Sticerd 25th Anniversary lecture

Can we afford our future?

Howard Glennerster

Twenty five years ago Michio Morishima shared a dream with us. He believed that economists and other social scientists lacked the laboratory environment that natural scientists enjoyed – an environment in which academics, younger staff and PhD students could work together. Moreover, as a theorist, he saw that generating better theories was an integral part of applied work, not some separate activity.

STICERD is the living outcome of that dream. The best ideas are often the simple ones and Michio's was no exception. We owe him a great debt.

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This evening I want to take on one of the big issues of our time - how should we respond to the economic challenges implied by our longer life, falling fertility, growing inequality <u>and</u> our rising expectations of our public services? A powerful cocktail in combination; too often considered separately.

In doing so I shall be drawing on the work of colleagues in STICERD, past and present, - the policy simulation modelling techniques pioneered by Tony Atkinson and Holly Sutherland, Jane Falkingham, Maria Evandrou, Ann Harding and John Hills. They have given us a way of thinking about policy options that did not exist when STICERD was formed.

Now, of course, as an aged person I am not suggesting there is anything wrong with living longer. As I used to tell my students I have already outlived my expected life span, as it was in 1936, by a good many years. I

hope the students I taught, the grandchildren I look after every week, my wife and indeed those in STICERD do not view my continued existence as a burden. We should be celebrating and enjoying our longevity. But that does not alter the fact that it and other demographic changes carry large economic and fiscal implications that many are choosing to ignore.

The fundamentals

Let us start with some fundamentals. In December 2003 the Government Actuary's population estimates assumed that life expectancy would be longer than previously. 'At a stroke' this raised the expected numbers of over 75s in the population by 10 per cent or by 700,000 people by 2031! No mean feat for a stroke of the demographer's pen.

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Despite the attention paid to these longer lives what matters most in economic terms is our failure to produce as many babies and hence future workers. [This is not a phenomenon I must say that one observes in STICERD. Each time I come, there seems to be a new arrival to the STICERD family being proudly shown off. Perhaps STICERD is at the leading edge of a new wave here too.]

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The number of children produced, on average, by each British woman born in the mid 1930s was about 2.5. For those born in 1947 it was nearly 2.2, and in 1957 just 2. It is now assumed that the number of children will level off at 1.74 for women born in 1972. The big difference compared to previous generations is that more women are having no children at all. Fertility rates in some other European countries are much lower.

compare countries' fertility. The UK's period total fertility rate is currently just above 1.6. This is rather higher than in several other

Demographers have various explanations for these changes: female

education, their greater economic autonomy, the stress of home <u>and</u> work responsibilities, the unequal division of labour in the household – particularly in the Mediterranean countries. (Smallwood 2003). But it is all still largely guesswork so far as I can see.

However, the implications are striking. Assuming no immigration, a fertility rate of 1.5 means the population will halve in 44 years.

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In 1950 there were four and a half potential workers supporting one pensioner. Now the figure is almost three and a half. In 2050it will be two and a half.

It is not just demography. The age at which men have been withdrawing from the labour force has, until very recently, been falling while life expectancy has been rising. In the UK nearly half of all men have left the labour force by the age of 60. [Average age 62.] But in 1880 three quarters of men over 65 were still at work both here in the UK and in the US. (Da Costa 1998). Indeed in 1910 in the US the average age at which men left the labour force was 74! (Burtless and Quinn, 2000).

The big costs to the public purse arise at the beginning and the end of life. An 85 year old costs the public purse five times as much as a 30 to 55 year old.

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But it would be a mistake to confine this to an issue of public expenditure. Whoever does the funding the same issues arise. Many companies have not adjusted their or their employees' contributions upwards to take sufficient account of changing life expectancy. Perhaps even more perversely the current switch from defined benefit to defined contribution schemes has been accompanied by a reduction in firms' contributions just when more is needed.

On top of all this come rising expectations. People want more from public services. This government has been driven to promise unprecedented increases in health and education and public transport spending.
Then there are other fiscal demands we forget. The extent of inequality in original incomes is much greater than it was, as Tony Atkinson showed in the first lecture. There is more redistributive work than ever for government to do in order to maintain an acceptable safety net.
So - can we really have it all? High quality public services, more rich to poor redistribution and more redistribution from the young to the old? Any one would be a problem on its own.

The reassuring case

Now there is a perfectly plausible argument that we should not get too fussed about all this. In the past century we have adjusted to a very big change in the demographic structure – bigger than anything envisaged in the next. The likely growth rates in productivity will outpace the decline in the number of workers as the excellent House of Lords Economic Select Committee report (HoL179-2003) points out.
In the past century we adjusted partly through many more women entering the labour force. There is less room now for that adjustment but even so if the UK increased the participation of women in the labour force to Swedish or Danish levels it would solve the problem. True but that would be a big change from a 1.5 earner family to a near 2 ft earner family norm.
In the 20th century we increased the share of the GDP going in social welfare expenditure, much of it age related. From 1948 to 1976 we

increased the percentage of the GDP devoted to social spending from 15 to 25%. We have done that once perhaps we can do it again.

