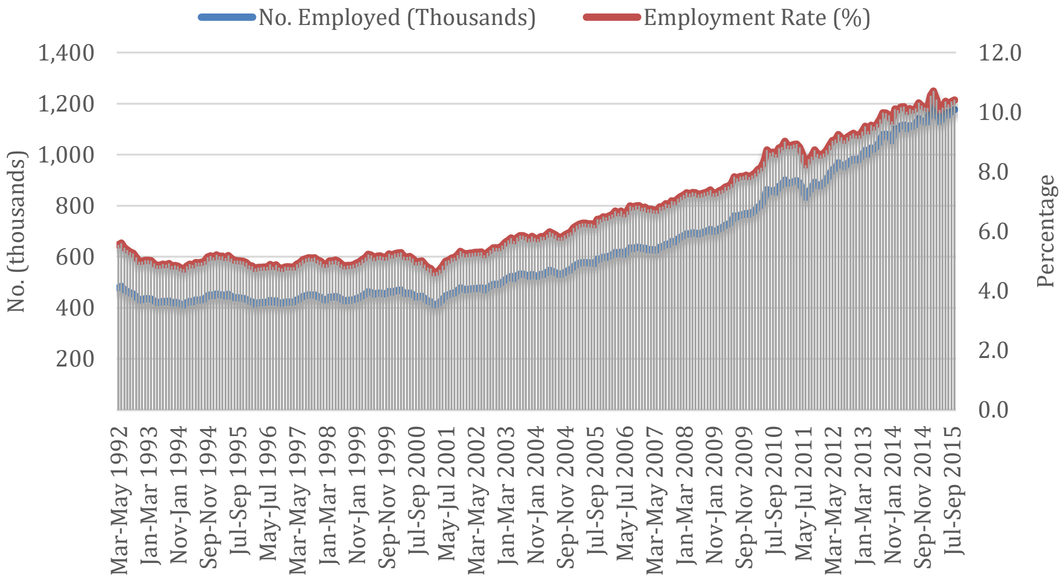

Fig.10 Number and percentage of people employed beyond state pension age, Q2 1992–Q3 2015[16]

As we explained in our response to question 7, IF's position on welfare reform is that the system needs to be comprehensively redesigned so that more resources are allocated on the basis of economic need rather than simply age. This represents the fairest way of addressing the pressure of an ageing population, as it would imply taking benefits away from wealthier members of the older generation through means-testing so that more could spent improving the lives of the poor among all age-groups, including the elderly. However, we recognise that reforming the welfare state so comprehensively will require time and is unlikely to appeal to the current government. Therefore, we have highlighted several smaller policy adjustments which would enhance intergenerational fairness:

1) Charge older workers National Insurance
As IF argued in a recent submission to the public consultation on closer alignment between Income Tax and National Insurance, the current exemption from paying NICs which people who continue working beyond state pension age receive is discriminatory (as it means two people with the same income are taxed at different rates just because of their ages), regressive and inefficient. It seems increasingly hard to justify now that almost 1.2 million pensioners continue working, and the revenue which is not collected could be used to help fund social care or other public services that benefit poorer older people.

2) Harmonise all age-related benefits with State Pension Age (SPA)
Age-related benefits currently have a variety of different qualifying ages; the fact that people become eligible for free prescriptions at 60, rather than SPA, has a particularly significant impact on government spending. Aligning them all with SPA would help reduce make the system more logical, and reduce cost to the government as the SPA is increased.

3) Raise the SPA more rapidly
Increasing the SPA is one of the most straightforward and effective ways in which the costs of an ageing population can be mitigated, but IF believes the current timetable of increases is too conservative, and should be reviewed.

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[16] ONS (2015) *Summary of Labour Market Statistics, 16 December 2015* Newport: ONS

Conclusion
IF has outlined in this submission our views on the intergenerational problems facing the welfare state, which we consider to be of increasing significance as our population ages. As we explained at the beginning, the welfare state relies upon an intergenerational contract in order to operate, which is being undermined by the difficulty of a poorer young generation having to honour a more generous welfare settlement for a wealthier older generation than they can expect to receive themselves when their time comes. Unless these imbalances are solved, intergenerational unfairness will grow, storing up problems of greater inequality and greater reliance on the welfare state for the future.

We would very much value the opportunity to give evidence in person to the select committee. If you would like to learn more about the work of the Intergenerational Foundation please contact:

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