

# Weaponising Interest Rates

How UK governments have set interest rates to the disadvantage of the young

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## About the Intergenerational Foundation

The Intergenerational Foundation ([www.if.org.uk](http://www.if.org.uk)) is an independent, non-party-political charity that exists to protect the rights of younger and future generations in British policy-making. While increasing longevity is to be welcomed, our changing national demographic and expectations of entitlement are placing increasingly heavy burdens on younger and future generations. From housing, health and education to employment, taxation, pensions, voting, spending and environmental degradation, younger generations are under increasing pressure to maintain the intergenerational compact whilst losing out disproportionately to older, wealthier cohorts. IF questions this status quo, calling instead for sustainable long-term policies that are fair to all – the old, the young and those to come.

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## Executive summary

Interest rates are a basic tool of economic policy. But governments are not simply using them as a tool; they have manipulated them – weaponised them – to deliver advantages to the older generation at the expense of the young.

- Young borrowers pay over 6% interest on student loans while old borrowers are charged 2% for care costs.
- Pensioner bonds pay 4% interest while young receive only 2.2% interest on a 3-year bond.
- RPI is still being used by government in ways that damage the young, despite government officials saying that “its use should be discouraged”.
- The government is transferring around £9bn a year from young to old by using too high a discount rate to work out pension contributions for public service pensions.
- The sharp drop in interest rates has contributed to a tax-free property windfall to older generations of over £1 trillion (£1,000,000,000,000).

# 1. Introduction

Interest rates are a fundamental part of the government's policy toolbox. They are used to influence the balance of saving and borrowing, and to offset the value of the present against the future.

The government does not set one, universal, rate however; different branches of government set different interest rates according to their own priorities. While the Bank of England sets the Bank Rate which impacts the whole economy in a variety of ways, various governmental departments set other interest rates. Each of these decisions has an impact on the economic balance between the old and the young:

1. The Treasury determines what interest rates the government directly charges on loans and pays on deposits held with the government (such as Student Loan debt<sup>1</sup> and National Savings and Investments accounts<sup>2</sup>). The Treasury also chooses between the two main measures of inflation, CPI and RPI, and that choice has significant effects on intergenerational fairness.
2. In making projections about the future, government departments use a discount rate to determine the present value of future revenue and costs. Different discount rates are used for different purposes and the choice of what rate to set has huge implications for current spending and the levels of pension contributions.
3. The Monetary Policy Committee of the Bank of England acts for the government in deciding the Bank Rate, the interest rate faced by commercial banks. This indirectly determines the consumer rates, with implications for asset prices and savings growth.<sup>3</sup>

This paper will demonstrate that in each of these cases, the government has set interest rates in an intergenerationally unfair way; it has been tempted by short-term pressures to set rates that clearly disadvantage the young in favour of older generations.

Finally, we explore and suggest potential policies that the government could adopt to institutionalise mechanisms that would avoid interest rates being used that damage the prospects of younger and future generations.

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<sup>1</sup> Student Loan Company: <http://media.slc.co.uk/repayment/qsg/how-much-do-i-repay.html#s2-5>

<sup>2</sup> National Savings and Investments: <https://www.nsandi.com/our-products>

