Institute
and Faculty
of Actuaries

Intergenerational Fairness and Provision

IFoA response to Select Committee on Intergenerational Fairness and Provision

10 September 2018

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We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

Actuarial science is founded on mathematical and statistical techniques used in insurance, pension fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities, particularly over the long term, and this long term view is reflected in our approach to analysing policy developments. A rigorous examination system, programme of continuous professional development and a professional code of conduct supports high standards and reflects the significant role of the profession in society.

Lord True
Select Committee on Intergenerational
Fairness and Provision
House of Lords
London
SW1A OPW

10 September 2018

Dear Lord True,

Call for evidence on Intergenerational Fairness and Provision

1. The Institute and Faculty of Actuaries (IFoA) welcomes the creation of this House of Lords Committee tasked with exploring intergenerational issues. Actuaries are experts in understanding financial and demographic risk, and the long-term consequences of decisions made today, and this theme is central to the question of intergenerational fairness. It is important that policymaking considers its impact on different parts of society and understands how consequences manifest over time. This includes how policy changes might affect different age cohorts, and its implications for future generations.

2. In our response we have focussed on answering questions where our members have direct expertise, in particular in relation to pensions, retirement and the cost of social care, all areas of particular current contention when it comes to intergenerational fairness.

Is the intergenerational settlement in the UK currently fair? Which generations are better off or worse off, and in which ways?

3. Over the past decade the issue of an intergenerational settlement, and whether or not it is fair, has steadily risen up the political agenda, across a range of public policy areas. The debate has focussed on the difference in outcomes between those entering adulthood in the wake of the financial crisis, who have generally weak pension provision and who also face the issue of being unable to afford to buy property (the 'Millennial' generation), and their parents, who have benefited from generous pension provision and low housing costs and are now either retired or will retire in the next 10 years (the 'Baby Boomers'). This juxtaposition is particularly stark and has provided the basis for much of the 'fairness' discussion, with the prevailing argument focussing on the Baby Boomers becoming better off at the expense of the Millennials.

4. This is partly because of the UK's changing demographics, in particular the ageing population. The population is growing, individuals are living longer, and in the coming decades there will be a growing proportion of older people in the population. The number of those over the age of 75 is projected to double over the next 30 years.[1] All the while, improvements in healthy life expectancy are not keeping pace with this increasing longevity.

[1] ONS (2016) National Population Projections, https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections

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Males can now expect to spend 16.1 years in poor health in later life, and females 19 years.[2] Research also suggests that the prevalence of multi-morbidity (the presence of 2 or more conditions) is forecast to rise, not just in the retired population, but in younger age groups too.[3]

5. All these trends point towards increased pressure on public services, in particular health and social care, as the number of people using public services outnumbers the number of those paying into the system through general taxation (i.e. the working age population). Taking social care as an example, already 1.2 million people do not have access to the social care they need – a 48% increase from 2010.[4] This should not be seen as older people creating a 'burden' on health and care services, but a demonstration that the system is inadequate.

6. Discussion of intergenerational financial transfers have been a key theme for exploration in the growing discourse in this area. As actuaries we are also concerned about the transfer of *risk* between generations, from within the family, from someone's employer, and from the Government to certain individuals.

7. Through recent changes in many areas of policy, the responsibility for shouldering risk has changed dramatically. Changes to the pensions system have forced individuals to take what could be seen as an unfair responsibility for risks associated with longevity and investment. A similar story is true for social care, with individuals generally living much longer in poor health and increasingly having to take responsibility for funding their social care needs. These changes have not been supplemented with adequate levels of financial education, and people are often ill-equipped to make these important decisions. The Government should take a lead role in delivering improvements in financial education through the new Single Financial Guidance Body, so that all generations understand the how best to make the decisions they will be expected to make.

8. As is often the caveat in discussions on intergenerational fairness, actions aimed at removing perceived unfairness *between* generations should not lead to greater unfairness *within* some generations. No one generation or cohort will be completely homogenous and there needs to be some transfer of risk and value within generations as well as between them.

What are the future prospects for different generations in the light of current economic forecasting?

9. The Baby Boomer generation is the wealthiest the UK has seen as they approach retirement, but there are serious concerns about how younger generations will fare when they reach older ages. This is particularly the case where the provision of occupational pensions continues to shift from generous defined benefit (DB) provision to riskier defined contribution (DC) provision. The issues here are two-fold: partly that the size of DC provision is typically much smaller and partly, as mentioned above, that the risks for members of DC pension arrangements are much bigger. We explore this issue further in our answer to question 3.

