ANALYSIS

Households increasingly dependent on public transfers

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The longer working careers and higher earnings of those now retiring have caused a rising trend in earnings-related pensions. As this has been accompanied by a strong increase in unemployment expenditure and slow growth in aggregate income from wages and salaries on account of the recession, a growing number of households now depend on current transfers. Accordingly, household income and expenditure are now less dependent on the economic cycle and countercyclical policy. In addition, the impact of monetary policy on aggregate demand is reduced by the growing role of property income in financing consumption. Contrary to the life cycle hypothesis, elderly people's savings rate has risen with age, and net wealth is highest amongst the elderly.

Population ageing may change macroeconomic dynamics

As a population ages, this weakens the public finances and the labour market, but also changes households' sources of income. With population ageing, public transfers assume a more pronounced role in households' income formation, and housing and financial wealth gains in importance as a source of income.

Population ageing also has implications for households' financing structure. Household debt is typically concentrated on young households and those of prime working age, with net wealth peaking in older age. In addition, households save differently in different phases of life.

Transformations in the household sector caused by ageing have the potential to change the dynamics of the macroeconomy as a whole. Economic policy may affect household behaviour differently from what we have traditionally been used to expect. Notably for monetary policy, growth in the share of elderly households may imply that the response of aggregate demand to interest rate changes will be more limited than before, as a larger part of consumption is financed by property income and public transfers.

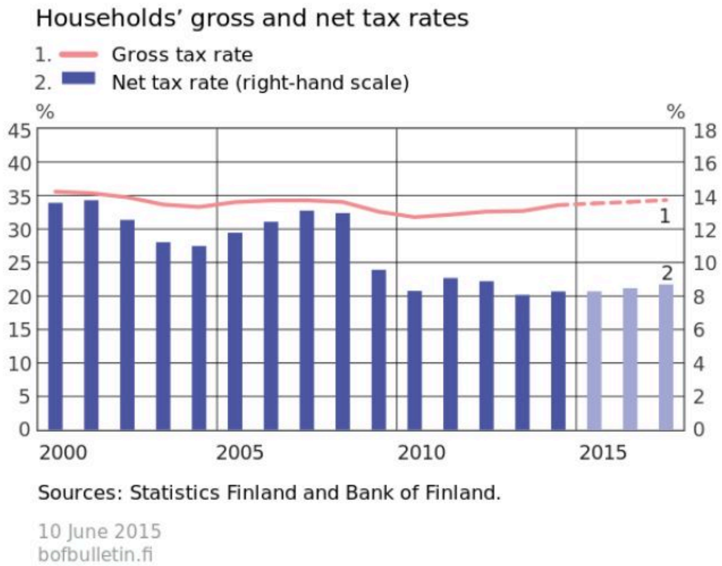
The most profound change in Finland's population structure has coincided with the economy's exceptionally deep and protracted recession. This article examines, on the basis of national accounts and household-level data, how the income flows of the household sector have evolved in recent years, it being one of the population groups hit hardest by the recession, and how household debt and wealth have developed and are distributed.

Public transfers an increasingly important source of income

The growing number of retired persons and weak employment developments in the recession years have strongly changed the income distribution of households. Compared with the situation in 2008, pension income has grown by 40%, while the total amount of wages and salaries has risen by about 10%. Hence, in 2014, current transfers already accounted for a quarter of gross household income (Chart 1).

