

Submission to Work and Pensions Committee Intergenerational Fairness Inquiry

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Executive summary

- The average incomes of current pensioners are similar to the rest of the population and they are now less likely to be in poverty than other groups.
- Recent retirees look financially well prepared for their retirement: the majority of English couples born in the 1940s have more than enough wealth to keep their living standards at the same level in retirement as during working life, even when housing wealth is excluded.
- In recent history each generation has tended to be better off than the last as national income has risen. But this trend has now stalled: those born in the 1960s and 1970s have no higher incomes than those born ten years earlier had at the same age. Younger generations also face an economic and policy environment in which it is harder to accumulate wealth for retirement than it was for their predecessors: it is harder to become a homeowner, private pension schemes are less generous on average, and the state pension will replace a smaller share of earnings on average. On the other hand, those in younger generations expect to inherit much more than older generations did.
- One element of current policy that is not sustainable indefinitely is the ‘triple lock’. Since the state pension rises in line with the highest of earnings or prices (or 2.5%) in each year, it will rise faster than either earnings or prices over time, and so take up an increasing share of national income. There are better ways to ensure the state pension rises in line with earnings over the long run but never falls in real terms (if that is the objective).

1. Introduction

1.1. In this submission we draw on a large volume of recent work by IFS researchers to present evidence on three areas that are relevant to the

committee's inquiry: the incomes, poverty and wealth of current pensioners; how the economic circumstances of younger generations compare to their predecessors; and the effect of recent tax and benefit changes on different age groups, along with a discussion of some possible reforms.

1.2. It is difficult to provide a comprehensive assessment of the relative economic circumstances of different generations, and the role of government policy in mitigating or exacerbating inequalities. Ideally one would compare the economic resources available to each generation over their lifetime, and quantify the effect of government policies on the distribution of these resources across generations. Such an exercise is beyond the scope of this submission.

1.3. Moreover, economic resources are not all that determines the relative welfare of different generations. Improvements in health, longevity and technology over time might well improve the welfare of younger generations relative to their predecessors. In that sense, the evidence presented here is only part of the overall picture that policymakers might wish to consider.

2. Incomes, poverty and wealth for current pensioners

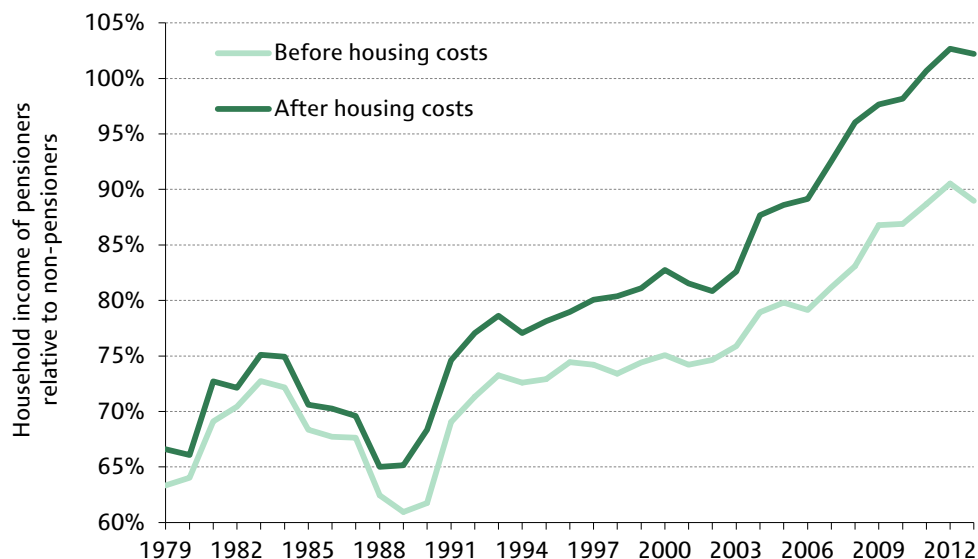
2.1. Figure 1 (reproduced from Chapter 3 of Belfield et. al. (2015) (<http://www.ifs.org.uk/publications/7878>)) shows the remarkable catch-up of pensioner incomes with the rest of the population. After housing costs are deducted (AHC), median income among pensioners is now higher than median income for the rest of the population, having been more than 30% lower as recently as 1990.

2.2. Figure 2 (reproduced from Chapter 6 of Cribb et. al. (2013) (<http://www.ifs.org.uk/publications/6759>)) shows the result of this catch-up in incomes on poverty rates by age: poverty rates (after housing costs) are now lower for those aged 65 and over than any other age group.

2.3. As Cribb et. al. (2013) show, the catch-up in pensioner incomes and consequent fall in poverty rates were driven by both higher private pension entitlements for younger cohorts and increased income from the state pension and pensioner benefits. The latter was driven by both increases in benefit rates and higher entitlement to state pensions (which

were themselves the result of policy changes and higher female employment rates).