10. In contrast to this, Automatic Enrolment (AE) has been successful in helping to ensure that employers are making some pension provision for their employees. The Millennials and generations that follow are likely to see the most benefit from this, as they begin to save

[2] Public Health England, Health profile for England, Chapter 1: life expectancy and healthy life expectancy, July 2017 https://www.gov.uk/government/publications/health-profile-for-england/chapter-1-life-expectancy-and-healthy-life-expectancy
[3] A Kingston, L Robinson, H Booth, M Knapp, C Jagger, Projections of multi-morbidity in the older population in England to 2035: estimates from the Population Ageing and Care Simulation, Age and Ageing, 2018
[4] Age UK, Care in Crisis, 13 October 2017 https://www.ageuk.org.uk/our-impact/campaigning/care-in-crisis/

earlier and their savings have more time to accrue interest and grow in value before they retire. It is widely considered that the so called ‘Generation X’, born between the early-to-mid 1960s and the early 1980s, will be the biggest ‘losers’ from these policy changes, suffering from the closure of DB schemes (considered too expensive as longevity began to increase significantly), but not benefitting from the introduction of AE early enough to accrue meaningful DC pots.

11. The number of people with care needs in later life is rising and, worryingly, so is the number of people with unmet care needs. It is important that we meet these needs, but that in doing so we do not place an unfair burden on younger and future generations. This could be achieved by introducing policies that mean those who are able to meet some of their care costs do so within a framework that is sustainable in the long term. It may be that we need both immediate solutions designed for current older generations to use their assets without having to sell their home, such as innovation in the pensions and equity release markets, alongside longer-term solutions for the current working age population that have an element of prefunded solutions for social care.

To what extent do different generations have a better or worse experience of the labour market?

12. Occupational pensions, one of the key areas of reward associated with employment, pose clear problems for intergenerational fairness. These issues are perhaps most stark when considering DB provision. These schemes were set up in an era when life expectancy post-retirement was less than it is today, and in general they were based on an intention but not a commitment to provide inflation-linked revaluation before payment and increases in payment. Promises made in the past therefore underestimated the cost of providing the level of provision now mandatory and many providers and employers are now paying the price.

13. Current market conditions are placing an increasing strain on the balance sheets of many employers, leading to a reduction in the generosity of pay and pension promises. Whilst the introduction of AE has undoubtedly been a success in increasing pension coverage, particularly amongst the Millennials, the quality of the provision on offer is much less generous, with many employers opting to offer the minimum required contribution rate. Not only are current workers being affected today, but the move away from DB towards less generous and riskier DC schemes means that this imbalance will only be exacerbated further down the line, with younger generations experiencing a reduction in living standards and ongoing uncertainty whilst working, and expecting this to continue into their retirement.

14. The majority of the Millennial generation will have little or no DB pension benefits when they retire, and as such it will be extremely important that those contributing to DC schemes are building adequate pension pots to see them through their retirement. Automatic enrolment has been partially successful in addressing this problem by getting almost 7 million workers enrolled in a workplace pension scheme since its implementation.[5] However, current contribution levels are unlikely to be sufficient for many individuals and there is a risk that people are unknowingly heading towards inadequate retirement provision.

To what extent does the tax system take account of fairness between the generations? What changes, if any, should be made to the tax system to achieve a fair intergenerational settlement?

[5] Department of Work and Pensions, Automatic Enrolment evaluation report 2016, December 2016, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/576227/automatic-enrolment-evaluation-report2016.pdf

15. The design of the UK's pension tax system provides opportunities to help or hinder intergenerational fairness. The recent introduction of the Lifetime ISA (LISA) was an attempt by the then Chancellor to offer an alternative way for individuals, particularly those in younger generations, to save for their retirement. The LISA also offers an alternative way for the government to tax these savings, with tax being levied on earned income before it is placed into the LISA. Traditional pensions are taxed at the point of withdrawal and the contribution from earnings is made before tax.

16. In tax terms, the traditional approach to pensions can in theory be better adjusted for inter-generational risk than the ISA model. The traditional pension taxation system, where tax is deferred from the point of earning to the point of spending, in theory allows the government to adjust the final tax rate where it is clear that the outcomes have unexpectedly favoured one generation or the other. This contrasts with the ISA, where the tax is taken up front and it is difficult to make later adjustments.

17. For example, there is no reason why the tax rates on pension income have to be the same as those on working-age earned income; those of working age are already taxed at a higher rate when National Insurance (NI) contributions are taken into account. The tax system has the potential to be changed by the government to the benefit of younger generations, with those drawing their pension paying more tax than those of working age. NI is also currently not paid by those above State Pension age, which raises additional questions of intergenerational fairness.