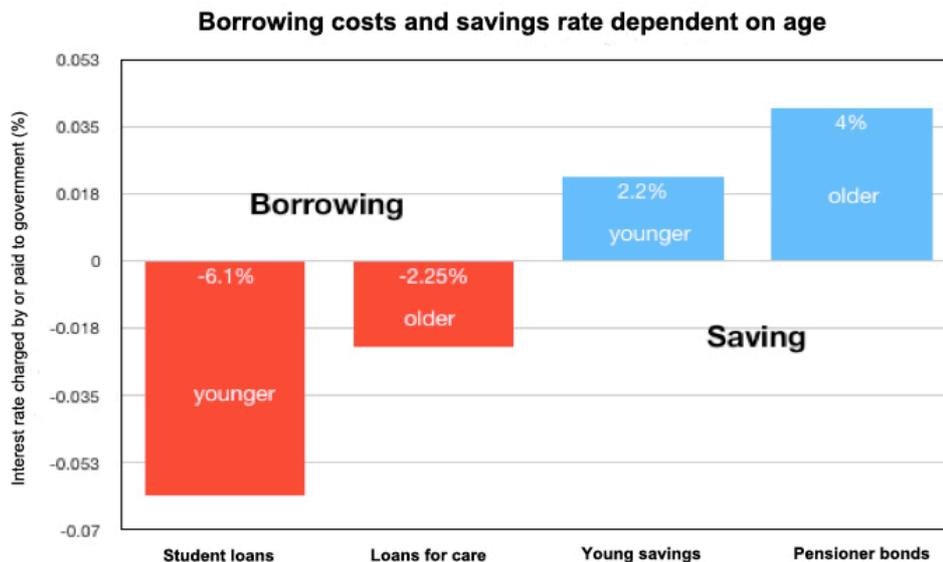
<sup>3</sup> Bank of England: <http://www.bankofengland.co.uk/monetarypolicy/Pages/how.aspx>

## 2. Rates set by age

The government acts as both as a borrower and a lender. As a borrower, it mainly offers deposit accounts through the NS&I (National Savings and Investments organisation) and various bonds of government debt that return interest over a given period of time, which can be acquired by individuals as a form of saving.

As a lender, it offers loans to people over the course of their life, including student loans and social care loans for the elderly and a range of welfare-related lending. In recent years, the government has decided that age is a justifiable basis on which to make loans at differential interest rates.

Figure 1



### Interest rates for savers?

Before the 2015 election, George Osborne in his budget decided to pay older people a significantly higher rate of interest on their savings through so-called “Pensioner Bonds”.<sup>4</sup> What was Osborne’s reasoning for the government giving higher interest payments on savings to the over 65s?

*“Pensioners have seen their incomes fall as a consequence of the low interest rates that Britain has deliberately pursued... so we will launch the new Pensioner Bond... open to everyone aged 65 or over... 2.8% for a one-year bond and 4% on a three-year bond. Much better than anything equivalent in the market today.”*

*George Osborne, Chancellor of the Exchequer (2014)<sup>5</sup>*

<sup>4</sup> National Savings and Investments: [https://www.nsandi.com/files/published\\_files/asset/pdf/65-guaranteed-growth-bonds-key-features-leaflet.pdf](https://www.nsandi.com/files/published_files/asset/pdf/65-guaranteed-growth-bonds-key-features-leaflet.pdf)

<sup>5</sup> HM Treasury: <https://www.gov.uk/government/speeches/chancellor-george-osbornes-budget-2014-speech>

It cannot be argued that these Pensioner Bonds were issued to help the poorest pensioners because by definition these were only available to pensioners who had some liquid capital.

As explained below (see pp.12-13), many older people have benefited from a significant rise in housing equity as a result of those same low interest rates; over this period, real average income fell across all households and Mr Osborne readily admits that these Pensioner Bonds are better than anything available to young generations.

In contrast, what does the Treasury offer for regular savers? A working-age person can open a direct savings account and save at 0.7% pa. If they are able to commit to a three-year bond – a long period to have savings unavailable for young adults with precarious finances – they could hope to receive a maximum of 2.2%.<sup>6</sup> Still a far cry from the 4% being offered for the same duration to those over 65 years of age.

### **Interest rates for borrowers?**

When an older person needs to pay for their social care, they can be lent the money by their local authority against the value of their property, under a “deferred payment agreement”. There is a maximum interest rate that the local authority can charge, set by central government based on the government’s low cost of borrowing.