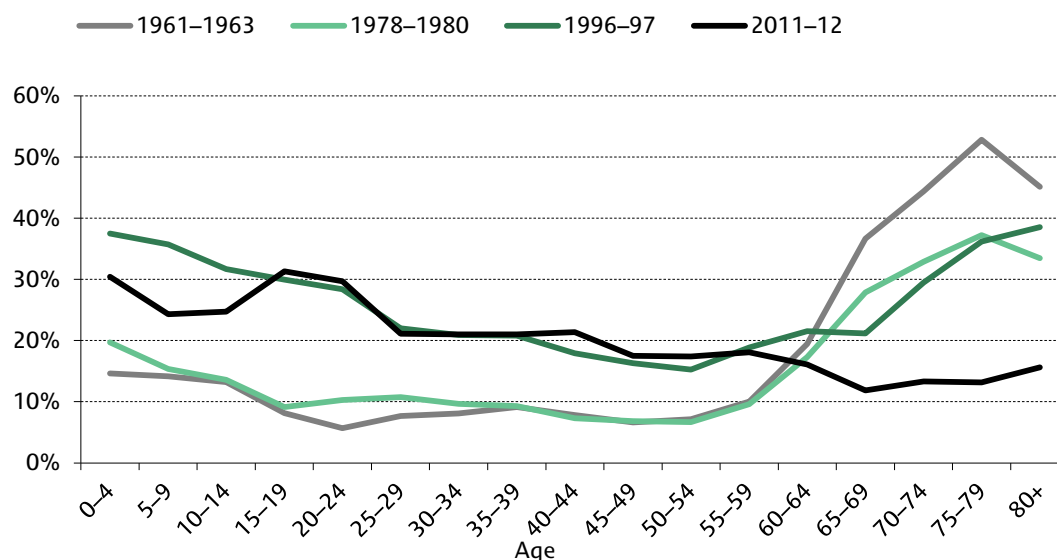
Figure 1. Median equivalised household income of pensioners relative to non-pensioners since 1979 (GB)



Note: Incomes have been measured net of taxes and benefits. Years refer to calendar years up to and including 1992 and to financial years from 1993–94 onwards.

Source: Figure 3.6, Belfield et.al. (2015).

Figure 2. Relative poverty rates by age (AHC)



Note: Figures are presented for GB up until 2001–02 and for the whole of the UK from 2002–03 onwards. Years refer to calendar years up to and including 1992, and financial years thereafter.

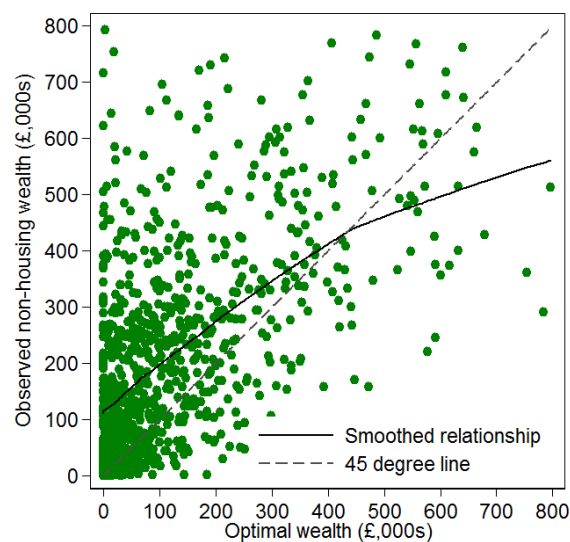
Source: Figure 6.3a, Cribb et. al. (2013).

2.4 Brewer and O’Dea (2012) show that the rise in median income and fall in relative poverty among those aged 65 and over has been even stronger

if we measure incomes in a broader way, accounting for the value of the housing consumed by different households as well as its cost.

2.5. Figure 3 (reproduced from Crawford and O’Dea (2014) (<http://www.ifs.org.uk/publications/7358>)) compares observed wealth (excluding housing) among English couple households born in the 1940s with an estimate of the amount they would need to maintain their living standards at the same level in retirement as during working life (‘optimal’ wealth). It shows that even excluding housing, the majority of households have more than enough wealth to keep to keep their living standards at the same level in retirement (they are to the left of the 45-degree line). They also calculate that more than 80% of households in the cohort will have an adequate income in retirement from state and private pensions (defined according to the Pension Commission threshold). To summarise, the majority of recent retirees appear financially well prepared for retirement when their resources are compared to their own resources during working-age life, as well as when they are compared to the resources of current working age households.

Figure 3. Comparing observed and optimal wealth holdings – excluding housing from observed wealth



Source: Figure 7.4, Crawford and O’Dea (2014).

