Institute for Fiscal Studies

Demographic change and fiscal policy

Paul Johnson

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

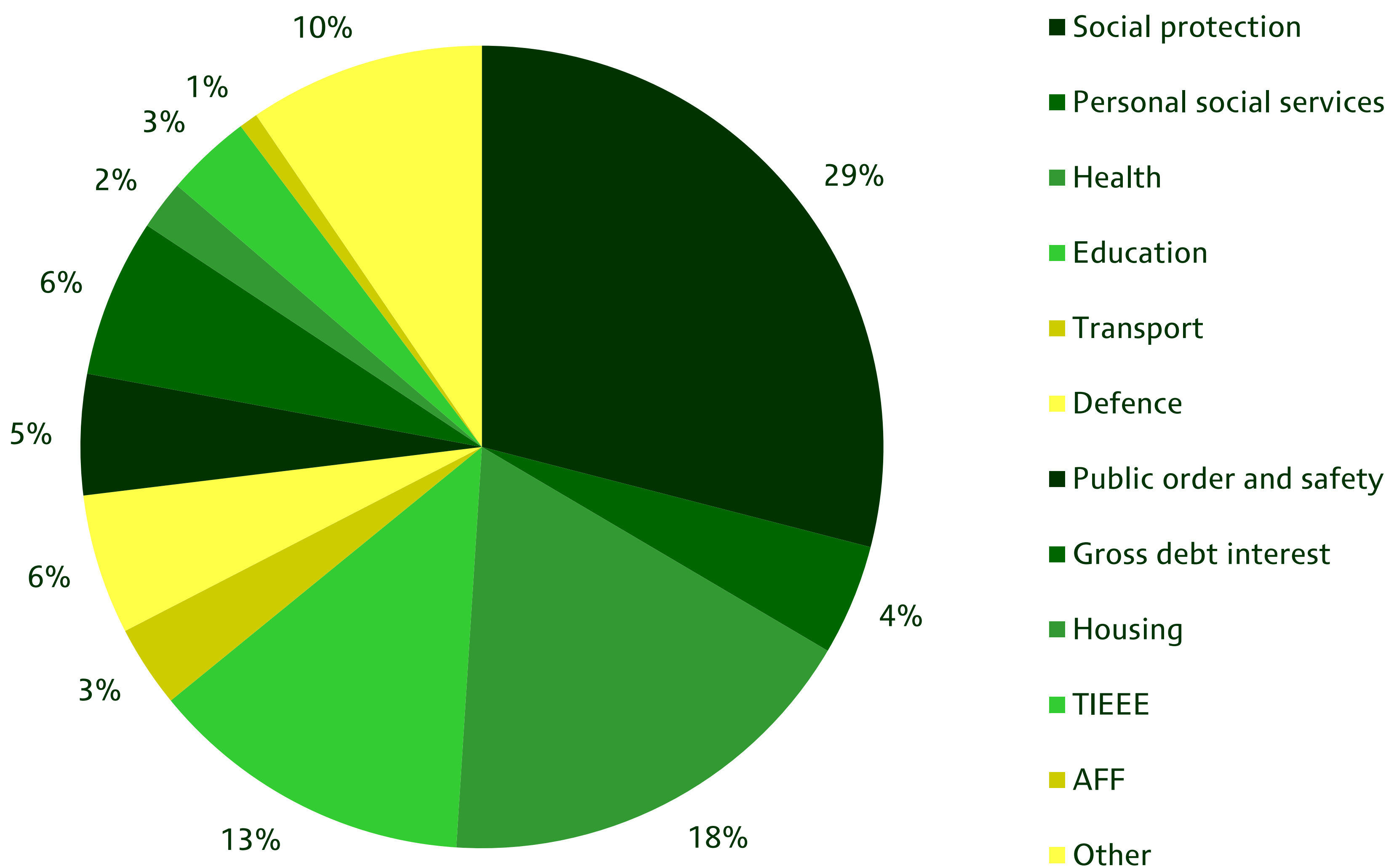
Demography and fiscal policy

- Age structure of the population clearly matters
  - Old people less likely to work
  - Spending on elderly much higher than on young
- Policy needs to be made understanding future costs
  - SERPS
  - Pension ages
- There are some sharp and unavoidable choices:
  - Raise taxes
  - Cut spending on health and/or pensions
  - Cut other spending even further

But don’t panic!

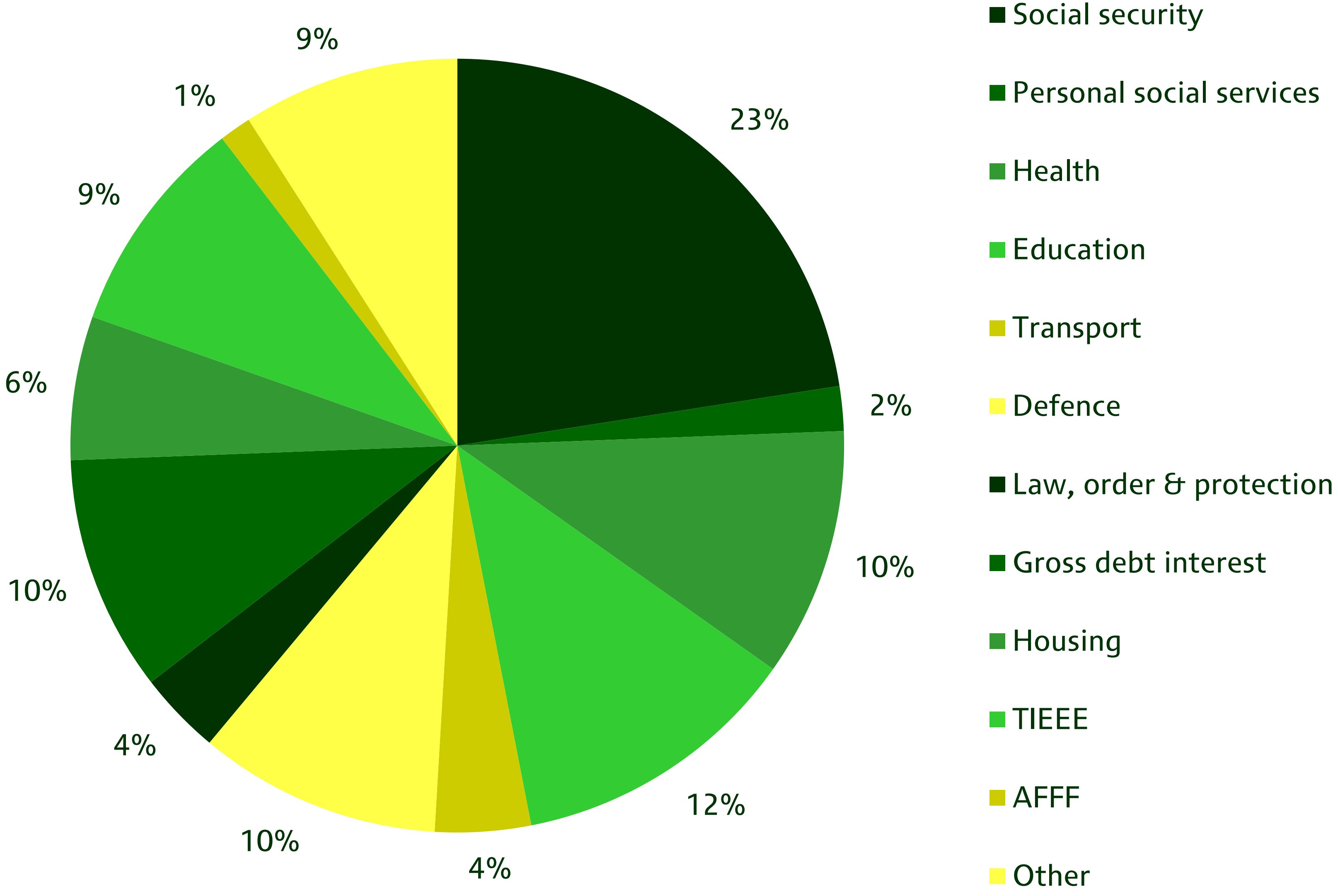
- Other things matter as much/more
  - E.g. Growth, tax receipts etc
- Some behaviour ought to adjust to compensate
  - Retirement ages
- There is scope to adjust policy
  - E.g. Pension age and indexation etc
- We have coped/are coping with major demographic change

Public spending in 2010-11



Institute for Fiscal Studies

Public spending in 1978-79



Institute for Fiscal Studies

But don’t panic!

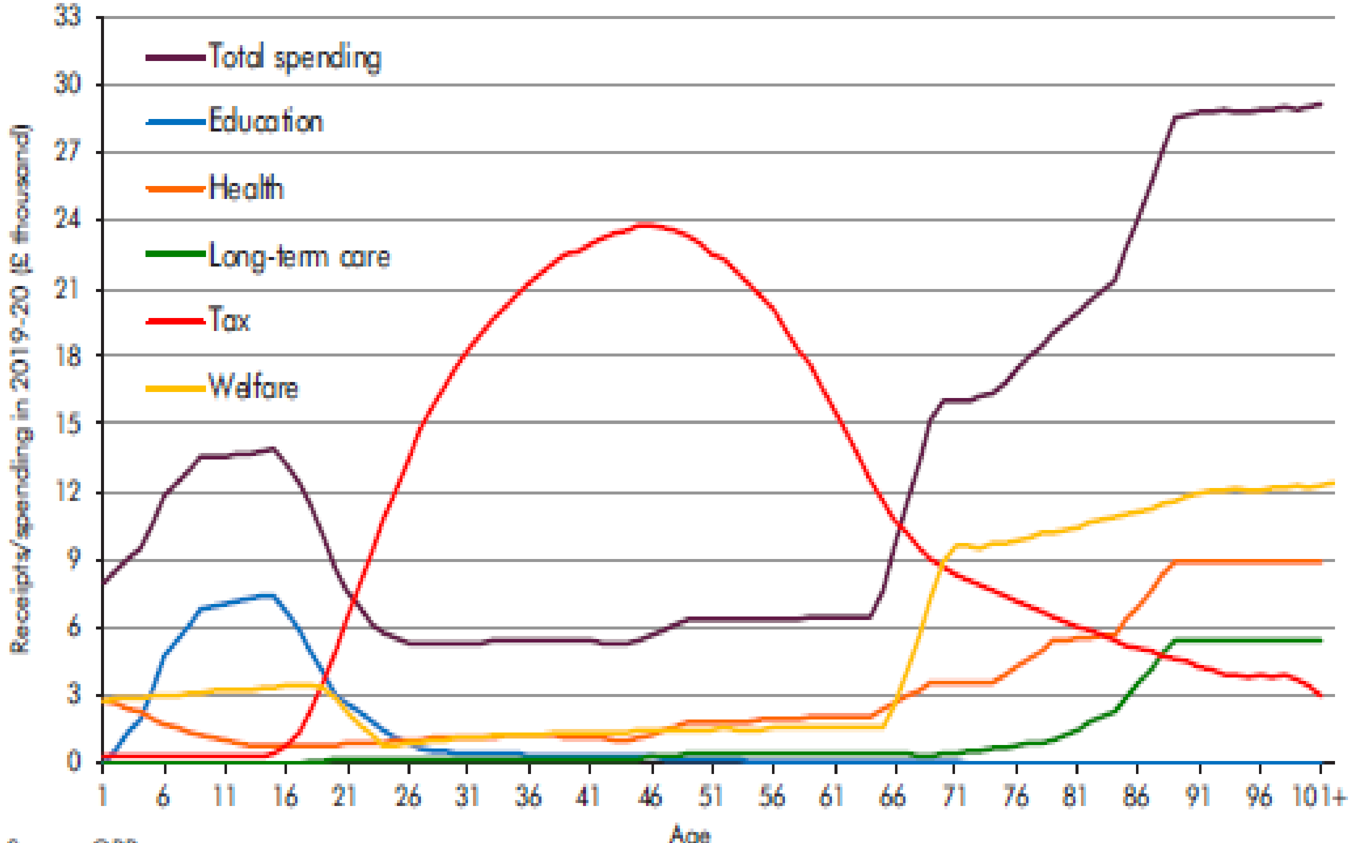
- Other things matter as much/more
  - E.g. Growth, tax receipts etc
- Some behaviour ought to adjust to compensate
  - Retirement ages
- There is scope to adjust policy
  - E.g. Pension age and indexation etc
- We have coped/are coping with major demographic change
- And we shouldn’t fixate on the fiscal issues, other economic impacts may be more important
  - See what is happening in current DB schemes

Institute for Fiscal Studies

Measuring fiscal impacts

- Two broad ways of looking at it
  - WGA/balance sheet
  - Flows (as in OBR's long term projections)
- For example one can present position with public service pensions as:
  - NPV of liability = £1.3 trillion
  - Spending each year from 2020 to 2070 between 1 and 2% of GDP
- I'm going to focus on the flow approach

Why does ageing matter to fiscal policy?