This rate varies by local authority so you have a sort of “postcode lottery” for interest rates, but there is a maximum rate which is set by the Department of Health every six months, of typically about 2% pa. An older homeowner is currently charged 1.65% pa if they live within the Reading Borough Council area, whereas they will be charged 2.65% pa by Surrey County Council.

Compare this with the interest on student loans, which has been set at RPI plus 3%, so the rate in 2017 stands at 6.1% pa, on average about 4% higher than the rate being charged to older people. It might be argued that there is a greater risk premium required in the case of student debt. Older people are offering their homes as collateral whereas students can offer no such guarantee and a large proportion of them will not go on to repay the full cost of their loan before it is written off. But is the risk really so much greater as to justify this significant disparity? Especially when a sizeable part of the difficulty in graduates paying off the capital of the loan stems from this high interest itself.

At this rate of interest, student debts compound up very quickly and a typical young graduate with debts of £50,000 will have to earn over £55,000 per year in order to pay off any capital. If they earn less than that their debt burden will increase year by year. The result is that most new graduates will be paying 9% additional “income tax” (loan repayments) for most of their working lives.

Put another way, young graduates are now paying £6 billion of interest each year on a debt which costs the government interest of only £1 billion a year.

To put these rates into perspective, the HMRC rate of interest on late tax payments and similar (which equates to quasi-borrowing by deferring payment of debt) is set at a uniform 2.75%.

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<sup>6</sup> National Savings and Investments: <https://www.nsandi.com/our-products>



From the above, it is clear that the government imposes an interest rate gradient according to age:

Age Group	Borrowing	Saving
Students	6.1%	0.7% – 2.2%
Working-age adults	2.75%	0.7% – 2.2%
Pensioners	2%	2.8% – 4%

This disparity will only further contribute to the wealth inequalities between the older and younger generations, as the younger generations effectively subsidise preferential rates for their predecessors and pay for decisions not made on cost and risk but for the political expediency of successive governments.

## RPI versus CPI

*“The position of the ONS is clear: RPI is not a good measure of inflation and we discourage its use.”*

*Jonathan Athow, Deputy National Statistician for Economic Statistics (2017)<sup>7</sup>*

The interest rate charged on student loan borrowing is particularly egregious because it uses the Retail Price Index (RPI) as its basis. The RPI has been discredited both as an international and national statistic since 2013<sup>8</sup> and the Consumer Price Index, which generally generates a lower inflation rate, has been adopted in almost all areas. Yet RPI is still used in the calculation of student loan interest and train fares.<sup>9</sup> This leaves younger generations with student loans bearing unfairly high interest rates, either through carelessness or a lack of political will to take account of their interests. In the case of train fares where increases are also linked to RPI this also falls unfairly on younger people, many of whom are forced into long commutes because of historically high, and rising, housing costs.

<sup>7</sup> Office of National Statistics: <https://www.ons.gov.uk/news/statementsandletters/lettertothefinancialtimes>

<sup>8</sup> National Archives:

<http://webarchive.nationalarchives.gov.uk/20160108030655/http://www.ons.gov.uk/ons/rel/mro/news-release/rpirecommendations/rpinewsrelease.html>

<sup>9</sup> Office of National Statistics:

<https://www.ons.gov.uk/economy/inflationandpriceindices/methodologies/usersandusesofconsumerpriceinflationstatistics>

### 3. Discount rates

The discount rate is a mechanism used to reflect the view that current assets are generally worth more than assets in the future. Similarly, liabilities in the future are thought to be less of a burden than liabilities of the same nominal value today. In order to assess how much less these assets and liabilities are valued at in current terms, economists and actuaries use discount rates as a quasi-inverse interest rate.

For example, given an interest rate of 2%: £100 in the current year, in 10 years would be worth  $(£100)(1.02^{10}) = £121.90$ . Similarly, given a discount rate of 2% that £121.90 in 10 years would only be worth £100 in present value. A higher discount rate has the effect of making future liabilities less burdensome in today's money.