However, that is definitely <u>not</u> the current Government /Treasury case. <u>That case is that there is not a fiscal problem.</u> My case is that there is. How so?

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The Treasury case.

- The changes in demography will have only a small impact on the economy and services like health and long term care. It is all fiscally sustainable without significantly more tax.
- The UK has already taken the key steps that are necessary, especially in the pension field. We have well developed funded pension schemes. They will grow to provide most people with a pension. The extra saving they produce will bring growth in productivity and output that will compensate for the decline in the number of workers.
- If not as people realise that the levels of pension being generated by a short working life are too small they will begin to work longer. That has already happened in the USA and is beginning to happen here. The last few years have seen the age at which men are withdrawing from the labour force stop falling. Women are working for more of their lives. It will all work out.

In short the Brits have got it all sorted even if others have'nt.

Can we really believe this?

Let us look at the Treasury figures.

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The reassuring message for health and long term care <u>is</u> based on some evidence. The Wanless Report (2002) did carefully review the medical and epidemiological research. A better educated population could lead a

healthier life. There is some American and some Scottish evidence that moderate levels of disability are declining in older people. The Treasury took this into account in their projections for long term care. After 2011 all the effects of longer life expectancy would be counterbalanced by reduced disability.

That seems to me optimistic.

Moreover I doubt whether future generations will be prepared to accept current standards of so called "care". People may live more healthy lives in the future but they will also be more demanding and there will be more of them.

On education falling numbers of school children will pay for some improvements.

So the Treasury projections on service costs seem to me optimistic but not nonsense.

It is when we come to pension spending that the whole soothing message becomes frankly incredible.

The politics, the economics and the equity implications all seem to me highly questionable.

It does not add up

Let's take the politics first. On present policies, the Treasury suggest that the total amount spent on state pensions, basic and second pension, the minimum income guarantee for old people as it was called, the new pension credit and age related disability benefit will fall slightly as a percentage of the GDP in the next fifty years – from 5 per cent to 4.8 per cent. That despite the rise in the population over 65.

- This is made possible by linking pensions to price increases not earnings. Spending per pensioner, as a percentage of average

earnings, is set to fall from 18% today to 13 % in 2050. All this at a time when pensioners are becoming a larger share of the electorate.

What about the economics?

All pensions are a claim by non producers on tradable goods and services produced by current workers. Claims on these goods and services can be taken away from current workers by force of law in taxes and paid to pensioners. Or current and future generations of workers must be persuaded to consume less by saving more to free resources for a growing elderly population. So savings incentives matter a lot.

- If state pensions do not rise with earnings and the means tested pension credit level does rise with earnings the number facing significant means tests on their future pension income will grow. It will be over half of households- 65 – 70 – 80 % according which model you believe (HoL 179 2003). They lose much of the point of saving. Many could still find it beneficial to save but the complexity and uncertainty of the situation could well lead many not to do so. If these disincentives were to last for a generation it is difficult to see how they would not have an impact. Just the people whom we want to save more are the very people who will be caught in this complex savings trap.
- A smaller young population is still going to have to pay taxes to support the older generation.
- Even if young people do save more for pensions they may not save more overall. More pension saving may reduce other saving.
- Even if they do save the extra savings may not translate into extra pensions that they expect given the volatility of asset markets. And these will be relatively poor people.

The point is that there is a good deal of uncertainty in all of this.
Most people are now joining defined contribution schemes so all the growing system risks that I have been talking about will fall on the individual not the firm. These will come on top of the private risks of long term sickness and an interrupted working life. Women will suffer most.

What of the argument that it will all sort itself out without any policy change? People will rebalance their life plans and work longer and adjust to a lower expectation of income in retirement.
There is clearly something in that.
We get besotted with replacement <u>incomes</u> in these debates. We should be worrying about utility. Ann and I are living on about 55 per cent of our past net income. Our children and mortgage are gone. And above all I have no dreadful academic committees to sit on or exams to mark. I have time to visit my grandchildren. I would trade all that for a 50 % pension any time.
The problem with this argument is that we are not all ex professors.
We know from US research (Aaron 1999) that people are remarkably ill informed about their likely financial state in retirement. An interesting study in the December issue of the <u>American Economic Review</u> showed that the poor and the young in Britain did not change their savings habits even when faced with a <u>huge</u> drop in their pension prospects resulting from the Conservative government changes. It was the higher income groups over the age of 45 that changed their savings behaviour. Many people may not wake up to the need to change until it is too late. Or they may not have the scope to do so.
All this is without considering the gender implications. Though the state second pension has some limited recompense for periods spent caring for

children or the disabled or the elderly private pensions do not. A woman with a shorter work record does badly in the private pension market and in the state second pension as colleagues in SAGE have shown (Falkingham and Rake 2001).
In short, the distributional consequences of the government assumptions are worrying as well as their overall political and economic implausibility.