Source: OBR

Institute for Fiscal Studies

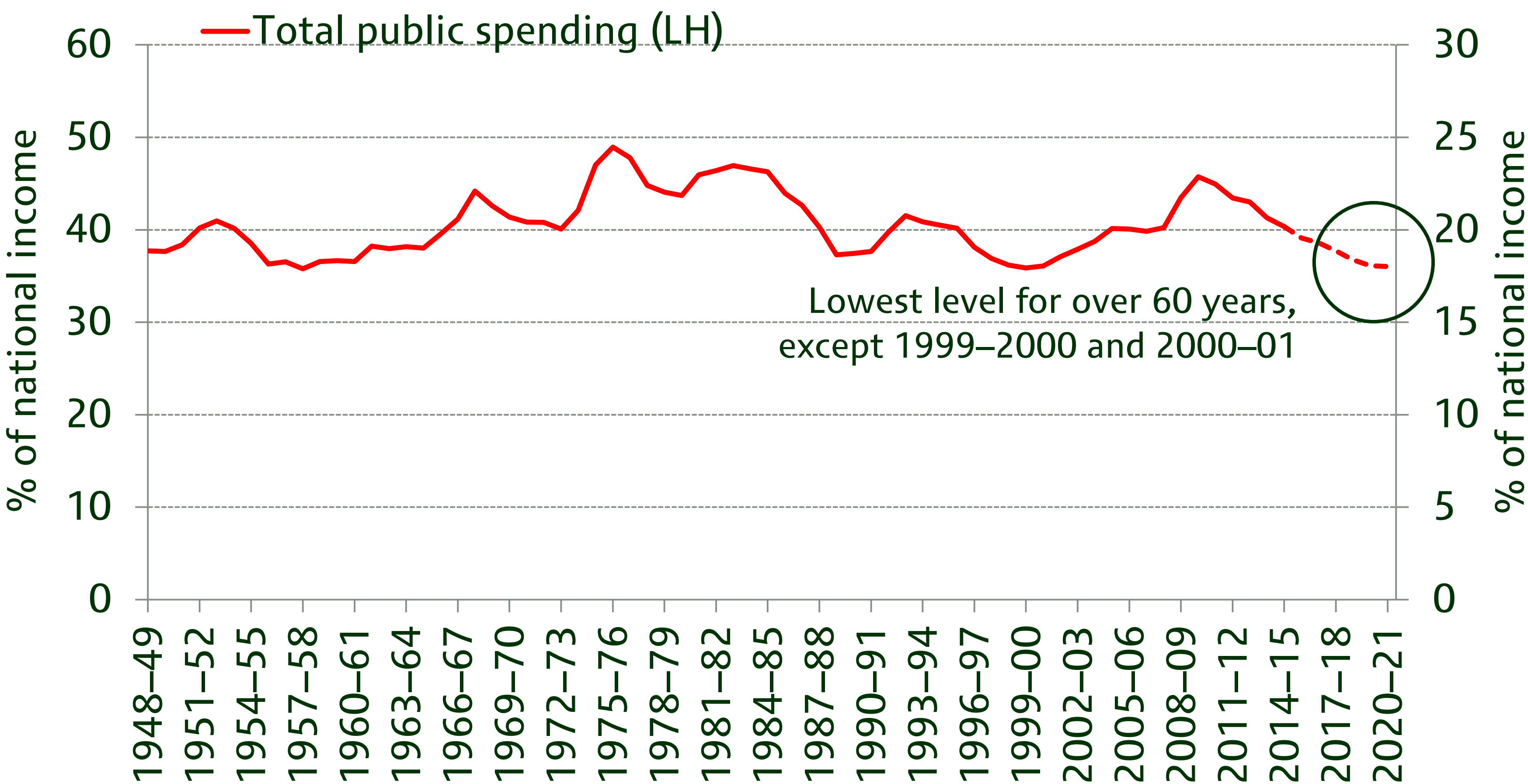
On OBR central estimates age related spending rises by 4% of GDP over 30 years to 2050

Institute for Fiscal Studies

Is that a worry?

- It implies tax rises or spending cuts elsewhere
- Starts, from a low level of spending assumed in 2020

Public spending to fall to a low level by historical standards

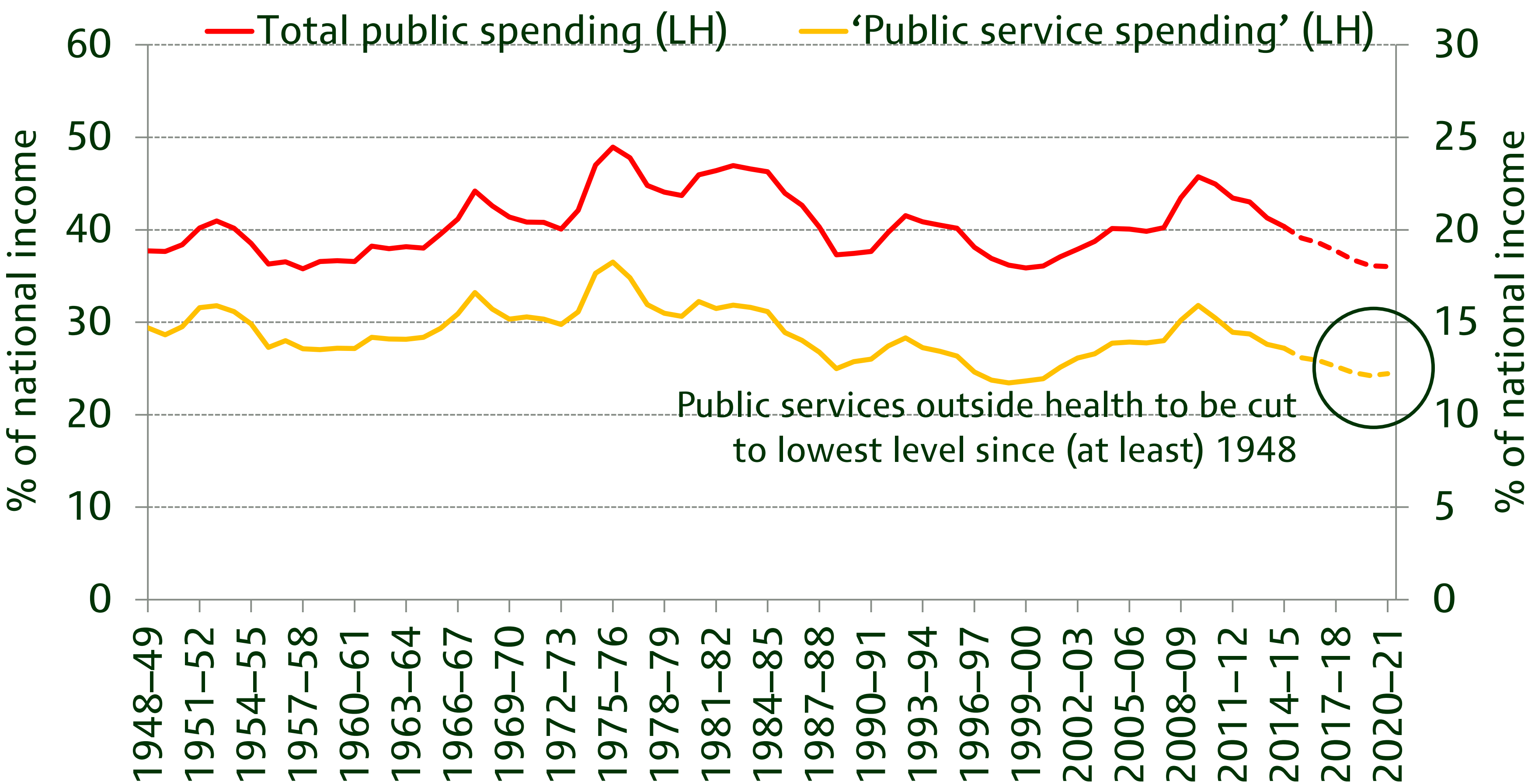


Institute for Fiscal Studies

Is that a worry?