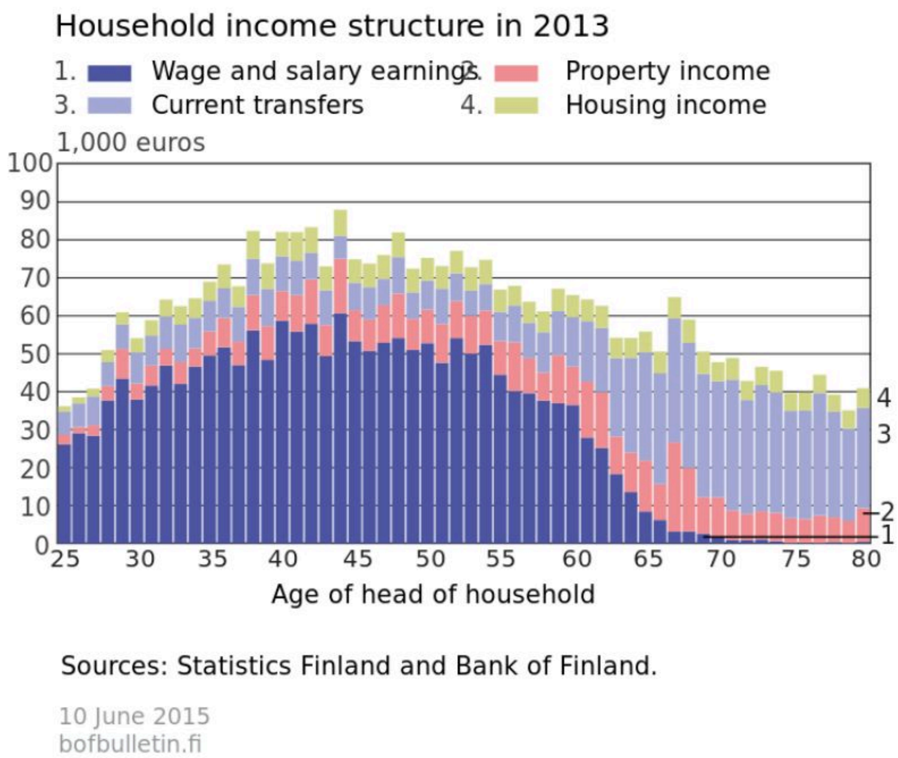
In addition to pensions, unemployment and social benefits have increased their share in household income during the recession. Over the forecast horizon 2015–2017, pension expenditure will grow further and, overall, public transfers will remain elevated, despite a decline in the income share of unemployment benefits.

Chart 1.



It is a matter of concern for the financing of public services that an increasingly large proportion of taxes and contributions from household income is used solely to cover current transfers. The situation has worsened markedly during the recession. Households' gross tax rate has risen by about 2 percentage points, standing currently at 34%. After deducting transfers from taxes and contributions, the share available for funding public services has diminished by almost 5 percentage points (Chart 2). The problem is that growth in pension expenditure will remain rapid for a long time, along with a simultaneous rapid increase in demand for health and care services.

Chart 2.



Costs of recession highest for unemployed and wage and salary earners

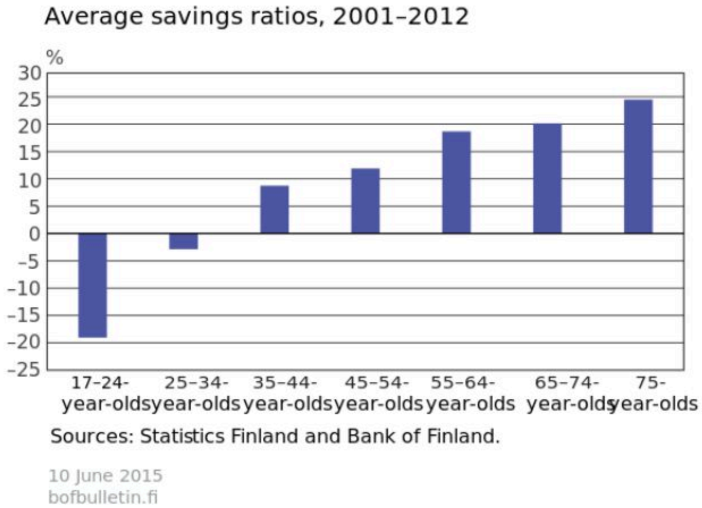
In addition to the fact that the number of pensioners has enlarged the share of pensions in aggregate household income, pensioners' average incomes have also grown rapidly. The median pensioner real income in 2013 was nearly 15% higher than in 2007 (Chart 3). Retiring persons' longer working careers and higher earnings levels have led to a trend growth in statutory earnings-related pensions. Median pensioner household income also continued to grow in 2012 and 2013, when income developments in other population groups were subdued.