Discount rates are used in several different contexts across government, but there is limited internal consistency as to which discount rate is used. They are also generally set at too high a level, which attaches less importance to the future and therefore penalises the young.

#### Why do discount rates matter so much?

The government is responsible for two types of pension schemes:

1. Public sector pensions to current and past government employees, often called “public service pensions”;
2. The state pension commitment<sup>10</sup>

Discount rates, set by the Treasury, determine the level of pension contributions that have to be made by today's workers; if these contributions are too low then large pension deficits will have to be paid for later by today's young and the unborn. A reduction in the discount rate of 0.5% will lead to a need for additional pension contributions of 3% of salaries.<sup>11</sup> From this you can see very starkly why representatives of older workers have been lobbying strongly for higher discount rates:<sup>12</sup> if they succeed in keeping discount rates 1% above what they should be, they have essentially transferred 6% of the total pension bill for each of these years from the old to the young, so the young will have to pay this bill.

In a review in 2010/11, the Treasury decided to use a discount rate aligned to expected GDP growth.<sup>13</sup> In 2016 the government decided to reduce the rate, though not by much, from 3% to 2.8%. Were they to reduce the rate to 2%, it would increase employee pension contributions by almost 5%.

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<sup>10</sup> Which is a welfare payment rather than a fixed contractual liability.

<sup>11</sup> HM Treasury (2010):

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/81610/consult\\_unfunded\\_pension\\_condoc.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81610/consult_unfunded_pension_condoc.pdf); cached: [http://www.hm-treasury.gov.uk/d/consult\\_unfunded\\_pension\\_condoc.pdf](http://www.hm-treasury.gov.uk/d/consult_unfunded_pension_condoc.pdf)

<sup>12</sup> *ibid.*

<sup>13</sup> HM Treasury (2011):

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/220809/consult\\_discount\\_rate\\_summary\\_responses.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220809/consult_discount_rate_summary_responses.pdf)

That would be a politically unpopular move, and so prove difficult to implement, so one can see why the government might have wanted to keep a high discount rate for this particular purpose. However, civil servants and politicians knew that the effect of using GDP growth as the basis for discount rates would be to shift the burden of making up the shortfall onto the next generation if GDP grew at less than the hoped-for rate.

Discount rates are also needed to work out the financial costs of various long-term projects, including government infrastructure investment and student loans. For student loans, the government uses a discount rate of only 0.7%.<sup>14</sup>

### **How much difference do discount rates make?**

You can get an idea of what effect different discount rates have by considering the current value of a student's debt, which is written off after 30 years. The average student will have around £21,600 of debt written off: at the 0.7% discount rate the government uses currently for student loans that debt is worth £17,521, whereas at the 2.8% rate that will be used for public service pensions calculations it would only be worth £9,433 currently, thus placing a much less significant current liability on the government's accounts. So one can see that using an artificially low discount rate in this context gives the appearance of wiping away almost half of the obligation.

In the case of public service pensions, rights to these are being accumulated by most of the 5 million public sector workers through their combined wage bill of about £179 billion.<sup>15</sup> If, as a result of using too low a discount rate, their pension contributions are too low by about 5% then this represents a transfer of about £9 billion from young to old in the sense that this is the rate at which liabilities are being built up for younger and future generations to pay.

### **How is the discount rate decided?**

In the government's own consultation on unfunded pensions in 2010, they outlined four possible ways a discount rate could be calculated:

1. A rate consistent with private sector and other funded schemes
2. A rate based on the yield on index-linked gilts
3. A rate in line with expected GDP growth
4. A Social Time Preference Rate (STPR) that makes allowances for the particular context of pension provision

Many economists believe that the second option – a discount rate that reflects the government's cost of borrowing, or the interest rate that it pays through its bonds – is the most theoretically sound method of calculation. This means that the current value of future assets is equal to the value of current assets that would need to be saved in order for those current assets to appreciate to a value equal to those future assets at the future time period.