2.6. In combination, this evidence on the incomes, poverty and wealth of current pensioners demonstrates that, while the relative generosity of the welfare state to different groups is a matter of political preference, it is no longer possible to justify greater generosity to current pensioners on the basis that they are worse off than the rest of the population –they are not –

or on the basis that their retirement incomes are ‘inadequate’ – for the most part, it seems they are not.

2.7. However, comparing the current circumstances of individuals at different ages is of limited use in assessing inequalities in the economic resources available to different cohorts over their lifetimes. It is more informative to compare the circumstances of different generations at the same age, as we do in the next section.

3. Comparing the economic circumstances of different generations

3.1. Figures 4.a and 4.b (reproduced from Chapter 2 of Hood and Joyce (2013) (<http://www.ifs.org.uk/publications/7007>) show that while successive cohorts used to have higher incomes than their predecessors had at the same age (as they benefited from rising national income), that trend has now stalled: those born in the 1960s or 1970s have no higher incomes than the predecessors born ten years earlier had at the same age. Hood and Joyce (2013) also showed that the additional income later cohorts did enjoy at younger ages was spent rather than saved.

Figure 4.a. Equivalised median household income by age for those born between the 1910s and the 1940s

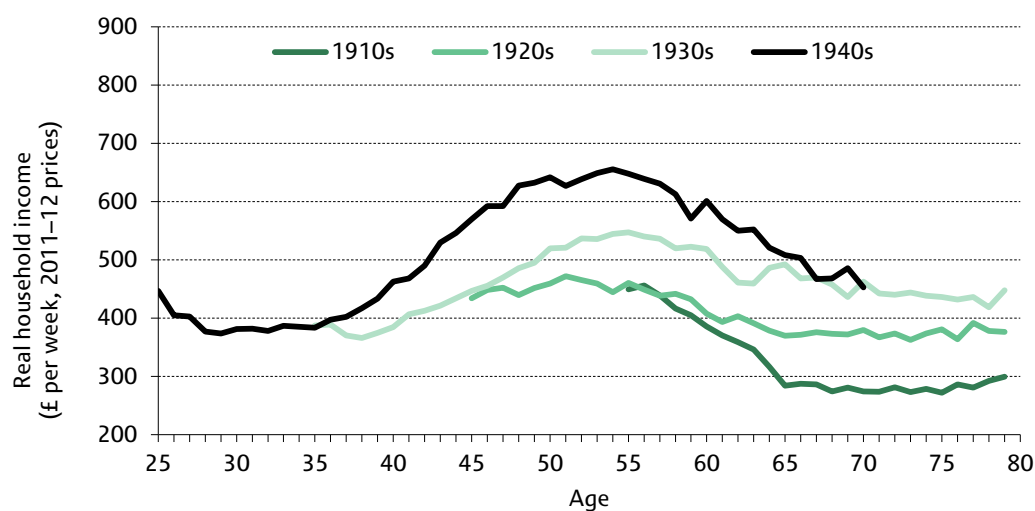
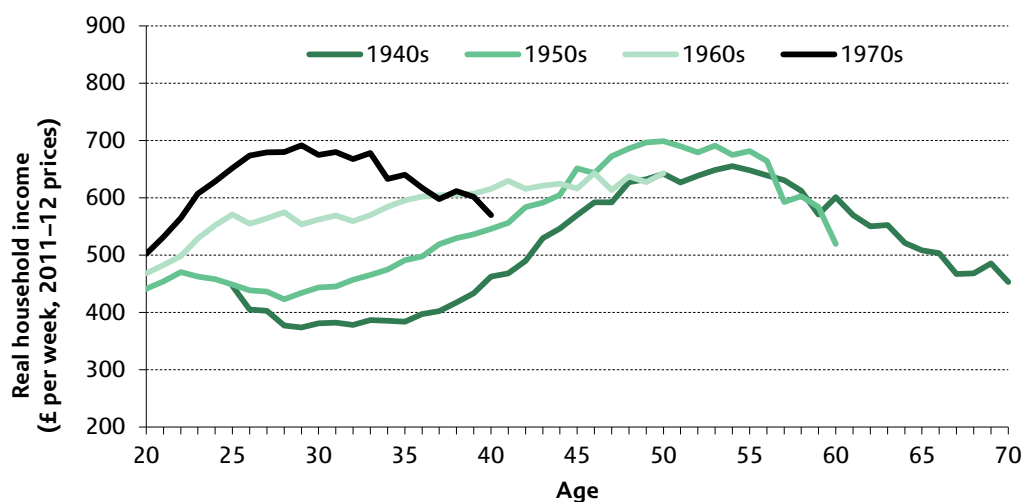


Figure 4.b. Equivalised median household income by age for those born between the 1940s and the 1970s



Note: Incomes are measured before deducting housing costs.