Entrepreneurial households saw their incomes grow strongly, particularly in 2010 and 2011. Subsequently, growth more or less stalled, and the median household real income in the case of entrepreneurs and farmers in 2013 was about 11% higher than in 2007. However, median entrepreneurial income appears to have progressed rather favourably, considering that in reference year 2007 the boom had already vigorously boosted entrepreneurial income.

Wage and salary earner households witnessed a total of 9% growth in median income in

2008–2013. The bulk of this growth was generated in 2009 and 2010. Income developments for the unemployed have particularly mirrored changes in the structure of those receiving unemployment benefits, broken down into earnings-related unemployment insurance and basic unemployment allowance. In 2013, the median unemployed person's income was 4% higher than in 2007.

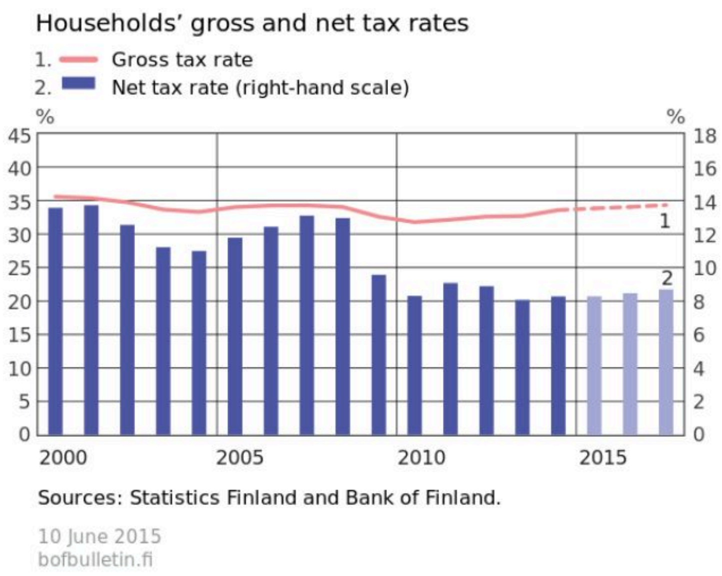
Chart 3.



The growing share of pension income in financing consumption has reduced uncertainty related to household income developments. Pensioners face neither unemployment risk, nor real income risk, as pensions are indexed to price and earnings developments. Therefore, in principle, population ageing has reduced the dependency of private consumption on the economic cycle. But it is still hard to distinguish the impact of this on consumption.

Although, of the socio-economic groups, pensioners have weathered the recession years well on average, the distribution of household income over the life cycle has been as normal. Average earnings-related and overall incomes are highest in households with the principal breadwinner aged around 40–50 (Chart 4). The average disposable income of households in this age group in 2013 was around EUR 71,000, which is nearly twice the amount available to 70–80-year-olds. However, average earned income already begins a slow downward trajectory at around age 55. This may be partly accounted for by the declining employment rate at the approach of retirement, but it could also stem from lower income due to falling productivity because of ageing. This would be consistent with the development of lifetime income generally observed in other countries.

Chart 4.



Households' property income increases until around the age of 40 as wealth accumulates, remaining at around EUR 10,000 up to the age of 70. Property income is already lower for households aged over 70, due to the age group's smaller level of assets. Moreover, in the oldest cohorts, a larger part of financial assets is invested in deposits, on which the average return has remained lower than that from shares and funds.