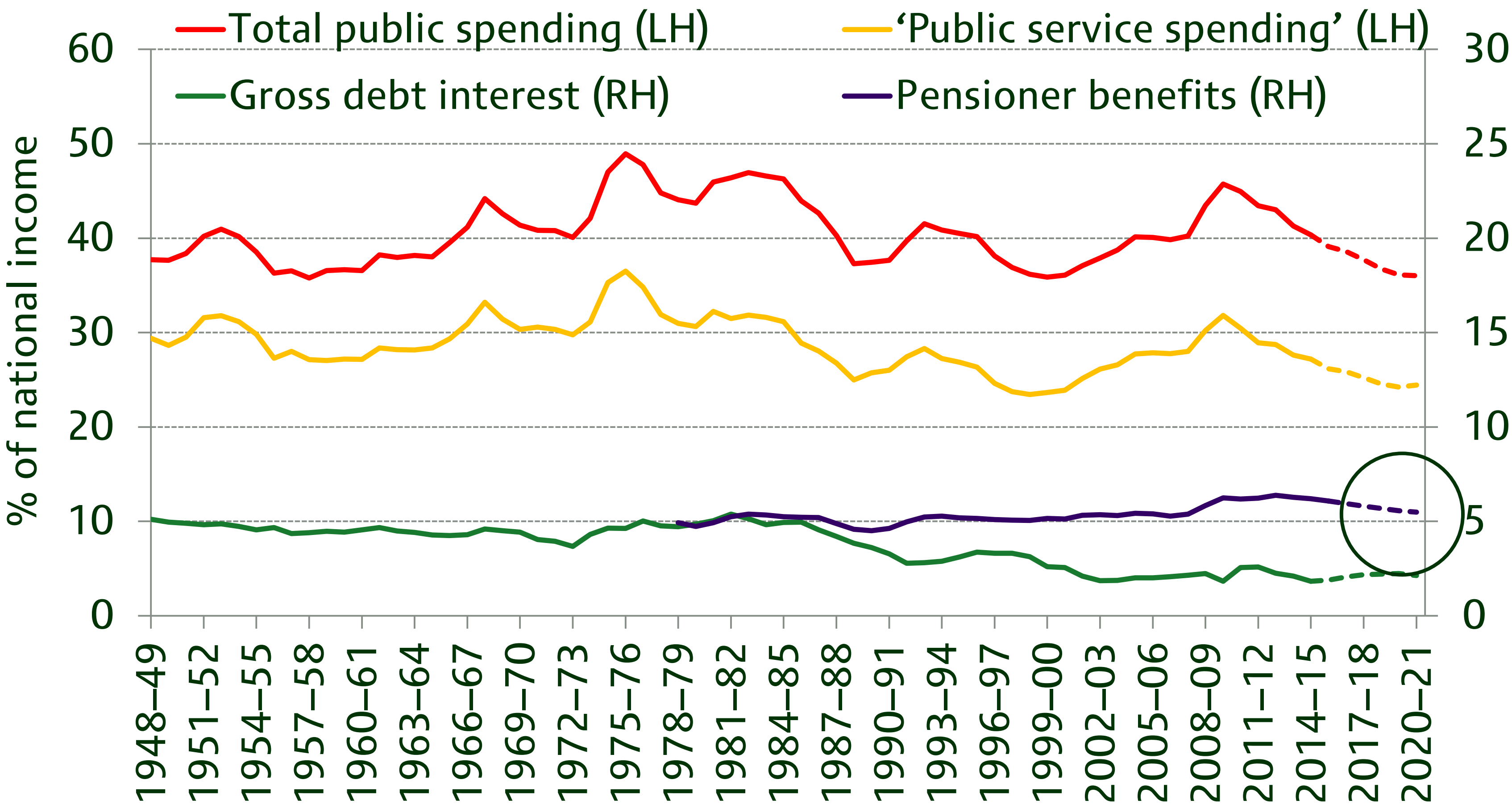
- It implies tax rises or spending cuts elsewhere
- Starts, from a low level of spending assumed in 2020
- But, spending on public services and working age benefits will be especially low
  - May not be able to maintain that

Public spending to fall to a low level by historical standards



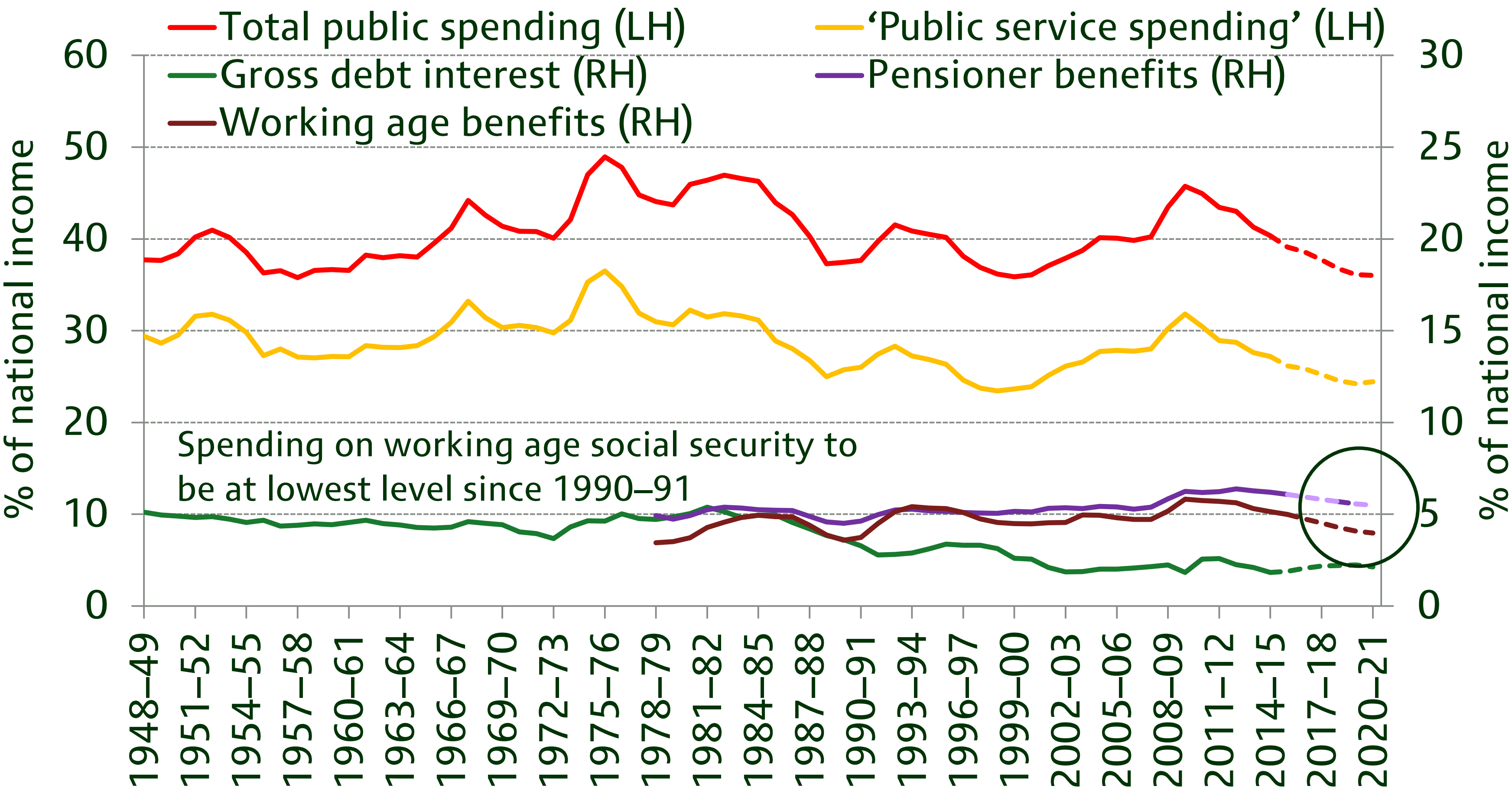
Institute for Fiscal Studies

Public spending to fall to a low level by historical standards



Institute for Fiscal Studies

Public spending to fall to a low level by historical standards



Institute for Fiscal Studies

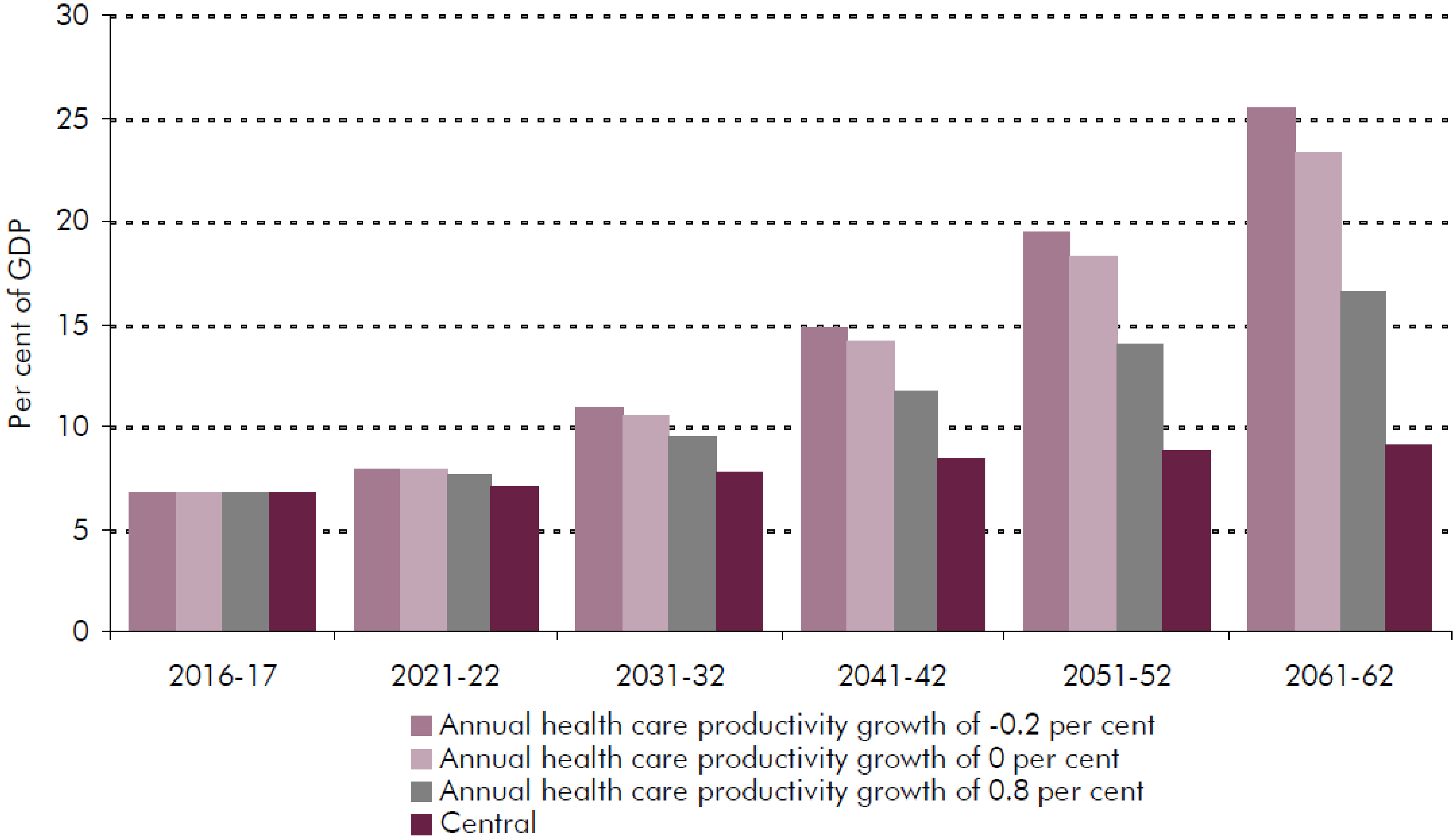
Is that a worry?