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<sup>14</sup> National Audit Office (2016): <https://www.nao.org.uk/wp-content/uploads/2016/06/Evaluating-the-government-balance-sheet-financial-assets-and-investments.pdf>

<sup>15</sup> Institute for Fiscal Studies (2017): <http://election2017.ifs.org.uk/article/public-sector-pay-in-the-next-parliament>

The first option is similar in principle, but the government's cost of borrowing will be lower than that of the private sector so, in the context of government commitments, it is the government's cost of borrowing which should be used.

The alternative view is that the discount rate should not be based on the future value of money but rather on the ability to pay. The government argued that for pension calculations it would be legitimate to use a rate based on increases in GDP so that liability calculations allow for the (assumed) increasing wealth of the country, and so they chose the third option. The fourth option was again similar, but also included a time-preference to consume now rather than in the future.

### **The intergenerational unfairness and inconsistent application**

The argument for setting the discount rate at the projected rate of GDP growth is that this reflects what the economy should be able to afford to pay. However, this stance on pensions by the government has serious intergenerational fairness implications.

This method of rate-setting puts all the risk onto the future generations if GDP growth turns out to be lower than the forecasts, because they will have to make up the financial shortfalls that will occur, as there is no mechanism to claw back contributions for those who should have paid more if growth falters. This has been borne out over the last few years when we have seen GDP growth frequently undershooting projections and public sector pension liabilities increasing.

Further, it is unclear why the pension claimants should benefit from a growth in the economy if their pensions are not to suffer from a shrinkage in the economy. The government has set up the scheme for government pensioners as a "heads they win and tails they don't lose" arrangement, prioritising their needs over the rest of the population.

This might be more understandable if the government had demonstrated their belief in the appropriateness of this measure by applying the same rate across all their accounting. However, they have not. The government's decision to cut the discount rate on student loans from 2.2% to 0.7% was justified on the basis that it would bring the discount rate into line with the government's cost of borrowing.<sup>16</sup> This inconsistency shows that the decisions being made on the discount rate are political, rather than attempting to balance the interests of older, younger and future generations.

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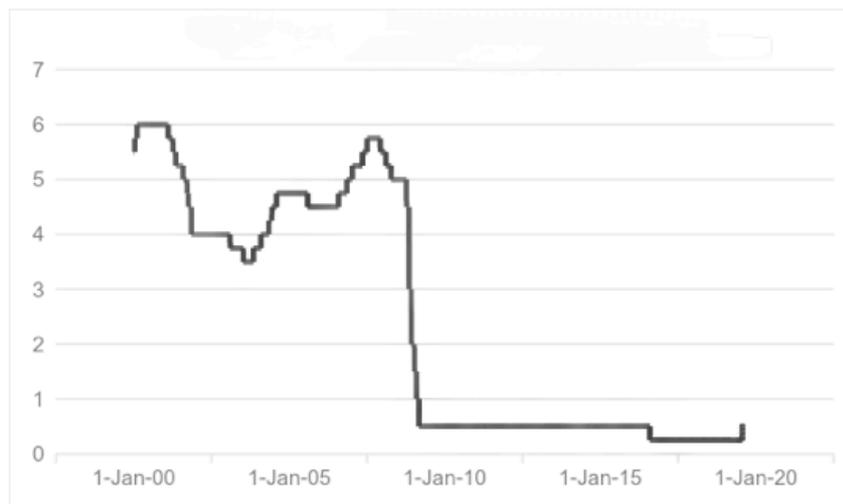
<sup>16</sup> House of Commons Library Briefing Paper 1079 (2017): [researchbriefings.files.parliament.uk/documents/SN01079/SN01079.pdf](https://researchbriefings.files.parliament.uk/documents/SN01079/SN01079.pdf)

## 4. Setting the bank rate

During the course of the 2008 financial crisis, the Bank of England slashed the Bank Rate<sup>17</sup> from 5.25% on 7 February 2008 to only 0.5% on 5 March the following year, reaching lows never before seen in the Bank's 300-year history. The Monetary Policy Committee has since kept the Bank Rate close to 0%, even taking it down to 0.25% in August of 2016,<sup>18</sup> although it raised it again in November 2017 to 0.5%.