Sources: Figures 2.2 and 2.3.a, Hood and Joyce (2013).

3.2 Brewer and O’Dea (2012) show that measuring incomes in a broader way, accounting for the value of the housing consumed by different households as well as its cost, reinforces the conclusion that those born after 1950 are more likely to be among the poorest in society - at any given age - than were those born between 1930 and 1950 at the same age.

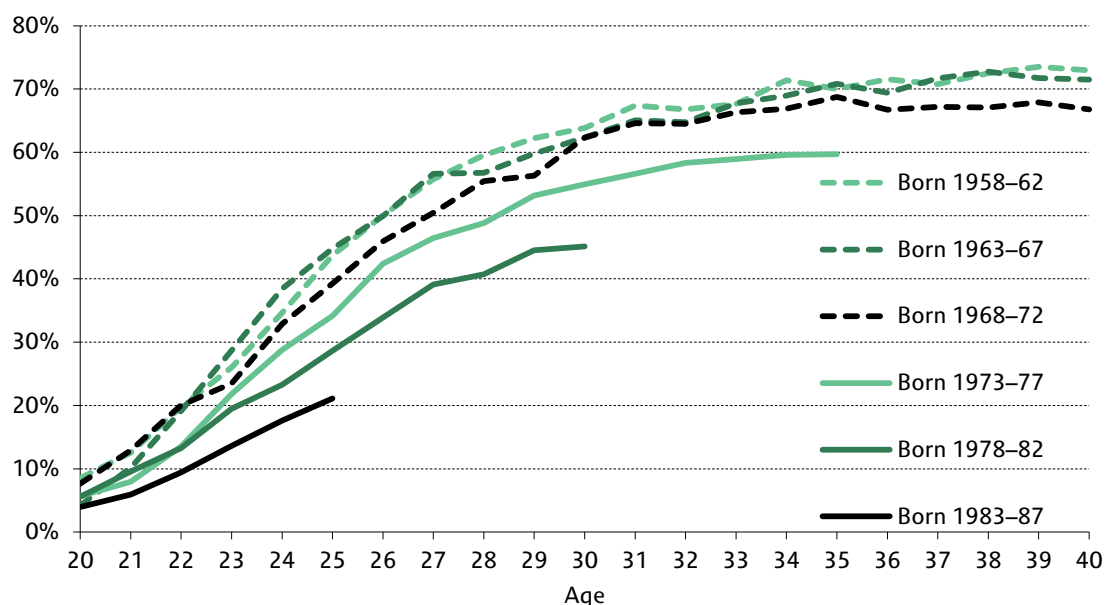
3.3 Figure 5 (reproduced from Chapter 3 of Belfield et. al. (2014) (<http://www.ifs.org.uk/publications/7274>)) shows that younger generations are much less likely to own their home than their predecessors were at the same age. At the age of 25, only 20% of those born in the mid-1980s were owner-occupiers, compared to over 40% of those born in the mid-1960s at the same age. There is also some evidence that homeownership rates for younger generations are flattening out at a lower level than those attained by the predecessors. One obvious reason for this is the sharp increase in the ratio of house prices to average annual earnings, from less than 4 in the mid-1990s to over 7 in 2013–14.¹ The decline in homeownership rates might be thought a cause for concern in itself, but it also has the potential to affect the wealth accumulation of younger generations over their lifecycle if the (leveraged) returns on

¹ Source: Figure 2.1, Belfield, Chandler and Joyce (2015)

(<http://www.ifs.org.uk/publications/7593>).

housing continue to exceed those on other assets, and younger generations are unable to access those returns.