- It implies tax rises or spending cuts elsewhere
- Starts, from a low level of spending assumed in 2020
- But, spending on public services and working age benefits will be especially low
  - May not be able to maintain that
- If we are to raise spending on health and pensions it will have to come from tax rises
  - Implausible there is scope for more big spending cuts elsewhere

Health

- Health spending across most OECD countries has risen year on year as a fraction of national income
- Partly down to ageing
  - more important has been apparent failure of productivity to grow in line with wider economy
- Best estimates for UK are that over the long term health care productivity has risen by about 0.8% p.a.
  - compared to 2% p.a. for rest of economy
- OBR central estimates assume going forward productivity rises with rest of economy

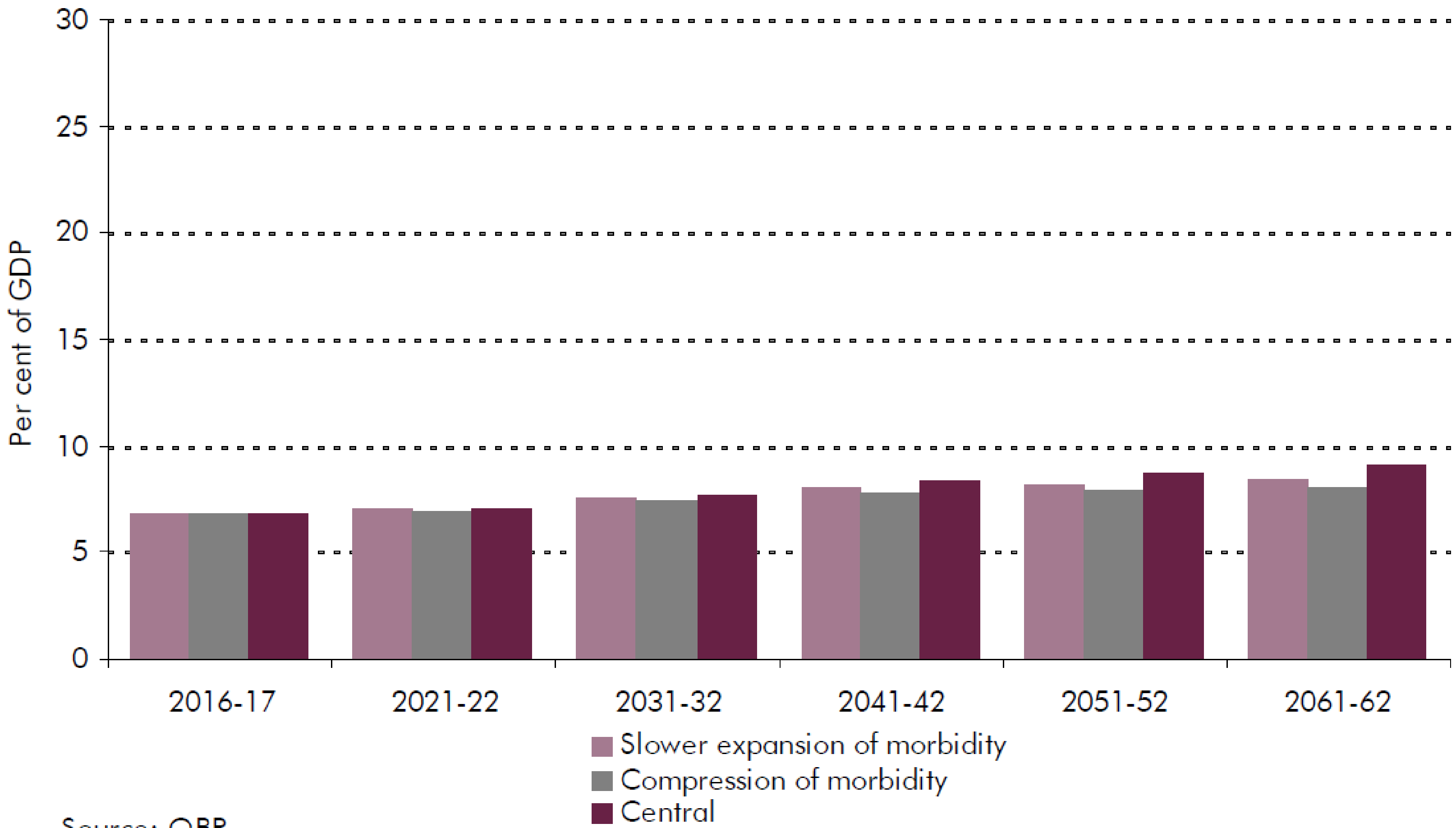
Different levels of growth in productivity in health have huge fiscal implications



Source: OBR

©

Assumptions about morbidity barely matter by comparison



Source: OBR

Institute for Fiscal Studies

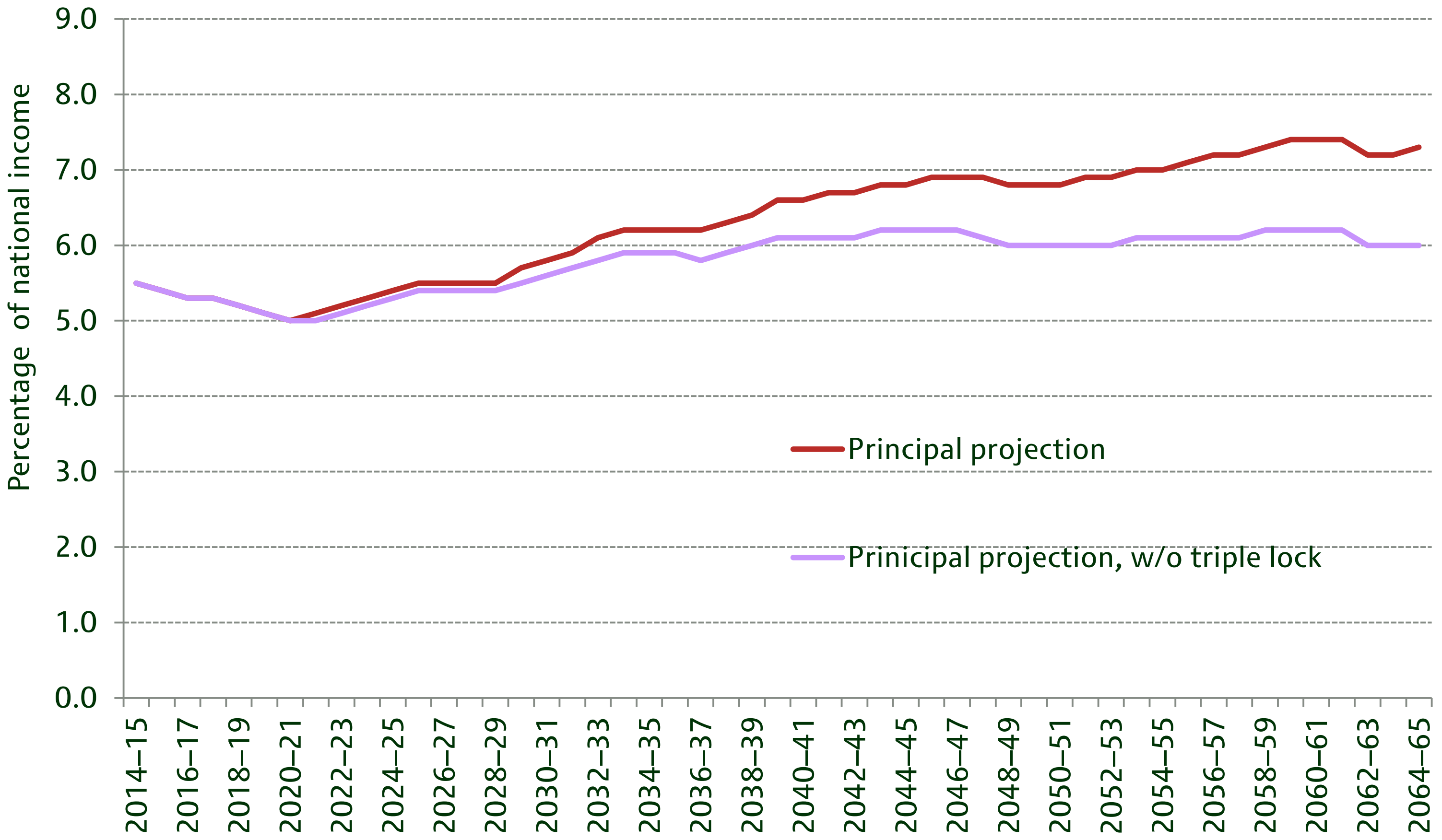
So my guess is

- Health spending will rise by more like 5% of national income than 2%
- Meaning we will need to find savings or tax rises of 7% of national income
- In the context that current plans (subject to change post June 23) are for spending to be at historically low levels by 2020

Pensions

- Recent reforms will reduce planned spending in the UK
  - Move to single tier pension
- Though what happens to indexation is crucial
- Over the longer-term the triple lock not the right policy
  - level of the state pension in 2050 should not depend on the variance of annual growth in earnings and inflation and the covariance between them
- Could have a target level of pension relative to average earnings
  - retain triple-lock whenever at or below this level
  - but when state pension above target only index by inflation

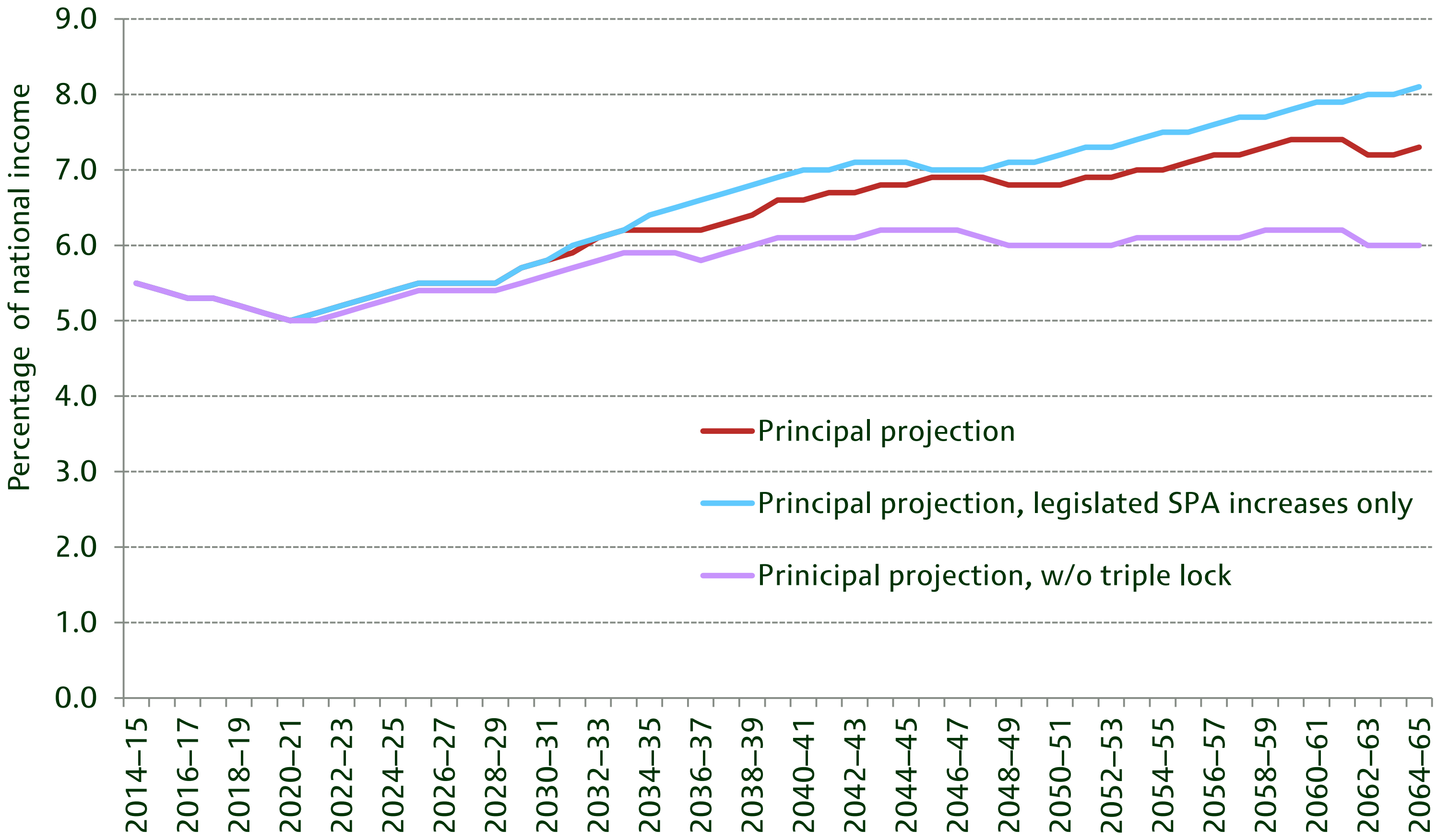
Impact of indexation on spending



Source: Office for Budget Responsibility (2015).