**Figure 2**

**Official Bank Rate (2000–2017)**



Source: Intergenerational Foundation from Bank of England data

These sustained low rates of interest have impacted intergenerational equality by:

### **a) Raising the value of assets**

With lower interest rates there is a lower cost of borrowing and lower return to savings. This historically low rate entrenches the position of those who hold assets and have assets against which they can borrow.

Lower interest rates have, over the last 20 years, created a tax-free windfall for homeowners, by boosting the value of their homes while cutting the cost of monthly payments for homeowners with mortgages. Homeowners, of course, tend to be middle-aged and older, as the average age of a

<sup>17</sup> This Bank Rate is the rate of interest that the Bank of England pays on reserve balances held by commercial banks and building societies, thus determining their cost of borrowing and spending.

<sup>18</sup> Bank of England: <http://www.bankofengland.co.uk/statistics/documents/rates/baserate.pdf>

first-time buyer has been rising steadily as house prices move out of reach for many young people. At the same time rents have risen sharply, to the detriment primarily of the young and the poor.

The estate agents Savills have shown this huge increase in property values over the last 10 years, driven by recent reductions in interest rates, and estimate that the total value of UK homes has passed the £6 trillion mark, handing a tax-free windfall to those with houses of over £1 trillion in the process.<sup>19</sup>

## **b) Putting upward pressure on housing costs**

In recent years many older people have leveraged their increased wealth and used their savings (which now are facing lower returns) to become buy-to-let landlords, placing even more upward pressure on housing costs for younger people since they compete with first-time buyers in the market.

Very low interest rates have clearly been determined with the objective of supporting house prices and not in relation to reducing housing costs for young people.

The Bank of England often says it is only setting one interest rate – the Bank Rate – for the whole economy with a view hitting its government-set inflation target of 2%, and that rising house prices are simply one impact of ultra-low interest rates rather than a deliberate aim of policy. The Bank has, though, recently been acting to staunch the flow of credit to the housing market by tightening lending criteria – for example, loan-to-value ratios that commercial banks use and by clamping down on lending to landlords.

One effect of sustained low rates has been to encourage younger people to buy properties at the ever higher prices which supports all property prices and has the effect of locking-in the economic advantage of a (tax free) windfall in property prices for the older generation. If rates are now raised significantly, this will create considerable economic pain for the many young people who have been encouraged to buy their own homes at these higher values and have taken on huge mortgages which have often offset the advantage that super-low interest rates bring for borrowers.

## **c) Trapping younger people into supporting low rates**

In housing, the population broadly falls into three categories: homeowners with little or no debt, homeowners with significant borrowings, and those who rent. Most of those in the first group will be older, whilst younger people are mostly split between those with mortgages and those who rent.

Those who have taken on a mortgage clearly have an interest in rates being kept at the current historically low levels. Various measures have been used to encourage first-time buyers who might otherwise have been put off by high price levels. One such policy is the government's Help to Buy Scheme. This intervention on the demand side rather than the supply side may have helped specific buyers but has also supported the whole market and so has helped existing owners even more than new buyers by pushing prices still higher.

Historically, inflation has helped borrowers because it has eroded the capital value of their debt. By contrast, a period of low inflation makes it a slow process repaying debt. So, these young borrowers should have an interest in a higher rate of inflation which the government may try to restrict by raising interest rates. In either case we can see that interest rates have unfortunately been made into a battleground between the generations.