Figure 5. Homeownership rates, by birth year and age

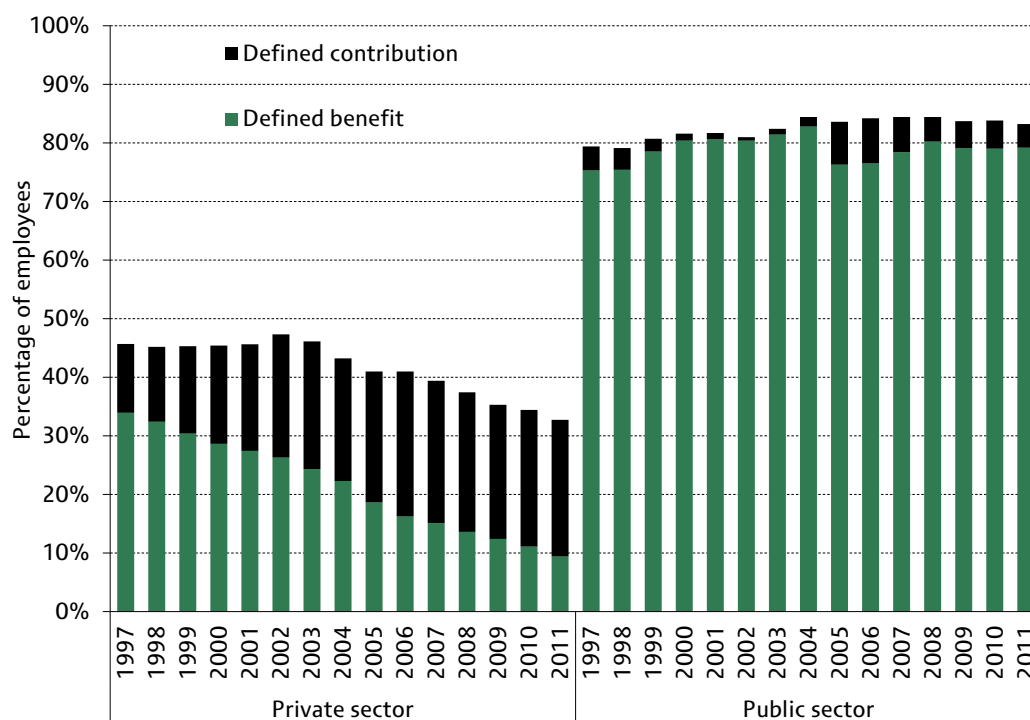


Source: Figure 3.13, Belfield et. al. (2014).

3.4 Figure 6 (reproduced from Chapter 3 of Hood and Joyce (2013)) shows the sharp decline in the availability of defined benefit (DB) pension schemes for private-sector employees. In 1997, DB schemes accounted for 74% of private sector pension plans to which contributions were being made; by 2011, they comprised only 29% of them. This rapid switch away from DB pension plans towards typically less generous defined contribution plans will have affected currently younger generations significantly more than older ones, both because they have more years of potential accrual of pension rights ahead of them, and because many DB schemes have been closed to new entrants.²

² Analysis of the generosity of DB and DC pensions in the public and private sectors can be found in Crawford, Emmerson and Tetlow (2010) and Cribb and Emmerson (2014).

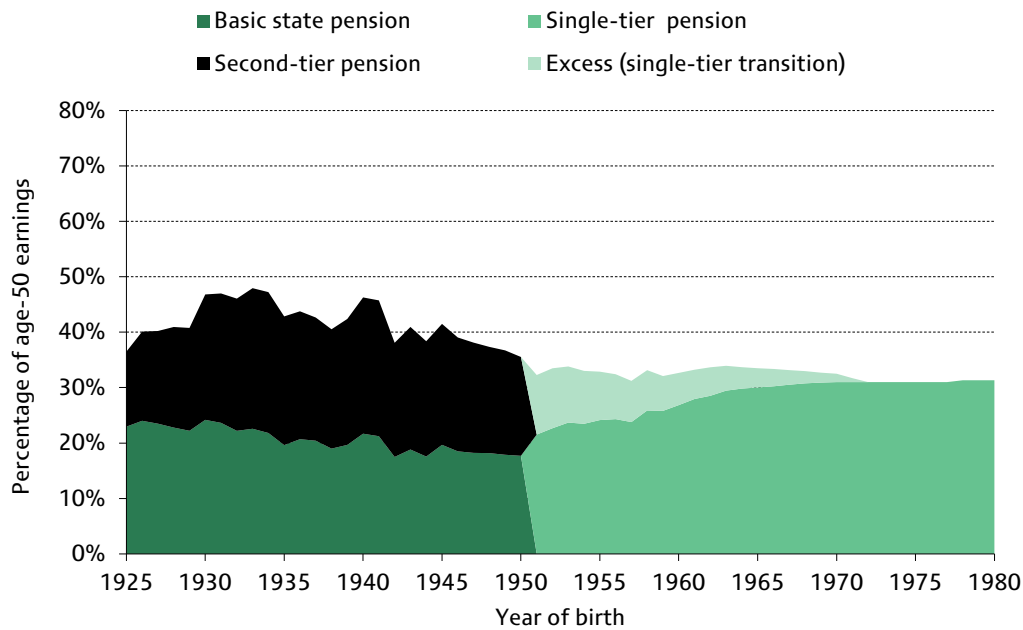
Figure 6. Percentage of employees with private pension to which employer contributes, by scheme type



Source: Figure 3.8, Hood and Joyce (2013)

