Are we dis-counting young people's futures?

Intergenerational Foundation

The Intergenerational Foundation (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 while 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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Foreword

This short pamphlet asks whether policy-makers across the political spectrum should be doing more to protect younger and future generations from the temptation to overly “dis-count” younger and future generations’ futures.

We at the Intergenerational Foundation, a non-party-political charity that exists to protect the interestes of younger and future generations, argue that governments both left- and right-leaning, have used, and continue to use, high discount rates that reduce pressure on government spending today. They do this by pushing the need to repay for today’s spending into the future. It means that generations to come, who may themselves face their own financial crises - such as climate change catastrophies or global pandemics - may also have to bear the cost of borrowing by previous generations.

This report brings together the views of young political activists from across the political spectrum. We thank the Young Fabians for hosting the debate around this subject. We are also grateful to the Young Liberals and Young Greens, for contributing to the debate. Sadly, the Young Conservatives chose not to participate.

There are mechanisms that can be used to better protect younger and future generations. One option is to implement intergenerational impact assessments on how different discount rates would affect younger and future generations in order to reach a more intergenerationally equitable solution. The other is to make the setting of discount rates independent of governments.

We hope that policy-makers will listen to the calls of the young in this report and urgently bring long-term thinking into policy-making.

Angus Hanton
IF Co-founder

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1. What is the discount rate?

Money today is assumed to be more valuable than money tomorrow. The discount rate quantifies this. Specifically it allows us to express future assets and liabilities in terms of their values today.

If we use a high discount rate it means that we are “discounting” future values more heavily than if we use a lower rate. This is quite separate from price inflation which is accounted for separately. The discount rate we choose to use really makes a big difference, as the folllowing illustration shows:

Suppose we have promised to pay out £1,000 in twenty years’ time, how should we assess today’s value of that commitment? If we use a discount rate of 6% that £1,000 lump will only be worth £311 in today’s money, but if we use a discount rate of 2.5% it will be worth around £610 in today’s money. That difference – more than twice – demonstrates how important it is to choose the “right” discount rate.

Discount rates can also be used to work out how attractive capital spending might be when we are trying to assess a value today for benefits that will accrue many years in the future. Discount rates can also help with working out how much to put aside for future contracting liabilities such as decontaminating nuclear power stations. However, for the UK government the most important application of discount rates is to quantify the value of pension promises it has made, and is making, to its employees. This pamphlet is focused on that question.

2. Why does it matter?

The government has very large pension commitments to its current and past employees and these are promises made without having any real “funding pot” to pay for them. They will have to be paid from future government tax revenue to be paid by younger and future generations. Hence they are called “unfunded”.

The current value of these future commitments depends on the discount rate used but even the low estimates made by the Treasury put that liability at almost £2 trillion or enough to absorb ALL the country’s tax revenues for about two-and-a-half years. If lower discount rates are used this number would be higher and could be well over £3 trillion.

So the discount rate used really matters from a total liabilities point of view, but it also has a big influence on today’s decisions on, for example, how much government employees should be paying in contributions and how many government employees can be afforded, and what their remuneration is really worth.

About 70% of unfunded government pension commitments come from the four biggest schemes: NHS, Teachers, Civil Servants and the Armed services.

3. What's the problem? And will it get worse?

The problem is that the government is using a discount rate that is significantly too high. Most economists favour reflecting more closely what the private sector does and they advocate using a rate that reflects the cost of money. They suggest using something close to the government's cost of borrowing which would roughly equate to the yield on government bonds.

However the government has invented a rate called the "SCAPE rate" (Superannuation Contribution Adjusted for Past Experience). This sets a rate that reflects hoped-for economic growth on the basis that if the economy grows it will be more able to afford to pay these promises. Typically in recent years this rate has been based on a growth rate of the economy that is higher than has been achieved - and optimistic growth rates continue to be applied.

Unfortunately these different approaches lead to very different results. The government-cost-of-borrowing approach means that NHS pension promises turn out to be worth 62% of salary, rather than the 30% which the government projects.

The burden of these promises is likely to get much worse if the government sector keeps expanding, which is the current trend, as well as if life expectancies continue to rise.

