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What does long-term care funding have in common with public sector pay and pensions?

(Dr Frank Eich, Pension Corporation)

- **The pensions debate in the UK focuses heavily on the diverging DB pension trends across the private and public sectors, which many perceive to be unfair.**
- **A bigger story is that today's private and public sector workers are probably doing well relative to smaller past and future cohorts as they are part of the baby boomers.**
- **This is because they can spread the cost of providing education to their children, and health and long-term care to their parents over relatively many taxpayers.**
- **By contrast, their parents' smaller cohort had to fund the baby boomers' education while their children's smaller cohort is expected to fund their rising health care costs.**
- **Tax smoothing could help to increase inter-generational fairness as would asking the elderly to contribute more to government receipts or the funding of the services they are likely to consume, most notably health and long-term care.**
- **Moving from unfunded to funded public sector pensions would, however, not necessarily increase inter-generational fairness.**

One of the key issues in the realm of pensions nowadays in the UK is that of the widening discrepancy between private and public sector provision. The decline in private sector defined benefit pensions is well documented and contrasts with the continued existence of these schemes in the public sector. Much of the public debate currently is that this is unfair as those in the private sector – who can no longer look forward to a generous occupational pension themselves – hand over parts of their incomes in the form of taxation just to pay public sector pensions.

While the private/public sector discrepancy is certainly something to worry about, far less talked about is a related issue, namely that public sector pay and pensions could be a subsidy across generations, benefitting those currently in the labour force, regardless of whether this is in the private or public sectors. Perhaps these flows across the generations dwarf those between sectors currently. So, what's the story?

Take the case of the large baby boom cohorts born in the late 1950s to mid 1960s who are now at their peak in the labour market and the main source of tax revenue for the government (the first baby boom directly after the 2nd World War was much smaller). Their taxes pay for the transfers and public services provided today. The welfare state being what it is – taking money from those who are active and healthy, and giving it to those who need it most - much of that spending goes to the young in the form of education or the elderly in the form of health and long-term care, and state pensions. Spending on education, and health and long-term care accounts for around a third of all government expenditure, while nearly half of all public sector employees work in either education or health.

As will be shown in a forthcoming research paper on pensionomics.com,[1] whatever they might be paying nowadays, today's taxpayers might actually be getting a good deal over their lifetimes. The large baby boom cohorts were preceded and are succeeded by smaller cohorts, so that an individual baby boomer contributes *relatively* little towards educating the young and looking after the elderly. Compare that with the baby boomers' parents who had to foot the bill for educating the large baby boomer cohorts and the baby boomers' children who will be faced with a much larger health and long-term care bill as the baby boomers reach old age over the coming decades. Put simply, a large cohort sandwiched between two smaller cohorts should be a net gainer in the welfare state as we know it.

What then could we do to address this state of affairs? First, societies could use public debt to smooth the burden of financing the welfare state so that every cohort ends up equally well off. The baby boomers' parents could have financed their children's education through taxation and taking

out debt, the latter to be handed over to the baby boomers themselves under the condition that they pay it off and eventually leave net assets to their own children, who in turn could liquidate them to make paying for their parents' health and long-term care just that little bit easier. This suggests that balancing the government's budget should ensure the sustainability of the public finances over the long term but might not necessarily be inter-generationally fair. Second, and conceptually related, individuals could accumulate assets during their working lives to pay for the services they will require in old age (pre funding). Third, the baby boomers could be asked to pay more taxes when they are old or contribute more (e.g. in the form of co-payments or insurance) to the funding of the services they will consume, notably health and long-term care. This would be unpopular with the grey vote and would require changes to the current tax system as the elderly contribute relatively little to income tax and none to national insurance contributions, two of the main sources of revenue for government. The Government's announcement earlier this week to establish an independent commission on long-term care funding is exactly about the issues of inter-generational fairness and sustainability too, and it is not surprising that emotions run high.

Perhaps counter-intuitively, moving from unfunded (pay-as-you-go) to funded public sector pensions would not necessarily help. In a pay-as-you-go system, the baby boomers' parents paid the substantial bill for teacher salaries but were able to shift the equally substantial bill for teacher pensions to the baby boomers themselves (who are now not too impressed by that). In turn the baby boomers paid a less substantial wage bill to educate their children, passing on the equally less substantial teacher pension bill to their thankful children. By contrast, in a funded system, the baby boomers' parents would have had to foot the substantial bill for teacher salaries *and* pensions, while the baby boomers themselves would have paid relatively little on salaries and pensions to pay for their children's education. The baby boomers seem to be getting a good deal regardless of whether public sector pensions are funded or unfunded though – it is a question of degree.

[1] *Who will pay? Inter-generational transfers and public sector pensions*, Dr Frank Eich, Pension Corporation Research, upcoming July 2010.