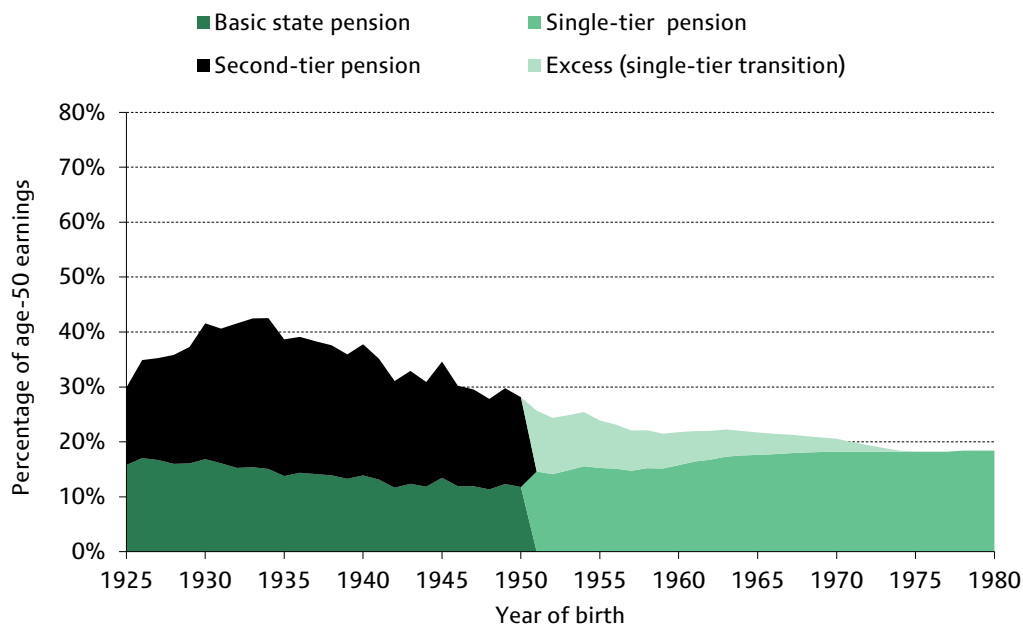
3.5. Figure 7a (reproduced from Chapter 3 of Hood and Joyce (2013)) shows the percentage of age-50 earnings replaced at retirement by state pension income for a male median earner born in each year from 1925 to 1980. Figure 7b shows the equivalent picture for a male who continually earns at the 80th percentile. Together, the figures show that replacement rates from the state pension have declined over time, and the decline in generosity is particularly pronounced for higher earners, who lose the most from the removal of the earnings-related element to the state pension system.

Figure 7a. Income replacement rates from state pensions at state pension age (SPA) for a male median earner who works continuously up to SPA, by birth cohort



Note and source: Figure 3.5.a, Hood and Joyce (2013).

Figure 7b. Income replacement rates from state pensions at state pension age (SPA) for a male 80th percentile earner who works continuously up to SPA, by birth cohort



Note and source: Figure 3.5.c, Hood and Joyce (2013).

3.6. The replacement rate that will be provided by the single-tier pension to those born in the early 1950s or later is significantly lower than the previous system provided to those born in the 1940s, and particularly

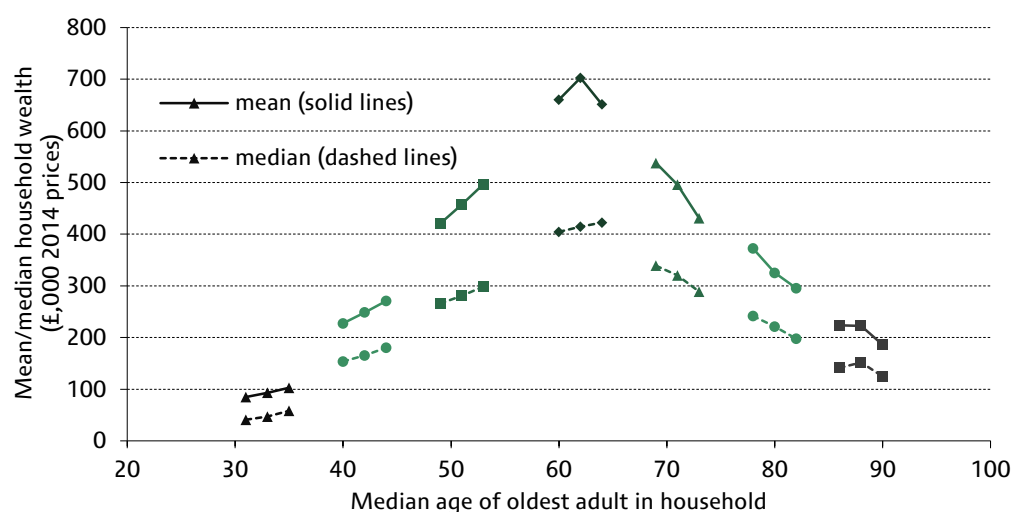
those born in the 1930s. A detailed analysis of the impact of the single-tier pension reform by IFS researchers (Crawford, Keynes and Tetlow (2013) (<http://www.ifs.org.uk/publications/6796>)) concludes that for those born after the mid-1980s the single-tier pension reform represents a reduction in state pension income for almost everyone (the only major exception is the long-term self-employed). They note that this reduction in generosity will help reduce the pressure an ageing population places on the public finances, but will increase the onus on individuals to save privately for their retirement.