4. What are the results of using a high discount rate?

Underestimating the true cost of these pension promises means that future taxpayers' money is being committed without this appearing in government accounts. This understatement is probably increasing by more than £50 billion each year – about one and a half times as much as the costs of the government's disastrous track-and-trace project.

Some of the problems from using too high a discount rate are:

- Employee contributions are much too low and the gap will be made up by younger and future generations. In round numbers, employees pay 10% and employers pay 20% for a benefit worth 60%, so 30% is "kicked down the road"
- Current government employees are being given a benefit, the value of which they do not realise
- Decisions on the costs of new government employees are distorting policy decisions
- Compared to the private sector there is a tax distortion in pensions with public sector staff being under-taxed
- UK government indebtedness is being under-estimated
- Lenders to the UK are being misled about the country's solvency
- To the extent that this is a conscious distortion of the true costs - at scale - it undermines trust and good government

5. Who else has worked on this and what do they say?

Several civil servants have been working on this for several years but they are deeply conflicted as both they and their social circles are major beneficiaries of the schemes. They are typically "high flyers" whose pension entitlements are particularly generous, and their political bosses (Ministers & MPs) are in the same types of scheme so are in the same boat

Two independent pensions experts have also been working on this issue for many years and they firmly believe that the government is using too high a discount rate. They are John Ralfe and Neil Record, whose papers on the subject are well worth reading.

6. What do young political activist groups want?

Using a fair discount rate to reflect the actual pension liability is more than just a debate over accounting measures. It is of paramount importance in ensuring that the public has a clear oversight of how much the UK Government's actual pension liability is!

Understating the liability poses the risks of short-term political expediency where the Government spends beyond their means following an optimistic budgetary outlook. However, there might be problems in the long run when the Government realises the true extent of the pension liability.

The issue of intergenerational fairness therefore comes into play. Future generations will need to bear the costs of the oversights by previous generations and pick up the tab with tough spending decisions further down the line. The oversights can result in having a lesser state pension pot than initially envisaged and adversely affecting the quality of life at retirement age. Alternatively, spending cuts elsewhere might have to be made to balance the books and have the same pension pot in real terms as the previous generations.

Conversely, overstating the liability can also cause the Government to cut spending on the economy or public sector benefits in favour of allocating more money into the pension pot. Doing so can thus damage the economy and skew spending priorities.

Democracy is ultimately based on trust and accountability so the Government owes it to us and themselves to be honest and disclose the true pension liability using accurate discount rates.

Living standards in real terms have declined over time and the younger generation should not have to bear any further future costs of current missteps. This can be fixed in the future by engaging with expert stakeholders in this field and coming up with the findings in a fair and transparent manner. After all, prevention is better than cure as the saying goes!

The Liberal Democrats and Young Liberals have a strong record of standing up for the interests of young people. Young people are under-represented in parliaments and councils across the country. Sadly, all too often government policies reflect the lack of consideration given to younger generation's interests. Whether on public sector pensions, fighting climate change or the future of social care, young people's voices are effectively discounted.

Young Liberals therefore applaud the Intergenerational Foundations long-standing commitment to fighting young people's corner on the Superannuation Contributions Adjusted for Past Experience (SCAPE) discount rate. The ever-increasing subsidies required to keep public sector pension schemes afloat show the present system is not working.

For years, successive governments have sought to wish away problems rather than tackle them. The Coalition Government's decision to lower the SCAPE discount rate has not been enough to move to a realistic assessment of the liabilities in public sector pension schemes. Since then the SCAPE rate had to be reduced twice already. If government retains its present methodology for setting the discount rate, it will have to fall again soon.

Young Liberals believe that government's repeated unwillingness to set a realistic SCAPE discount rate is one symptom of the underlying rough deal younger generations are receiving today. This goes way beyond the discount rate employed in pension calculations. The Social Time Preference Rate (STPR), which civil servants use to assess government projects, has been left unchanged since 2003. Moreover, the STPR plays little to no role in public debate, despite its grave implications for government policy. It could not be further away from reflecting society's preferences.

As an interim step, Young Liberals welcome and support the Intergenerational Foundation's campaign to hand over control of the SCAPE to an independent body. Looking further, Young Liberals want to see a better deal for younger generations. This must include a reform of all discount rates including the SCAPE rate and the STRP. Discount rates are too important to be dismissed as a mere technicality and need to become a key instrument to safeguard intergenerational fairness.