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<sup>19</sup> Savills (2016): <http://www.savills.co.uk/news/article/72418/198296-0/1/2016/total-value-of-uk-homes-passes-£6-trillion-mark>



#### **d) Trapping young people in low saving rate returns**

Another effect of low inflation and low interest rates has been the inability of younger generations to save adequately for lifetime milestones such as finding a deposit for a first home. With interest rates close to zero and inflation generally very low over the past seven years, savings rates have plummeted. In fact, anyone saving in an easy-access savings account is likely to have seen their “nest egg” fall in real value.

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## 5. Recommendations

There are several measures government could adopt to stop the choice of interest rates and discount rates being so arbitrary and to stop them working against intergenerational fairness.

### **The basic rate charged by government when it lends should be made uniform, regardless of the age of the borrower**

HMRC have standardised their interest rates for borrowers and lenders regardless of ages and situation – the rest of government should follow their lead. The government should adopt a universal rate charged to those borrowing from it, which should reflect the actual cost to the government of that lending and so be equivalent or closely related to the gilt rate. Clearly in some instances it will be necessary to add a modest additional risk premium to account for the possibility of default, but in these instances it should be made clear to the borrower what their risk premium is and justification given as to how that figure was reached.

### **The rates paid by government to depositors should be uniform, regardless of the age of the saver**

Similar to the previous recommendation, the government should commit to offering the same rates of interest on National Savings and Investments products, regardless of the age of the saver. Obviously products that require the depositor to commit over different time-scales should be able to offer differentiated rates, and that may benefit those who can commit to longer-term saving, but these differentials are based on the long- and short-term rates the government itself faces and what the government can do with those deposits, rather than a giveaway to a particular generation.

### **RPI should be consigned to history**

No longer recognised by the ONS as a national statistic and only still in use in a limited number of places, mostly to the disadvantage of younger people, the Intergenerational Foundation recommends the complete phasing out of RPI and replacement with CPI. We also suggest that procedures should be put in place, such as referring to the “national inflation measure” rather “RPI” or “CPI”, so that similar issues do not occur in future if the inflation measure needs to be changed.

### **A standard set of discount rates should be adopted for all government calculations based on the government’s cost of borrowing**

HMRC’s Green Book<sup>20</sup> already offers a schedule of discount rates to be used across government projects, but these are ignored in the important cases we have highlighted above and in any case stem from a flawed method of calculating the discount rate. However, it demonstrates that a standardised set of discount rates is an achievable prospect.

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<sup>20</sup> Gov.uk:

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/220541/green\\_book\\_complete.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220541/green_book_complete.pdf)



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We recommend using the government gilt rate (as a proxy for the cost of borrowing) as the basis for setting a government discount rate schedule. This schedule should be adopted across all government departments.

### **An intergenerational ombudsman should be appointed with the power to review government interest rates**

While the previous suggestions would ameliorate the current unfairness within the system, political pressures to change the system will always exist and further measures, which benefit one generation over another, may emerge. Therefore we recommend the creation of an intergenerational ombudsman with a remit to oversee future changes in interest rate policy right across government, so there would be an active protector of the interests of all generations.

### **Intergenerational fairness impact assessments should be undertaken**

An additional policy tool would be the introduction of intergenerational fairness impact assessments. Such assessments could protect younger and future generations from the temptation to put short-term gain above long-term benefit.

## Conclusion

Young people's prospects are often stunted by government policy, but nowhere is the government's prejudice in favour of older generations clearer than in its approach to interest rates. Policy-makers may sometimes, in the past, have simply blundered into inconsistent approaches but increasingly it looks like a deliberate policy.

Some interest-rate unfairnesses are on a fairly small scale, such as the pensioner bonds, but they have had the effect of legitimising the arbitrary setting of different interest rates for different age groups. In other cases the effects are enormous, such as the high rates charged for student loans and the high discount rates that shift the burden of pension contributions heavily towards younger generations.

Interest rates that disadvantage the young have become weapons of policy and are fuelling intergenerational unfairness.