Demographic change and fiscal policy

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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

- Social protection: 29%
- Personal social services: 10%
- Health: 18%
- Education: 13%
- Transport: 6%
- Defence: 5%
- Public order and safety: 6%
- Gross debt interest: 3%
- Housing: 2%
- TIEEE: 1%
- AFF: 1%
- Other: 10%
Public spending in 1978-79

- Social security: 23%
- Personal social services: 9%
- Health: 9%
- Education: 6%
- Transport: 4%
- Defence: 1%
- Law, order & protection: 10%
- Gross debt interest: 10%
- Housing: 10%
- TIEEE: 10%
- AFFF: 10%
- Other: 1%
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
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?
On OBR central estimates age related spending rises by 4% of GDP over 30 years to 2050
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

Total public spending (LH)

Lowest level for over 60 years, except 1999–2000 and 2000–01
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

Public services outside health to be cut to lowest level since (at least) 1948
Public spending to fall to a low level by historical standards

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Notes and sources: see Figures 6.1 and 6.5 of The IFS Green Budget: February 2016.
Public spending to fall to a low level by historical standards

- Total public spending (LH)
- ‘Public service spending’ (LH)
- Gross debt interest (RH)
- Pensioner benefits (RH)
- Working age benefits (RH)

Spending on working age social security to be at lowest level since 1990–91

Notes and sources: see Figures 6.1 and 6.5 of The IFS Green Budget: February 2016.
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
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

State pension spending projected to rise

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

State pension age rises from:
Age 60 to 61  Age 61 to 62  Age 62 to 63

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
State pension age increases

- **Women: Pre 1995 Pensions Act**
- **Men: Pre 1995 Pensions Act**
- **Women: Post 1995 Pensions Act**
- **Men & Women: Post 2007 Pensions Act**
- **Women: Post 2011 Pensions Act**
- **Men & Women: Post 2011 Pensions Act**
- **Men & Women: Post 2014 Pensions Act**
- **OBR: central post 2014 Pensions Act?**

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.
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.
Employment rates of older men over time

Source: Labour Force Survey.
Employment rates of older women over time

Per cent employed or self-employed

Year

Source: Labour Force Survey.

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Employment rate by mortality – men

Source: Labour Force Survey and 2012 UK population projections.
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

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Pension costs have played a big role in average wages rising less quickly than productivity.
Recent cohorts are also less likely to own a home

- Born 1963–67
- Born 1973–77
- Born 1983–87
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