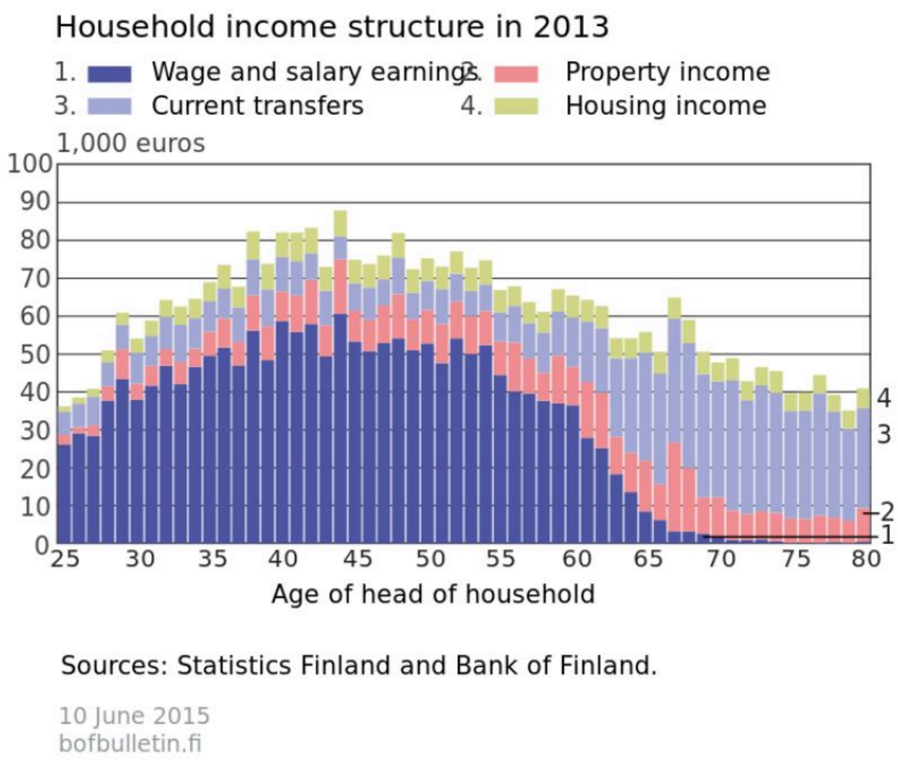
In addition to capital income per se, property income also includes savings generated by owner-occupation compared with living in rented accommodation. This benefit has been measured by imputed income from housing. Imputed income from housing reaches a peak at the age of 40, but shrinks slowly with age. Combined asset and housing income accounts for just under 25% of total income until close to retirement, while this share is already about 10 percentage points higher for those aged over 60.

Elderly people not consuming their wealth

Besides their income level, the financial situation of households is determined by their wealth. According to the latest study on wealth, households' net wealth would appear to be highest for those aged 65–74 (Chart 5). In 2013, real wealth – i.e. in practice housing wealth – accounted for 60–70% of the gross wealth of households in all age groups, meaning that growth in household wealth, irrespective of age, has largely been dependent on the pace of increase in housing prices.

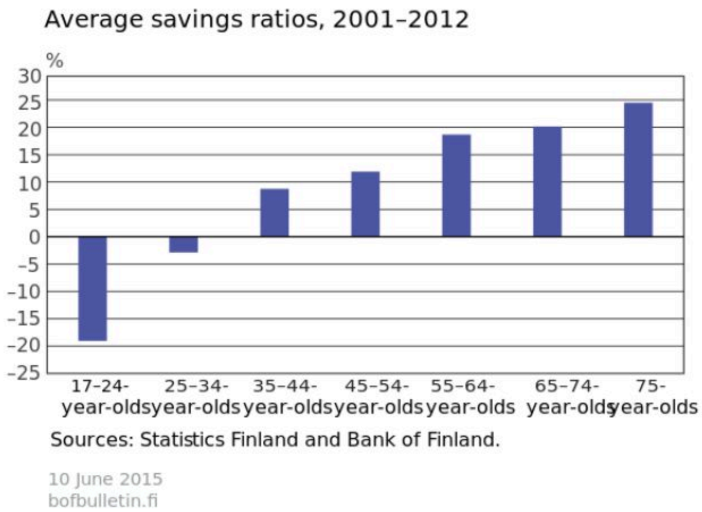
Surprisingly, 45–54-year-olds hold the highest amount of debt, and still older cohorts also have relatively high amounts of debt. Consequently, it is hard to justify the size of debt by the phase in the life cycle, although debt accumulation by older cohorts has been on the increase in the other Nordic countries, too. This not only reflects an overall increase in indebtedness but also, in part, the fact that working careers currently commence later and housing loan maturities have lengthened.