So what happens if the politics of pensions does go wrong? What happens if we begin to relax the assumption about falling state pensions in relation to earnings?
So here are my alternative projections to the Treasury ones.
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- In the case of health care the Treasury numbers may not be that far out. We may come to realise that throwing money at doctors is not the best way to improve health. I assume 3.5% more of the GDP going on health than in 2001/2.
- On <u>Education</u> the Treasury build in the planned increases in resources up 2011 and then assume a decline in spending as the school population falls. But note these figures take no account of the extra money coming from the proposed 'graduate contribution'. This does not show in the public accounts as a tax but it will feel like one all the same.
- Long term care costs have been underestimated it seems to me. The higher numbers of old people, pressure to raise standards of care, the new regulatory regimes, will, are already, pushing up costs. I have taken a midway position still short of the LSE

Health and Social care model's high case assumption. (An increase of 0.5% of GDP

- o If we wished to maintain state benefits for the elderly in line with earnings growth we would have to assume 3.6% more of the GDP going in benefits. It would be difficult to avoid that happening to benefits for the non elderly. If it did it would wipe out the assumed savings in the Treasury estimates from lower benefit spending.
- o Taken together, then, assuming no other changes we are talking of about 8% more of the GDP going in taxes by 2051 than were in 2001/2. That is an increase of nearly a fifth in the total tax take. It is, for sure, about what happened from 1950 to the present but it is not exactly what I see political parties campaigning to do. On the contrary. Two indeed are going for cuts.

What we are faced with then is not inevitable economic disaster but the need to wake up to some not very pleasant choices and risks. We are living in a fools' paradise. We cannot extend our lives significantly, have fewer children, not like foreigners, and improve public services without: [slide9]

- Paying more in taxes.
- Reducing our mid life consumption patterns significantly to pay for private pensions and insurance.
- Working a lot longer.
- Getting used to lower incomes, or replacement rates, in retirement.

If we wont pay more in tax the problem merely transfers to us as individuals.

For my recent book I asked a range of private insurers and pension companies what it would cost to insure a family in order to secure a half pay pension, medical cover and long term care of a decent standard. It would have taken a third of their gross income. That is roughly twice what such a family were then paying through their taxes for access to such services. It may be a better way of doing things but is not cheap.

We could say lets keep taxes and contributions the same and pay for a constant level of state pension by working longer. That would mean working until 73!
Much less has brought riots on the Continent and with some reason. Simply to raise the age at which pensioners could draw a full pension from the state or private schemes would mean that there would be losers concentrated at the bottom of society, especially those from less skilled backgrounds and those with poor health. They would end up getting no pension. As Tanja Burchardt's work shows many of those who are not in employment before retirement age have low skills, poor health and are not attractive to employers (Burchardt and Le Grand 2002).
To raise the full pension age to 70 would reduce my expected years of pension by about a quarter (18 – 13 years). For a manual worker the reduction would be about 40 per cent (13 to 8 years). To get anything like such a policy through would mean giving something to the likely losers.

How can we sell the future?

- For the long term we have to do something about fertility – tackling the compatibility of family life, children and work, introducing good child care and education from the age of three or earlier. There are other very good reasons for doing this on

educational and social exclusion grounds but it might also be a good pension policy.

- Being more relaxed about immigration might help in the short run but to maintain the present age balance would mean accepting half a million new workers a year. The Daily Mail would go bonkers! In the long run immigrants age too!
- Market failures in health and long term care suggest to me that tax funded services make the most economic sense for most people. But even larger costs falling on local authority council taxes makes an additional case for local authority finance reform. (A better way to use the value of property to offset long term care costs I would add to the currently discussed suggestions.)

So what to do about it?

A feasible future for pensions?

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- A significant level of private saving for retirement has to be predicated on a secure platform of a state benefit you get regardless of how much you save.
- That pension has to be above the income support level and rise in the same way as the income support/pension credit level however that is done.
- That will cost money which will have to be paid for largely by raising the age at which this benefit can be drawn. Such a rise in the state full pension age would give a signal to people about the age they normally withdraw from full time work. This has had a clear effect in the US where the age of full pension is being raised to 67. It has changed the way people think about the age at which they withdraw from full time employment.