Institute for Fiscal Studies

State pension spending projected to rise



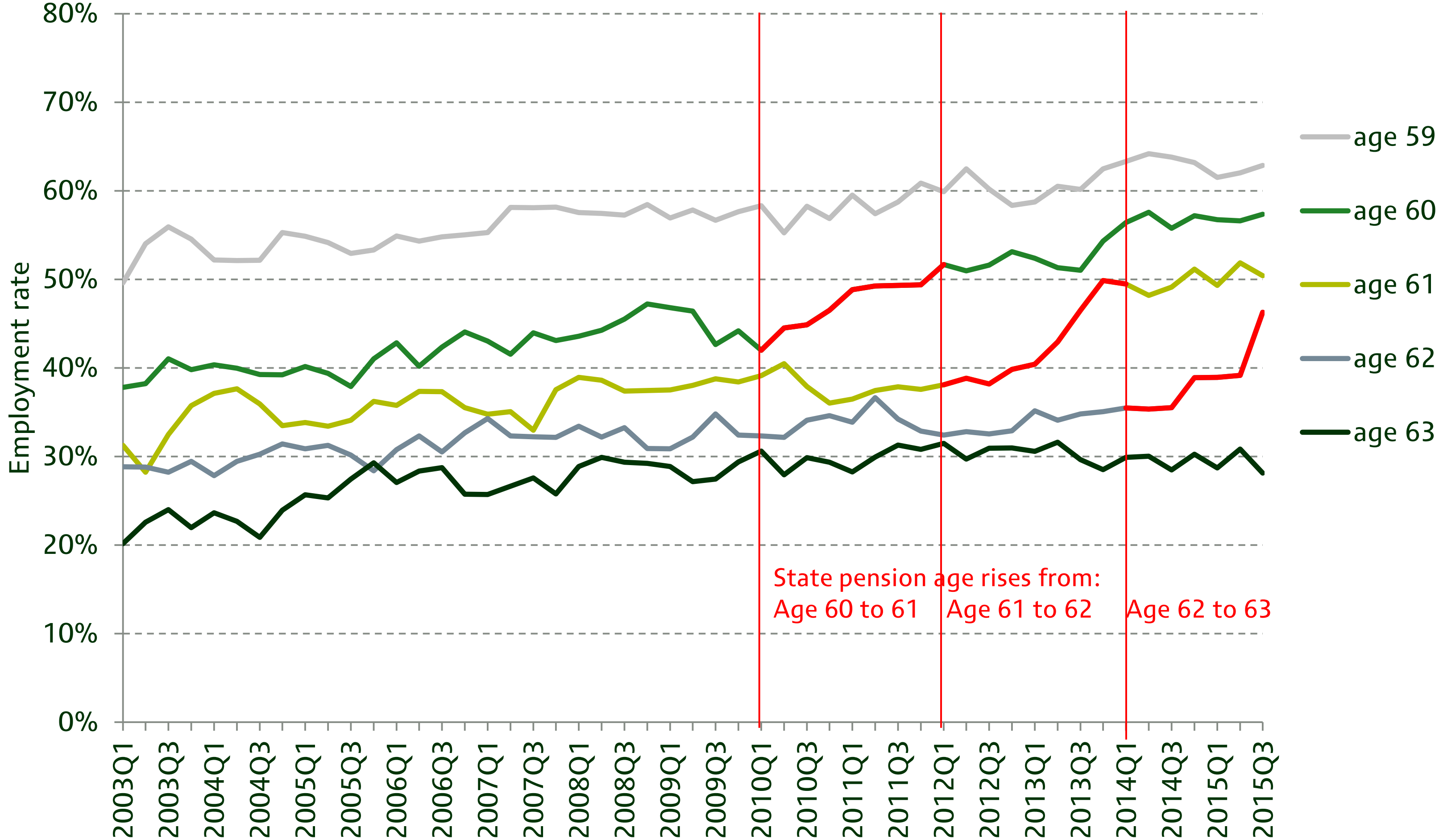
Source: Office for Budget Responsibility (2015).

Institute for Fiscal Studies

Impact of raising pension age

- Female state pension age is rising at the moment
  - Good evidence it saves a lot of money and leads to more work

Increases in female state pension age continue to push up employment rates



Source: Labour Force Survey.

Evidence from the rise in female state pension age

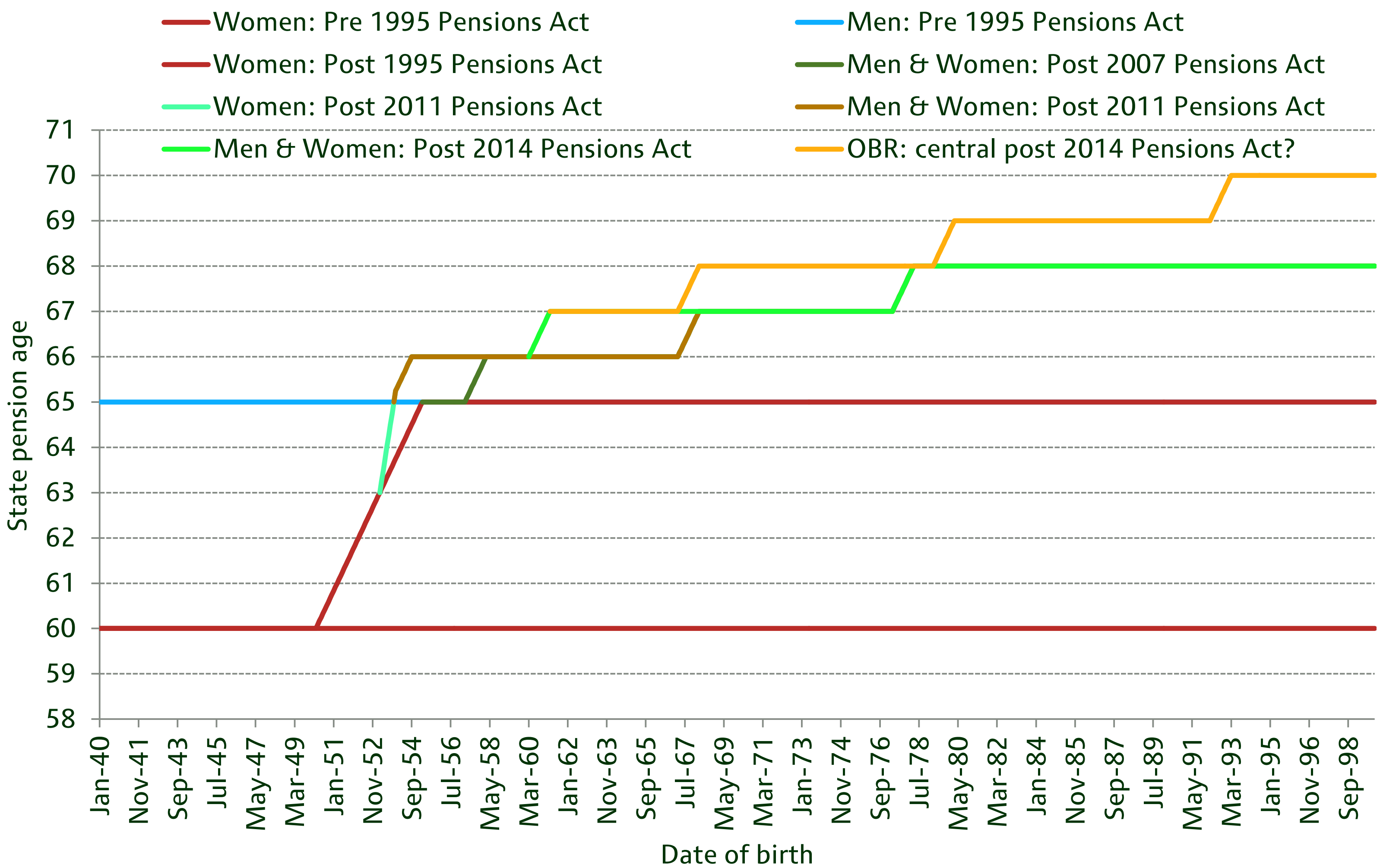
- Examined in Cribb, Emmerson & Tetlow (2013)
- Find that increasing the female state pension age has had a significant effect on women's and men's labour supply
  - increased employment rates of 60 year old women by 7.3 ppt
  - increased husbands' employment rates by 4.2 ppt
  - increased proportion of 60 year old women who are unemployed by 1.3 ppt
  - evidence of joint retirement behaviour amongst couples: 5.4ppt more two earner couples, 4.7ppt fewer couples where no one works
- Overall Exchequer saving of a one year increase in female SPA: £2.1 billion
- What drives this effect?
  - response among women: little evidence of credit constraints or strong change in marginal financial incentives; more likely driven by wealth effects or social norms
  - response among husbands: evidence of joint retirement

Impact of raising pension age

- Female state pension age is rising at the moment
  - Good evidence it saves a lot of money and leads to more work
- Further changes are planned

Institute for Fiscal Studies

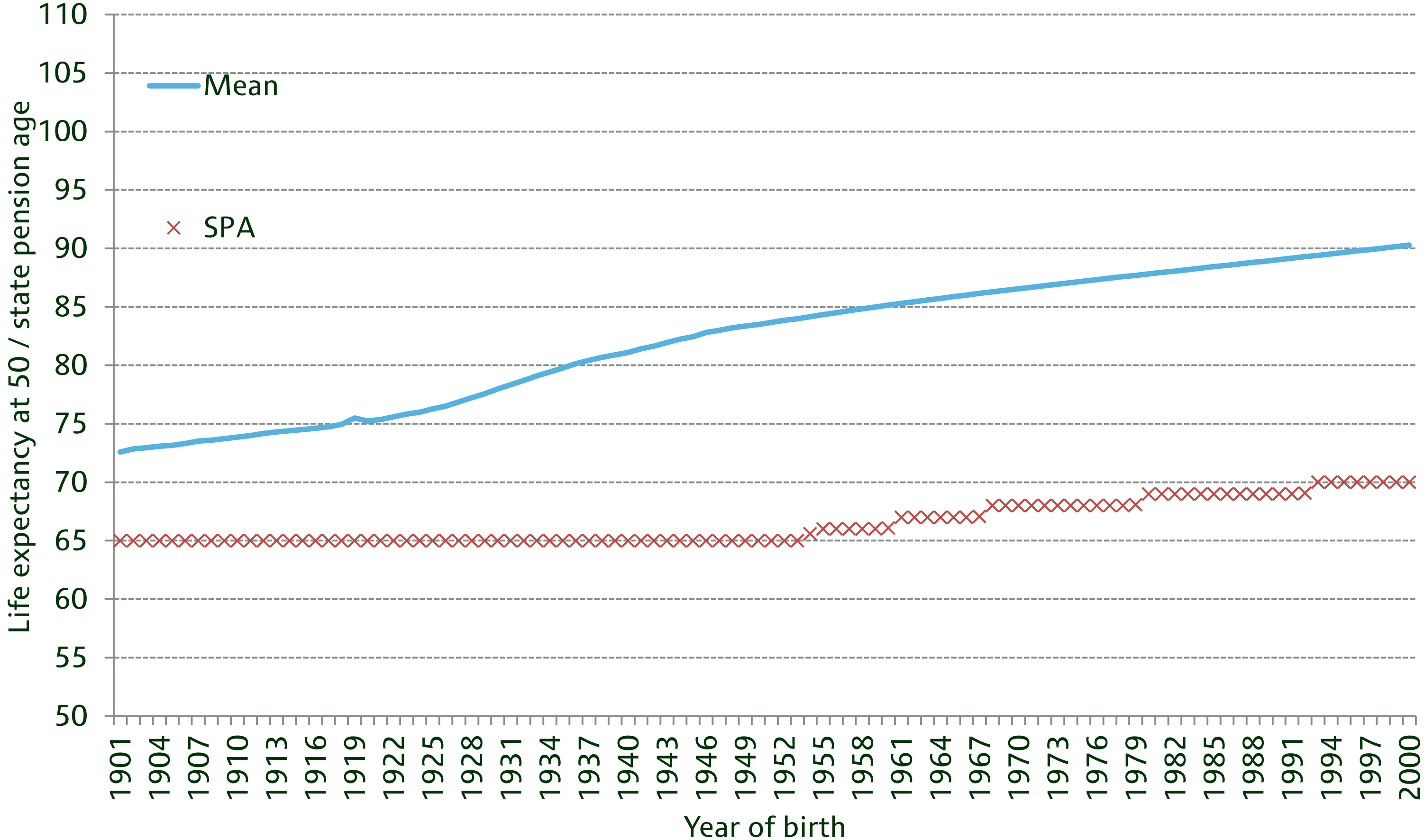
State pension age increases



Source: Department for Work and Pensions (2014); Office for Budget Responsibility (2015).