Young Greens

The Young Greens agree with the Intergenerational Foundation that the Government is using a discount rate for pensions that is significantly too high and we condemn any resulting intergenerational inequity. We argue that because the discount rate has an impact both on equity and sustainability, that setting it is an inherently political decision. Rather than an independent body setting pension discount rates, we encourage you to vote Green, for representatives who care about funding pensions sustainably and equitably, through a real-time scheme.

Often in the debate of pensions, the question is framed as to how much the old will cost the young. Historically, older people had an important role in society to care for children, share society's culture with them, and in pre-literate societies older people were the repositories of the society's history, continuity and identity. Nowadays, old age is strongly associated with ill-health, inactivity and decline. Older people are often seen as having outdated and insignificant ideas, and are blamed for the mistakes of the past. In this debate, we need to respect the wealth of skills and experiences that older people have, and how they continue to contribute to society.

Discount rates can be decomposed into a 'time preference' component and a 'wealth' component. The 'time preference' component captures that people are impatient to consume things. Somewhat ironically, the suggestion that we are rendering our planet uninhabitable may greatly increase our time preference for present consumption. The 'wealth' component captures that the economy will grow and future generations will be richer than the present one. It suggests that if we're concerned with equity, theoretically, we should do less to protect future generations. However, Greens recognise that the desire for perpetual economic growth is driveing environmental changes to a point where we are limiting the potential for future generations to enjoy comfortable lives. In this sense, we might reasonably suggest a negative wealth component to the discount rate.

Rather than couching the pensions debate in terms of putting money away now, to spend later, that is, we couch the debate in terms of meeting people's needs, and being entitled to have our needs met. After all, what we will be concerned about when we are old is not our bank balance but whether there is somebody there to wash our bodies or make our food. If there are very few young people they will be in a position to negotiate higher wages for looking after old people, making old people's money intrinsically 'worth less'. It is in this sense that money is only ever socially constructed and has no intrinsic value.

When one realises that money has no independent value, one can begin to see that the only workable model is a real-time pension scheme. That is a scheme where contributions from working people pay for the pensions of workers who are now retired. Imagine a real-time scheme for teachers, unlike other pension schemes that rely on over-optimistic predictions of growth, or the irrational behaviour of Darth Trader and their colleagues at the stock exchange, the only bet one is making with this scheme is that people will still be having children in the future, and that teachers will still be being paid to educate them. This seems like a far safer bet to us.

A real-time scheme re-emphasises that it is the balance of people in production, and of people not in production that matters in the economy. Debates on the value of money are clouding the discussion, it is the energy of strong-working age people that will make us comfortable in retirement, not pieces of paper with pictures of the Queen on them. We have become used to seeing money as a store of value guaranteeing us deferred consumption, but in understanding the pensions debate, our faith in our value of money only clouds the discussion.

7. What is to be done?

The discount rate used should be one that reflects the true cost of these pensions and not one which attempts to build in estimates about future ability to pay.

The issue needs to be more widely understood so that the current distortions can be addressed.

A permanent independent body could be established to oversee government pensions policy decisions and such a body would be made up of people who were not conflicted. The precedent of independent bodies to constrain government, and remove it from certain decisions, has already been set with the establishment of the Office for Budgetary Responsibility, and giving the Bank of England the power to set interest rates..

Each of the government pension funds should be required to do a sensitivity analysis - showing what their liabilities and annual increases in commitments would be under different discount rate assumptions.

Appendix - discount rate definition

The discounted present value of future assets or liabilities is calculated according to the same logic as compound interest accumulates on an investment. A lump sum today can be invested and earn interest over time, making the initial sum worth more in the future. Applying the same logic in reverse, one can see that future assets should have a decreased value in the present. The formula for present value is given below, showing the inverse relationship between present (discounted) value and the discount rate.

$$V_P = \frac{V_F}{(1+r)^t}$$

V_p - present value of an asset or liability
V_F - value of the asset or liability at maturity
r - discount rate (assumed to be constant)
t - time to maturity

Details of results from section 1 one are given below:

$$£311 = \frac{£1{,}000}{(1+0.06)^{20}}$$

$$£610 = \frac{£1{,}000}{(1+0.025)^{20}}$$

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