- The form that the state pension takes must secure pensioners against the system risks and the private risks of an interrupted work history and caring responsibilities, at least up to a reasonable floor.
- It should take into account the gender inequalities that any private insurance schemes imply.
- Since many higher income pensioners would gain the tax system used to get the extra revenue has to be more progressive.

Does any country come close to following this model?

- The Dutch have an even larger funded private sector than we do (measured in terms of pension fund assets as a percentage of their GDP it is about 120% of GDP compared to our 80%). Most of their schemes are compulsory industry wide ones. The big firms - Shell, Phillips etc - run their own schemes. (They have been mostly defined benefit based and there are the same debates about their future. They, too, are facing problems of rising costs and demographic strain (Reil, Hemmerijck and Visser 2002).)
- [Incidentally they are discussing a 'life course insurance'. This would encourage savings to enable the movement of income through time to pay for child care, parental leave or early retirement (Knijn 2004).]
- To go back to the present the system derived from the outcome of large scale collective bargaining of a kind we do not have.
- It was designed in its present form in the 1950s long before the demographic implications of the present century were appreciated.

- But it provides some elements we could look at. Knowing what we do now about the future demography we could build a cheaper variant.

Critically private pensions have been based on what is, essentially, a citizen's pension derived from years of residency and linked to the minimum wage.

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- It can be drawn at 65 by men and women alike. Entitlement accrues over 50 years of residence. (too long for new residents)
- Contributions take the form of a percentage tax on individuals' income. (Currently 18%.) Since there are no work related contributory conditions it is much more generous than ours to women and those with an interrupted work record.
- Their approach takes virtually everyone off means tested support. The Dutch have the lowest percentage of poor elderly in Europe.
- This citizen's pension has been over half of the net average wage for a couple.
- The Netherlands gave up a national means tested pension because it was proving a disincentive to saving.

The combination of this pension and the second occupational pillar is aimed to provide 70% of previous earnings in retirement.

Now I am not suggesting anything like as generous a target replacement rate. The Dutch set this rate in more favourable demographic times. There is much discussion about the present degree of generosity which is going to mean rising pension costs for both employers and the government especially as the Dutch have a faster ageing pattern than us. (Public pension costs could rise from 8% to 13% of GDP by 2050.)

So it is easy to say the Dutch have nothing to tell us. I think that is wrong.

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- The firm public base meant that there was a stronger incentive for most people to agree to be members of a funded scheme - hence their near 100 % coverage achieved by tripartite employer, government, union bargaining. Such is the ignorance of pension issues that some form of compulsory membership is probably necessary.
- As I said earlier I do not buy the argument that the funded pensions are the only or even best model for pension reform. But having chosen that route there is no way back; we need to create a public pension scheme that is consistent with it. A flat rate citizen's pension linked to earnings, above the income support level that does not rely on gendered contributions has a lot to commend it. We could abolish the basic state pension, the second state pension, the pension credit, most of the reliance on means testing and the hopeless complexity of our system by adopting a <u>scaled down version</u> of the Dutch model.
- The Dutch have no employer contributions. The revenue comes from the individual income tax. That would be a big change. As economists we know that the worker ends up essentially paying the employer's contribution too in lower wages. Voters would not be so sure. So the financing could be through a specific social security tax paid by employer and employee right up the income range. That would be an effective rise in the top rate of tax for individuals. Heresy, I know, but there it is.

A simplified pension system that encouraged saving would be the positive sell. The quid pro quo would have to be a higher full pension age.

- To pay for the scheme this age would have to be set at 68 [rather more than the IPPR age of 67 assuming many would have to receive it before then on grounds of long term illness.]
- At the moment just over 96% of those reaching that age have lived in the UK for 40 years and could qualify for a full pension.
- Those who are certified as incapable of work could qualify earlier. I do not see how it could be sold politically without some such clause.

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The problem with such a scheme is the transition from here to there. People who have rights of a sort in the old SERPS and new second pension would be very upset if they lost them. Those rights would have to be phased out over a decade.

These changes to the basic pension could go along with changes to the tax regime for private pensions. This would involve tax credits designed to give carers and those bringing up children some pension rights in the second tier funded schemes. They would be paid for by reducing the pension tax relief now given to those on high incomes who gain disproportionately from the present tax regime. This would be my answer to those who say that a basic citizen's income in old age would end up spending most on those who did not need it. Of course it would if we did nothing else to the tax system. Translating the present pro rich tax relief into tax credits for carers and those bringing up children would be one way to even up the distributional effects of such a scheme. (Le Grand and Agulnik 1998)

In short, of course we can afford our future. But we have to be honest about the kinds of changes it will involve so that we can debate them sensibly. No political party is doing so at the moment. Sadly!

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