Institute for Fiscal Studies

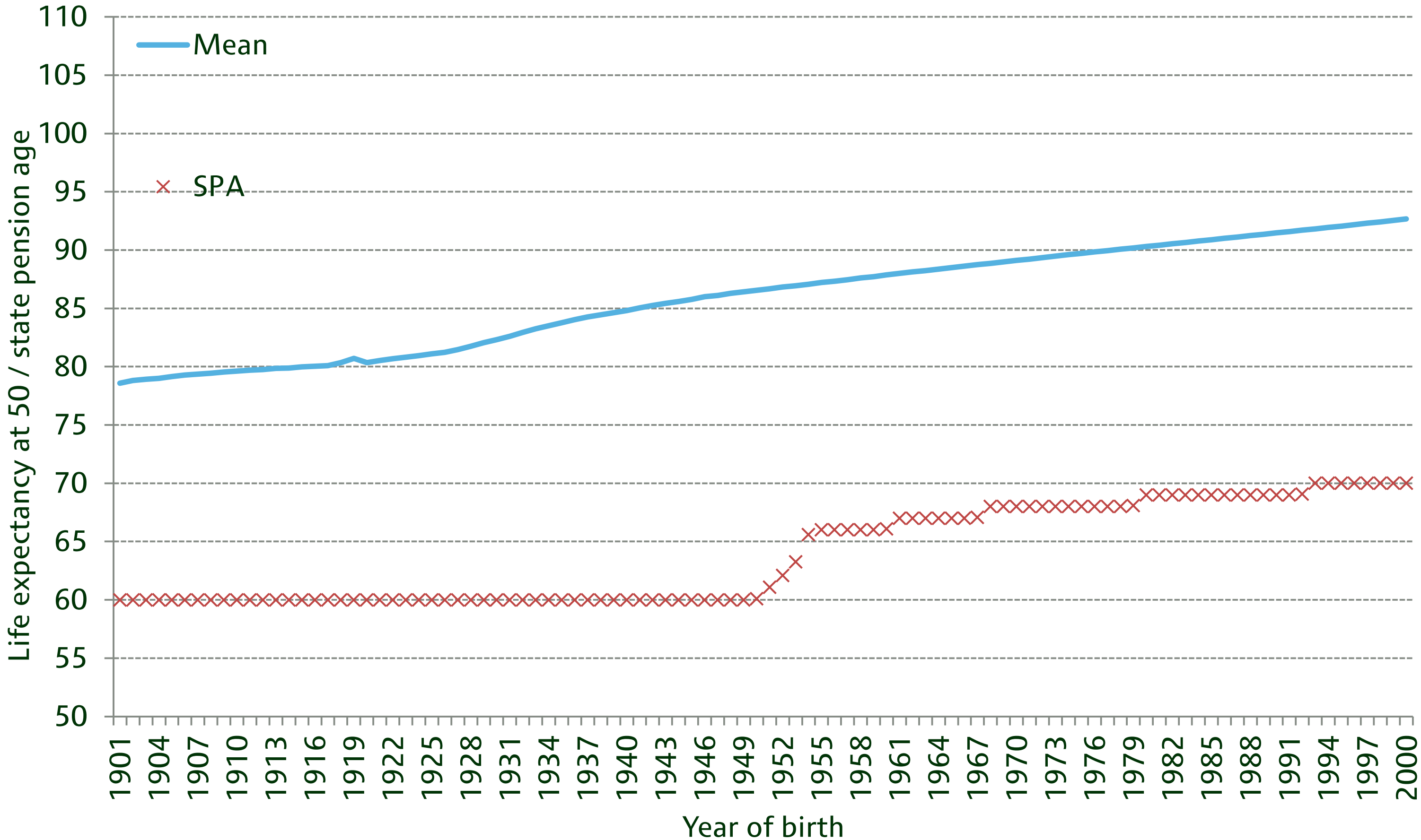
Life expectancy at age 50 & state pension age: Men



Source: Authors' calculations using 2014 Life Tables from the Office for National Statistics; and SPA underpinning OBR's 2015 Fiscal Sustainability Report.

Institute for Fiscal Studies

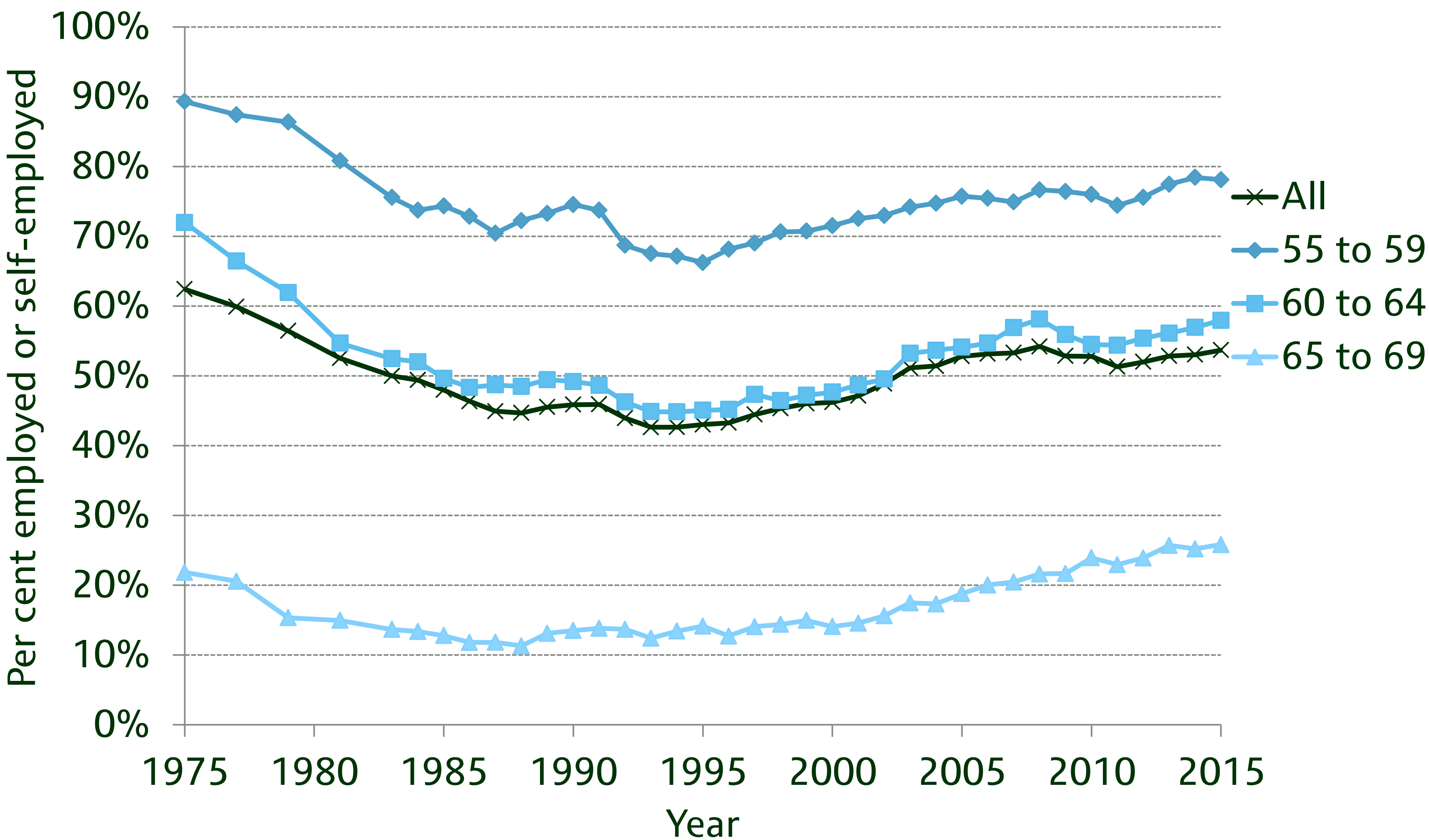
Life expectancy at age 50 & state pension age: Women



Source: Authors' calculations using 2014 Life Tables from the Office for National Statistics; and SPA underpinning OBR's 2015 Fiscal Sustainability Report.