18. Lower overall levels of saving into occupational pensions amongst younger generations, means that many will be unable to benefit from tax deferral to the same degree as previous generations.

How does the Government's practice of running public finances on a cash flow rather than on a balance sheet basis affect the intergenerational settlement?

19. As actuaries, our members have particular expertise in managing cash flows and balance sheets in the private sector, and some of the lessons from this practice could be usefully applied to the Government's handling of its own pension liabilities. The State Pension is an important policy that has gone from being a non-contributory system to a pay-as-you-go (PAYG), contributory system, with NI contributions levied on the working population of the day to pay for the pensions of those currently in receipt of the State Pension. The National Insurance Fund which supplies the State Pension is managed on a cash flow basis.

20. The Government Actuary's department regularly provides analysis to the Government on the state of the fund, and its 2018 analysis suggests that the fund may be exhausted by 2032 if current funding arrangements persist.[6] Because of the way the account is funded, it is likely that a rise in NI, paid for only by those of working age, would be required to top up the fund to a sufficient and sustainable level. This would pose obvious problems for intergenerational fairness, especially with those over State Pension age exempt from NI. Running this fund on a balance sheet basis, i.e. showing the full extent of the pension liability alongside the NI take at any given time, could add more transparency to the intergenerational debate. It could also be used to help to set future tax levels to meet this liability for each generation so that

[6] Government Actuary's Quinquennial Review of the National Insurance Fund as at April 2015, October 2017, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/653374/QR_2017_report_Oct_2017.pdf

younger generations are not unfairly burdened as larger populations reach State Pension age.

21. The importance of the State Pension in providing a minimum income standard for older people also means that its sustainability and affordability will be key to ensuring that future generations benefit from the same level of security that current generations experience. We are already seeing a level of pessimism amongst younger generations in their expectations of the State Pension. A recent survey from the IFoA suggested that many UK respondents (compared with those from the USA and Australia) expect to rely on the State Pension for their retirement, and were least likely to have other savings set aside to fund their retirement. By contrast, only half (53%) of the youngest cohorts of respondents expected to receive some form of State Pension in the future, compared with 81% of the oldest respondent group.[7]

22. Clearly the collapse of any PAYG system such as the State Pension would be justifiably lamented by anyone who has paid in but not seen any benefit, and would be a prime example of intergenerational unfairness. As such, anything that undermines the affordability and sustainability of the State Pension should be discouraged. The 'triple lock' is an example of this and the IFoA has consistently argued that the policy is unnecessary if the amount of the new State Pension (which is aimed at creating an affordable and sustainable system over the long term) has been properly set.[8]

23. The 'triple lock' policy has been one factor which has helped pensioner incomes to increase at a quicker rate than incomes of the working age population. Whilst the policy was clearly well-intentioned, and its success in helping to reduce the rate of pensioner poverty should be celebrated, the increase in benefits of at least 2.5% pa far exceeds the pay increases recently seen by those in work. We suggest that 2.5% is an arbitrary figure and not in keeping with the rate of earnings increase amongst the rest of the population. It is important that pensioners are not left behind with a stagnant State Pension whilst the cost of living rises, but linking the uprating more closely to the actual experience of the rest of the population would be a more inter-generationally fair way to do this. Evidence from both John Cridland's review of State Pension age[9] and the Work and Pensions Select Committee's review of intergenerational fairness[10] suggest that the triple lock is increasing State Pension expenditure as a share of national income and is unsustainable over the long term.

Should you want to discuss any of the points raised please contact Catherine Burtle, Senior Policy Analyst (catherine.burtle@actuaries.org.uk / 0207 632 1471) in the first instance.

Yours sincerely,

Marjorie Ngwenya
President, Institute and Faculty of Actuaries

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[7] IFoA Policy Briefing: Retirement Readiness Survey Report from Australia, the United Kingdom & the United States, October 2017 - https://www.actuaries.org.uk/documents/policy-briefing-retirement-readiness-survey-report-australia-united-kingdomunited-states
[8] IFoA response to Department for Work and Pensions - Independent Review of the State Pension Age Interim Report, February 2017 - https://www.actuaries.org.uk/documents/ifoa-response-department-work-and-pensions-independent-review-state-pension-age-interim-report
[9] Department of Work and Pensions, State Pension age review: final report, July 2017
[10] Work and Pensions Committee, Intergenerational fairness inquiry Committee Report, November 2016