3.7. Taking together this evidence on homeownership, private pension schemes and the generosity of the state pension, it is clear that younger generations face an economic and policy environment in which it is harder to accumulate wealth for retirement than it was for their predecessors: it is harder to become a homeowner, private pension schemes are less generous on average, and the state pension will replace a smaller share of earnings on average.

3.8. Some indicative evidence of the impact of some of these changes is given by Figure 8 (reproduced from Chapter 1 of Crawford, Innes and O’Dea (2015) (<http://www.ifs.org.uk/publications/8050>)), which shows the evolution of average household wealth (including private pension entitlements but excluding state pensions) between 2006–08 and 2010–12 for different age groups. The rate of wealth accumulation for different cohorts as they age shown in the figure suggests that younger generations are on course to have less wealth at each point in life than their predecessors had at the same age, unless the rate at which they are accumulating wealth picks up in future.

3.9. However, it is important to recognise that differences in wealth levels across cohorts reflect not just the different economic and policy environments that they have faced (and therefore the different lifetime resources they have had access to), but also any differences in attitudes towards saving or portfolio choice. For example, Hood and Joyce (2013) showed that despite higher incomes, individuals born in the 1960s and 1970s saved no more than their predecessors had at the same age, despite higher incomes.

Figure 8. Inflation-adjusted average total wealth 2006–08 to 2010–12



Source: Figure 1.2, Crawford, Innes and O’Dea (2015).

3.10. One respect in which younger generations look better placed than their predecessors is that if people’s expectations are correct, the receipt of inheritances will be much higher among those born in the 1960s and 1970s than those born earlier – discussed in detail in Chapter 4 of Hood and Joyce (2013). This trend towards larger inheritances for younger generations is also shown in Section 2 of Crawford (2014) (<http://www.ifs.org.uk/publications/7696>).

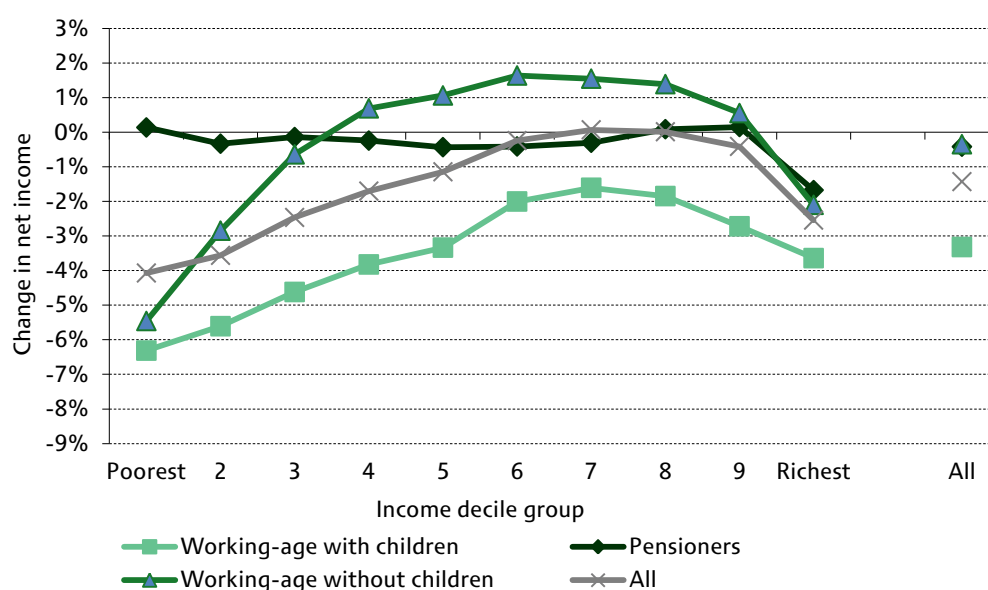
4. Tax and benefit changes and options for reform

4.1. A comprehensive assessment of the impact of recent government reforms on intergenerational fairness would include the effects of changes in public spending. However, as O’Dea and Preston (2012) (<http://www.ifs.org.uk/publications/6076>) argue, it is extremely hard to assess the distributional impact of public spending. We therefore focus on the impact of recent tax, benefit and state pension changes, and discuss some potential reforms to those areas.