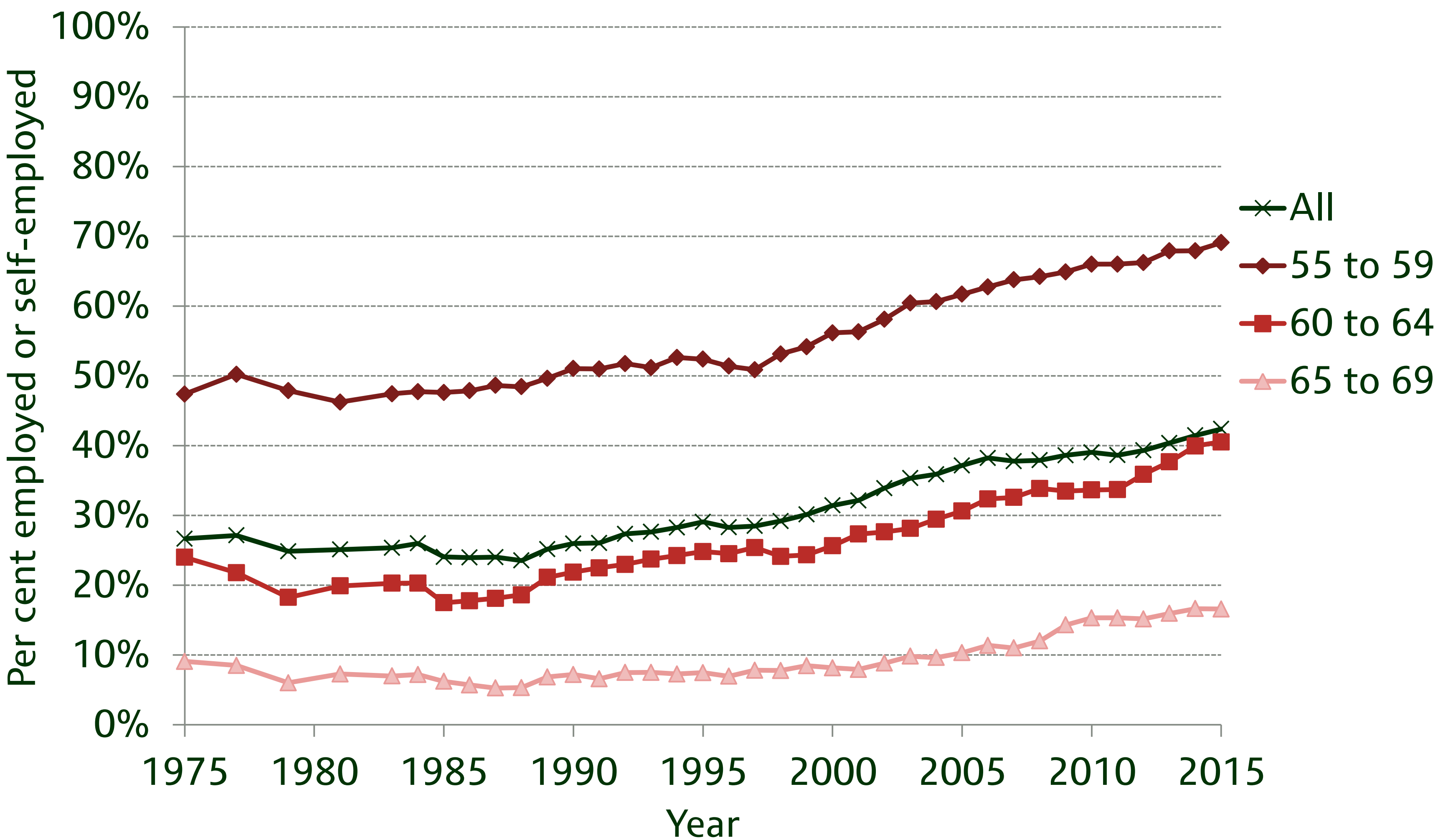
Institute for Fiscal Studies

Employment rates of older men over time



Source: Labour Force Survey.

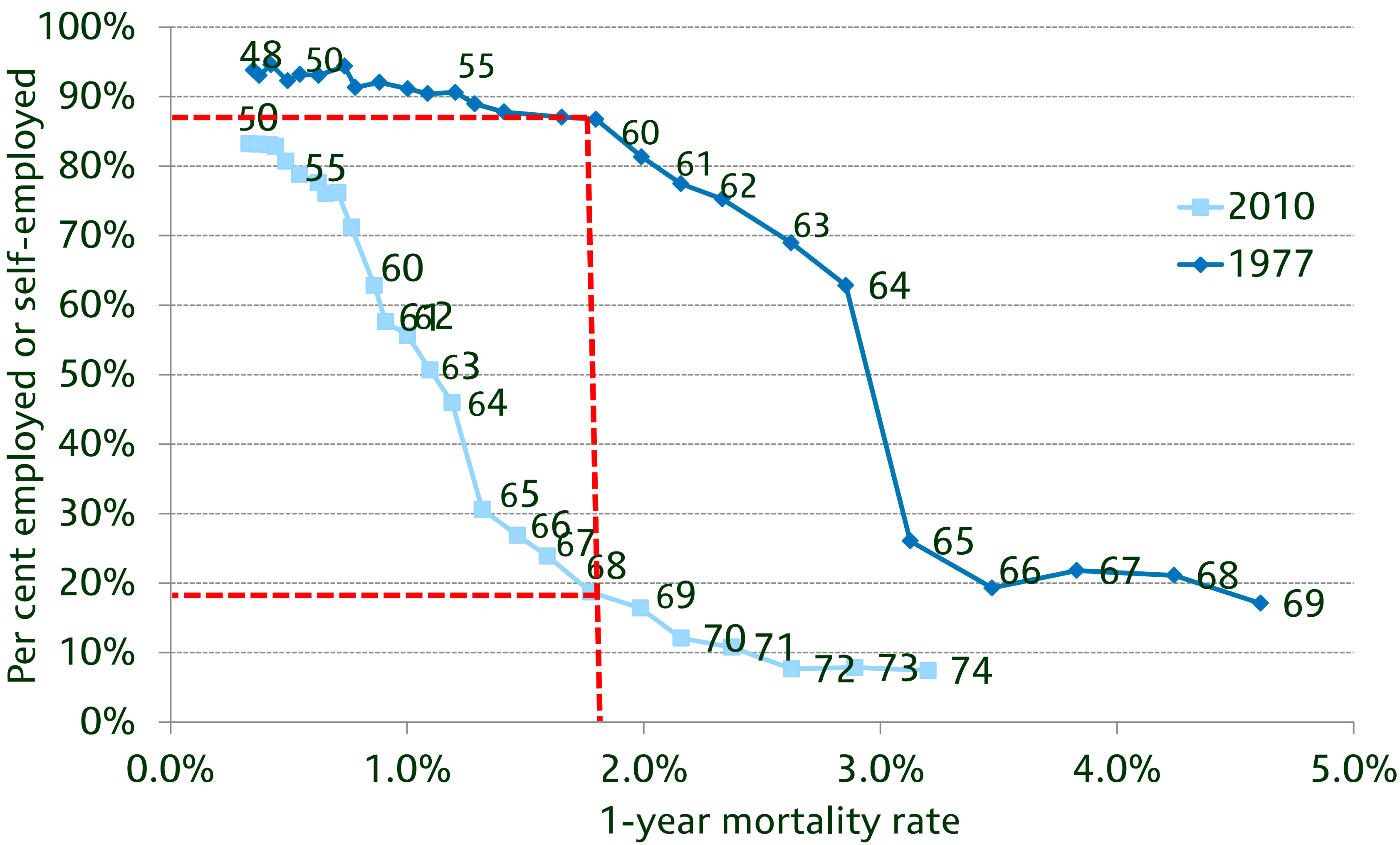
Employment rates of older women over time



Source: Labour Force Survey.

Institute for Fiscal Studies

Employment rate by mortality – men



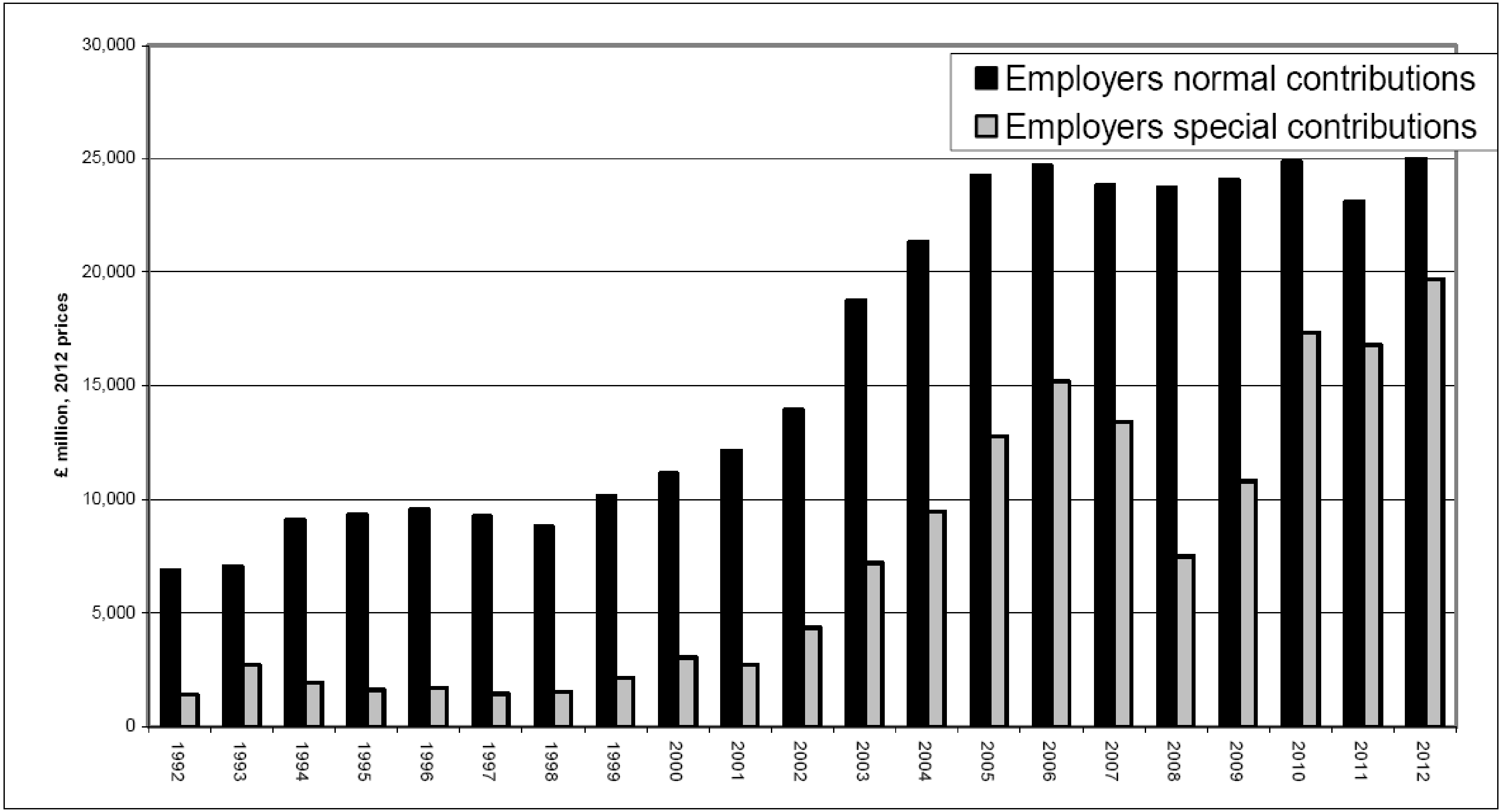
Source: Labour Force Survey and 2012 UK population projections.