Chart 5.



The possibility of running down savings and liquidating housing wealth by, for example, reverse mortgages makes it easier for households to maintain their consumption after retirement. However, Finnish households have not generally run down their savings in retirement to finance consumption. On the contrary, household saving appears to increase with age (Chart 6).

Chart 6.



The highest savings rate is ascribed to households aged over 75, i.e. the age group with the lowest income level. The savings behaviour of elderly households is thus against the ordinary life cycle model assuming that households smooth their consumption over time by saving when young and by drawing on their savings when growing older. Older cohorts' reluctance to consume their savings is likely to be explained, in part, by their willingness to leave an inheritance. The phenomenon is, by definition, not exceptional in international comparison. For example, the savings rate in Germany, Austria and the United Kingdom appears to rise towards the end of the life cycle.

Although, from households' point of view, savings may actually increase with age, at the level of the economy as a whole this is not the case. An increasingly large proportion of aggregate private and public consumption will in the future need to be financed by income on capital. In practice, this means that the surplus on the pension funds will decline. If there is a wish to keep pensioners' consumption relative to their incomes unchanged, the change in the age structure will strongly raise consumption across the economy as a whole. This threatens to cut the savings ratio for the economy as a whole.[1]

Elderly households' higher propensity to save may ease the situation to some extent as their population share increases. If cohort-specific savings ratios were to remain at the same level as in 2012, a mere change in the population's age structure would increase the savings ratio of the economy as a whole by about 0.2 of a tenth of a percent by 2040. Accordingly, the direct impact of the age structure on the savings ratio would remain rather limited.[2]

Changing impact of interest rates on consumption

With population ageing, the structure of household income, consumption and wealth is changing. As public transfers assume a more pronounced role in household income formation, the response of private consumption to cyclical situations will be weaker. Income uncertainty will also be allayed by employment pensions being virtually protected from fiscal consolidation. However, the increasing importance of current transfers means that a smaller proportion of tax revenues will be available for public service provision.

The savings rates of households and the economy may develop divergently. If the trends currently observed are to continue, the average household savings rate will rise slightly. However, at the level of the national economy as a whole, a substantial part of consumption will need to be financed by reducing pension savings, which will lower total savings. This pressure could be reduced if the public sector's expenditure pressures were alleviated by unwinding elderly people's housing and financial wealth. In this regard, proposals have been made, among other things, for private long-term care insurance to be financed by reverse housing loans.

With financial wealth focusing on older cohorts and debts on younger households and those of prime working age, population ageing will lead to an increase in households' average wealth. As wealth grows, the role of property income in financing consumption will increase, which may change the impact of interest rate changes on consumption. Lower interest rates will mean a negative income impact for an increasingly large proportion of households. Similarly, higher interest rates will provide elderly people with an opportunity to increase consumption. Consequently, the effectiveness of monetary policy may diminish.

Source

Riihelä, M. – Vaittinen, R. – Vanne, R. (2014) Väestörakenne ja talouskehitys – ikäryhmät Suomen taloudessa ['Population structure and economic trends – age groups in the Finnish economy'] Reports of the Finnish Centre for Pensions, 07/2014.

Footnotes

1. Using 'life cycle accounts', Riihelä & al. (2014) have analysed different cohorts' private and public consumption relative to income. According to their estimate, around 2030, all capital income in the economy will be needed to finance private and public consumption if consumption per person is to be maintained at the current level. ↑

2. The savings rates (Chart 6) are based on the Household Budget Survey by Statistics Finland and clearly overestimate the savings rate based on national accounts data. ↑

Key words

ageing, household income, monetary policy, saving, wealth