4.2. Figure 9 (reproduced from section 3 of Browne and Elming (2015) (<http://www.ifs.org.uk/publications/7534>)) shows that the tax and benefit reforms implemented by the coalition government had very different impacts on working-age and pensioner households. In particular, relative to an ‘unchanged policy’ baseline, low-income pensioner households fared much better than low-income working-age households on average, reflecting the fact that they were largely protected from the benefit cuts implemented by the coalition, with the state pension instead

being 'triple-locked'. Note, however, that if one looks at the impact of reforms relative to a baseline of CPI indexation, the difference between pensioners and working-age households with children is much smaller. This is largely because the 'triple-lock' was less of a giveaway relative to CPI indexation than to linking the state pension to average earnings growth (the 'unchanged policy' baseline), as a result of the (unusual) falls in real earnings.

Figure 9. Impact of tax and benefit reforms introduced between May 2010 and May 2015 by income decile and household type



Note: Income decile groups are derived by dividing all households into 10 equal-sized groups according to net income adjusted for household size using the McClements equivalence scale. Assumes full take-up of means-tested benefits and tax credits. Source: Figure 3.4, Browne and Elming (2015).

4.3. The differential impact of tax and benefit reforms implemented by the coalition is part of a longer-run pattern in the impact of changes in government policy. As Browne and Elming (2015) show, pensioner households gained significantly more than working-age households on average from changes implemented by the Labour government between 1997 and 2010, partly explaining the catch-up in pensioner incomes shown in Figure 1. And pensioners have again been largely protected from the large package of benefit cuts announced by the Conservative government in the July 2015 Budget.

4.4. One element of government policy introduced by the coalition government (and preserved by the Conservative government) that is not sustainable indefinitely is the 'triple-lock' on the basic state pension (and

from April 2016, on the single-tier pension).³ The latest estimate from the Office for Budget Responsibility (in Chart 3.7 of the *Fiscal Sustainability Report 2015* (<http://budgetresponsibility.org.uk/fsr/fiscal-sustainability-report-june-2015/>)) is that state pension spending will rise from 5.4% of GDP in 2015–16 to 7.3% of GDP by 2064–65. In the absence of the triple lock (assuming the state pension increased in line with earnings instead), spending is forecast to rise to only 6.0% of GDP over that period. Two-thirds of the increase in state pension spending as a share of GDP forecast over the next 50 years is the result of the triple-lock, rather than an ageing population or increased eligibility to the state pension.

4.5. The fact that spending on a triple-locked state pension rises as a share of GDP over time is a direct consequence of the design of the policy. Since the state pension rises in line with the highest of earnings or prices (or 2.5%) in each year, it will rise faster than either earnings or prices over time, and so consume an increasing share of national income. Eventually that must become unsustainable.

4.6. An additional problem with the triple lock is that the value of the state pension in the long term depends not only on long-term wage growth and long-term inflation, but also the volatility of wage growth and inflation (as well as the correlation between them). There is no plausible objective to which the triple-lock is the best solution.

4.7. It seems plausible that the policy objective motivating the triple-lock is to ensure that the state pension does not fall behind earnings (as it would with price indexation), while protecting pensioners from real cuts to income in periods when real earnings fall (which would occur with straightforward earnings indexation). If this is the case, the government could instead set a threshold for the percentage of average earnings below which the state pension is not allowed to fall. The state pension could then be increased in line with prices, unless doing so would reduce its value below that threshold. This policy (currently in place in Australia⁴) would achieve the above objective – the state pension would increase in line with earnings over the long run but never fall in real terms – without the presumably unintended long-run effects of the triple lock. If the

³ The triple lock is discussed in detail in Section 3.1 of Hood and Phillips (2015) (<http://www.ifs.org.uk/publications/7535>).

⁴ See <http://guides.dss.gov.au/guide-social-security-law/5/1/8/50>.

government believes the state pension is currently too low relative to earnings, it should state what it thinks the appropriate level is, and lay out a path of discretionary increases to reach that level. There is certainly no economic rationale for a minimum increase of 2.5% each year that applies regardless of changes in meaningful economic variables like earnings and prices.

4.8. Compared to the future level of state pensions, other changes to pensioner benefits have relatively little effect on overall spending, or the sustainability of the system. For example, means-testing the oft-discussed winter fuel payments and free TV licences (by restricting entitlement to recipients of pension credit) would save somewhere between £1½ billion and £2 billion a year – less than 2% of total spending on state pensions and other pensioner benefits. (Abolishing them completely would save £2.8 billion a year, but would create low-income losers.⁵)

4.9. Beatty et. al. (2014) (<http://www.ifs.org.uk/publications/7338>) provide evidence that cuts to these universal benefits would likely have a different impact of pensioner spending patterns to a cut in the state pension – they find that households spend 47% of their winter fuel payment on fuel, whereas that figure would be 3% if they treated the payment purely as cash.

⁵ Figures in this paragraph are from Browne and Hood (2015) (<http://www.ifs.org.uk/publications/7530>).

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