Institute for Fiscal Studies

Non fiscal impacts

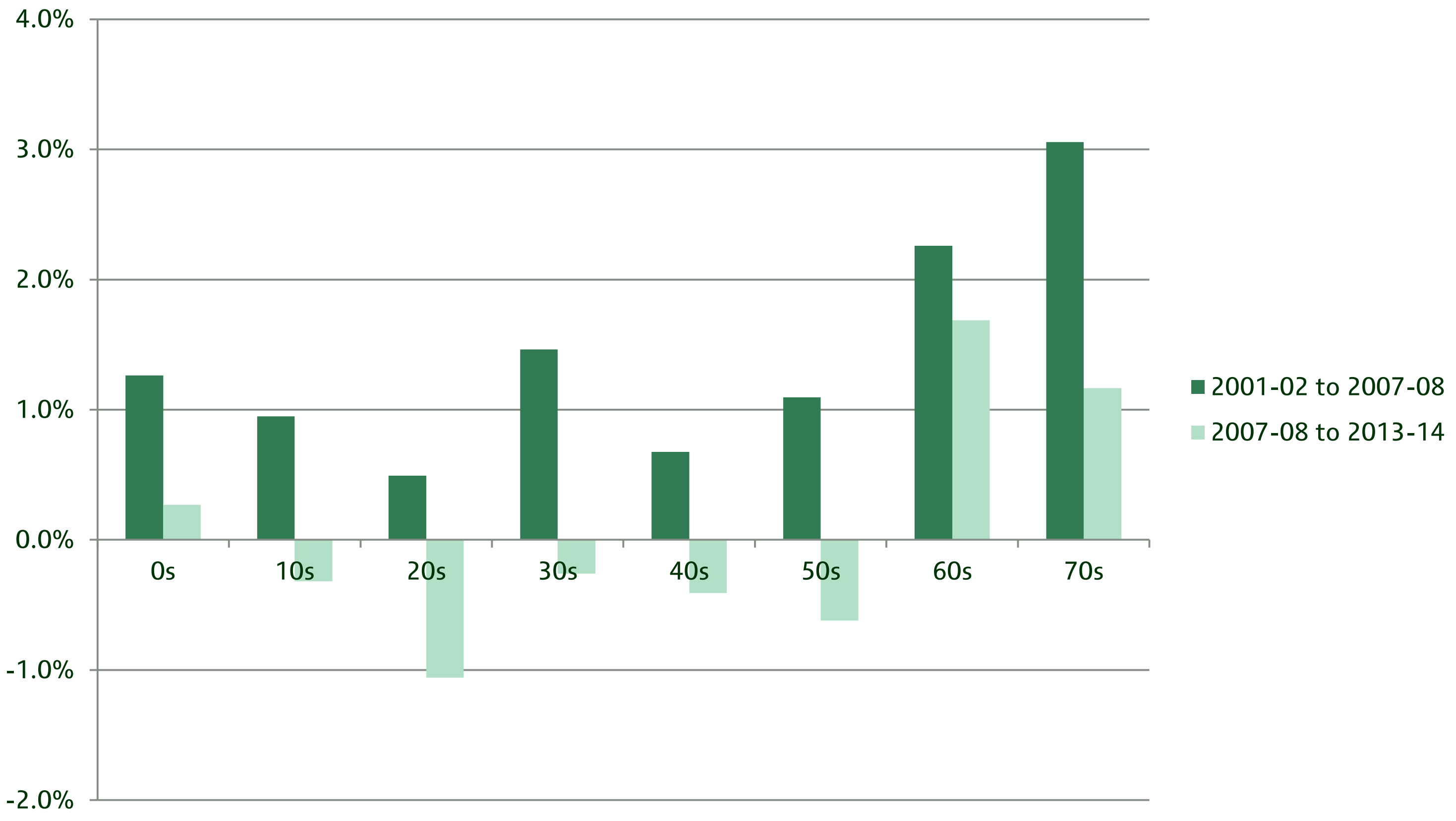
- Much more worrying is:
  - Impact of DB schemes
  - Low wages for current workers
  - Concentration of wealth in current older generation
  - Housing market and policy
  - Impact of low interest rates

Employer contributions to pension funds – in constant prices terms



Source: Office for National Statistics

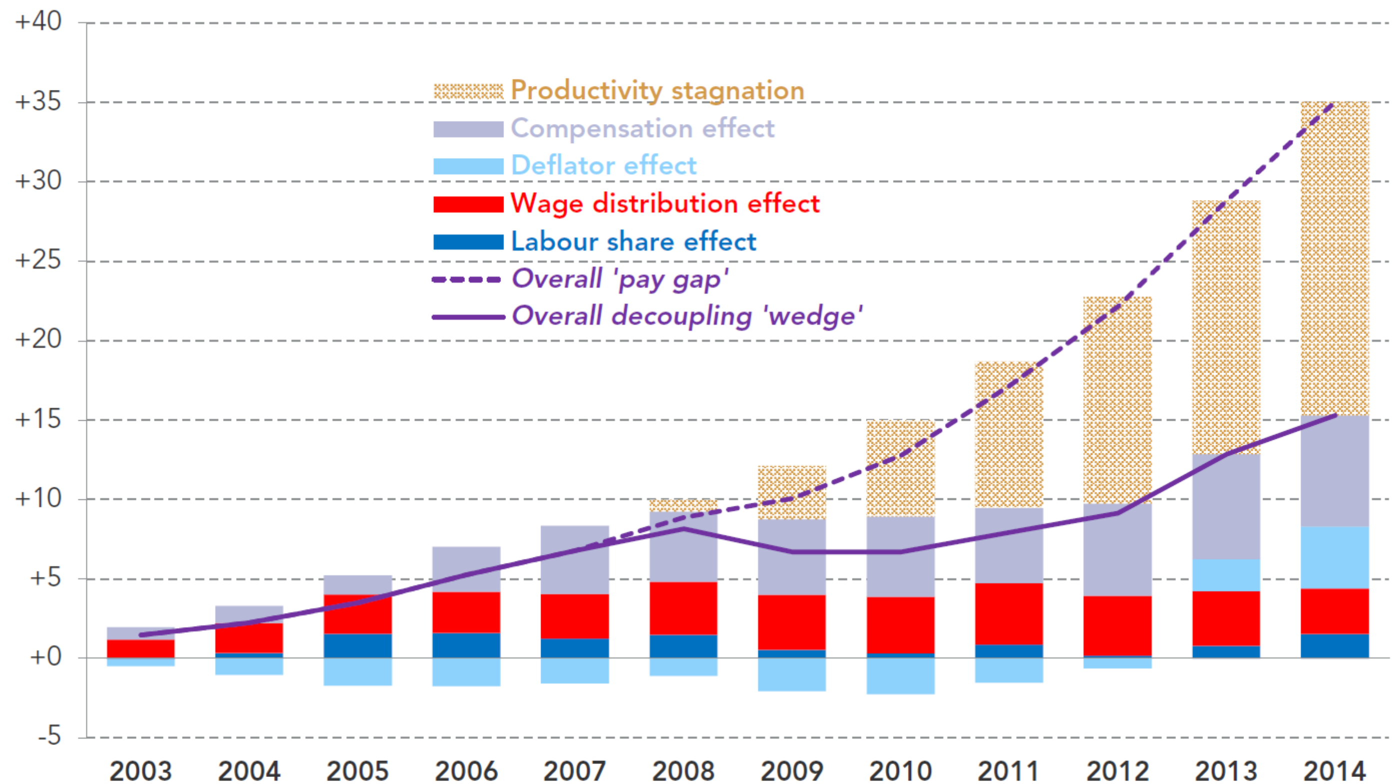
Pensioner incomes rising as workers get poorer



Annual real income change by age

Institute for Fiscal Studies

Pension costs have played a big role in average wages rising less quickly than productivity



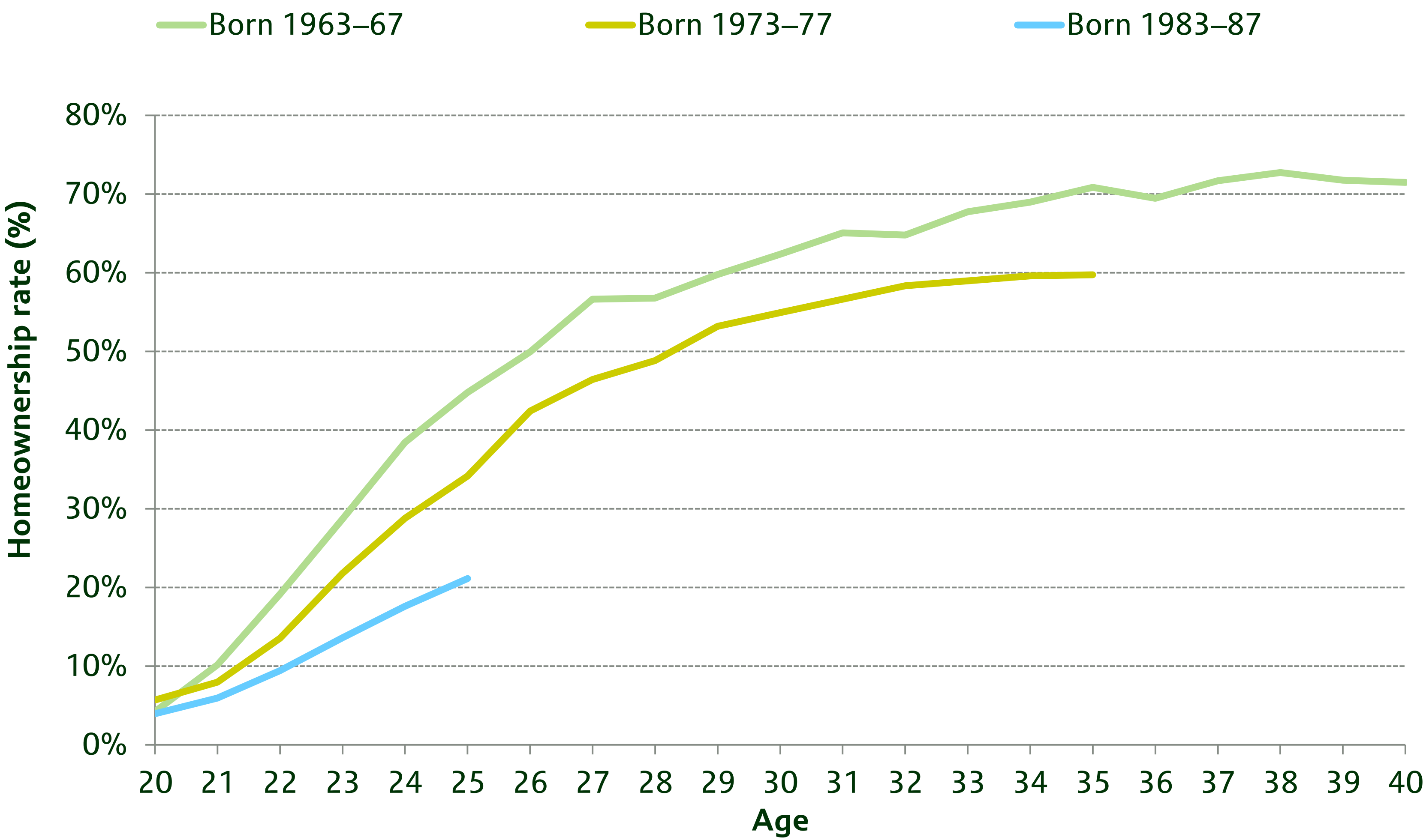
Notes: 'Pay gap' refers to how much higher median pay would have been in the period 2002-2014 in the absence of any further decoupling of median pay growth from productivity growth and the absence of productivity stagnation after 2007.

Source: RF analysis of ONS, *National Accounts*; and ONS, *Annual Survey of Hours and Earnings & New Earnings Survey*

http://www.resolutionfoundation.org/wp-content/uploads/2015/09/Productivity-briefing.pdf

Institute for Fiscal Studies

Recent cohorts are also less likely to own a home



Institute for Fiscal Studies

Long term consequences

- Younger generation
  - have no occupational pension
  - Struggle to buy a house
  - Low wages
- In addition zero or negative real interest rates make saving as much for retirement as previous generations impossible
- Therefore
  - Increasing importance of inheritance
  - Increased pressure on state resources (e.g. Housing benefit)
- Future fiscal pressures may be different

Conclusions

- Fiscal impacts of ageing on pension spending are manageable
  - Indexation needs to be sorted out
  - Pension age should rise
- Impacts on health spending are much less certain and potentially much bigger
- By mid century health and pensions could easily account for half of spending
- We will have to increase taxes to cope
  - Unless we aim for a state very different from one we are used to
- Other economic impacts may be more important
  - The long term consequences of policy mistakes concentrating wealth in one generation may be profound