What is Intergenerational Equity?

Then I say, the earth belongs to each of these generations during its course, fully, and in its own right. The second generation receives it clear of the debts and incumbrances of the first, the third of the second, and so on. For if the first could charge it with a debt, then the earth would belong to the dead and not to the living generation. Then, no generation can contract debts greater than may be paid during the course of its own existence.
—Thomas Jefferson

Policymakers and advocates, when arguing for a particular approach to public pension finance, often raise the issue of intergenerational equity. We sometimes find these arguments confusing, because "intergenerational equity" means different things to different people. In this article we explore this issue—the different views of and approaches to intergenerational equity and the different outcomes they may produce.

FRAMING THE ISSUE

For most expenses—cash compensation being an obvious example—the issue of "which generation pays?" doesn't come up. Because wages must be paid currently, the "first generation" (to use Jefferson's terminology) pays the current wages of current employees in the ordinary course.

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Pensions are, however, different. A public employee provides current services in exchange for a pension accrual, but the pension benefit itself isn't paid until some time in the *future*. Because there is no current necessity to pay the pension, there is the possibility that the funding of that pension accrual may be deferred into the future. As a practical matter, the only way that future pension benefit can be "paid currently" is by currently funding it, e.g., by making a contribution to a trust equal to the present value of that future pension benefit.

To restate, with respect to a pension benefit, there is no payment that must be made "now." That fact presents the possibility (not an issue with respect to cash wages or most other fringe benefits, such as health insurance premiums for current workers) that a future generation can be made to pay. And that possibility raises a question of intergenerational equity: Is it equitable that a future generation should pay for the current generation's pension cost?

NOT A SIMPLE QUESTION

Whatever approach you take to this issue, there are complexities lurking underneath the seemingly simple question "which generation pays?" A key one is: how do you determine

the “current cost” (to be funded today) of a future pension? Unknowns such as future life spans and future inflation (for plans with COLA provisions) will influence the future cost of that pension benefit. And, you have to discount that future cost back to the current period.

What we see is that there’s actually no answer to that question (“how do you determine the current cost?”) that is guaranteed to produce “intergenerational equity.” The calculation is always an estimate. If you take a “conservative” approach you may overestimate costs; the current generation will overpay and, in effect, transfer wealth to a future generation. If you take an un-conservative approach, the current generation may underpay and, in effect, transfer a financial burden to a future generation.

Today’s large unfunded public pension liabilities suggest that in many cases the preponderance of estimates have fallen short in the un-conservative direction. The dilemma faced by today’s generation of funders (generally taxpayers) is whether to effectively pay double its share, pay just its own share, or pay even less than its own share (the result of too-widely-used negative amortization strategies).

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DIFFERENT VIEWS, DIFFERENT EQUITIES

Different stakeholders may have different views as to what constitutes intergenerational equity. Imagine these hypothetical voices weighing in on this question:

Thomas Jefferson “Each generation should pay fully for the cost of its own pensions.” This approach is intuitive and is what has traditionally been meant by intergenerational equity. The argument for this approach might be described as: you bought it, you pay for it, and so it inevitably calls for full pre-funding of pensions.

The budget director “Each generation of taxpayers should be required to pay the *same* pension expense as a percentage of payroll.” The result is smooth and predictable costs. But, what if, because of large unfunded liabilities, future benefits for younger workers need to be cut in order to make room for burgeoning amortization payments to cover the cost of benefits promised to older workers? Haven’t we compromised intergenerational equity at the worker level?

The public sector worker “Workers across generations should receive the same benefits for the same work.” Individual equity may be achieved, but taxpayer equity across generations is very much in question. Rapidly growing funding costs to maintain individual equity put an enormous strain on the sense of intergenerational equity among taxpayers.

Advocates for other local interests “Public services like education involve current costs that have future benefits. We routinely spread (defer) the cost of building schools, so why shouldn’t we also spread (defer) the cost of the pensions paid to educators?” Translated: why should current taxpayers incur the full costs associated with expenditures that will benefit citizens for decades to come, especially if doing so means cutting back on other vital services?

Paul Samuelson (Nobel Prize-winning economist) “Pension benefits should only be paid for when they come due. Any pre-funding of pensions imposes an unnecessary burden on the current working generation. Social Security is a Ponzi Scheme that works! Public employee pensions are no different.” This is because, as Samuelson actually wrote in a 1967 Newsweek article, “Always there are more youths than old folks in a growing population. More important, with real incomes growing at some 3 percent per year, the taxable base upon which benefits rest in any period are [sic]

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> much greater than the taxes paid historically by the generation now retired…" Needless to say, things didn't work out that way. Within a few years of this appearing in print, both birthrates and real wage growth collapsed. (This point seems especially relevant to the many demographically and economically declining municipalities with underfunded pension plans.)

Because decisions about public pension funding are inevitably political, decisions about pension funding may have more to do with political expediency than with any sort of world view of what's right or equitable. But that doesn't stop advocates for almost any funding approach from citing intergenerational equity as a rationale.

REAL-WORLD CONSEQUENCES

One of the problems with thinking about these issues under the heading "intergenerational equity" is that it makes them seem abstract. Moreover, these issues are often framed in terms of "which group of taxpayers is going to be made to pay," with the discussion degenerating into an argument over tax equity and income inequality. At which point the real issue—which generation will pay?—is lost.

But in real life, intergenerational *in*-equity can have devastating consequences for citizens and pensioners alike. Consider the situation we see in many cities where a two-tier system of compensation has been created. Old employees (Jefferson's first generation) are given privileged benefits that are paid for by reducing the benefits (and sometimes the compensation) of "new" employees (Jefferson's second generation). Alternatively (or even at the same time), services to the second generation of taxpayers, e.g., schools, parks and libraries, may be cut.

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In these circumstances, whatever your theoretical view, the conclusion must be that something went wrong with the intergenerational calculus.

While subject to multiple interpretations and thus sometimes confusing, the concept of intergenerational equity does capture something crucial that is at stake in public pension finance. There *are* limits—both practical and moral—on the ability and the right of one generation to bind another.

Most of us do not "buy in" to Jefferson's perspective, even roughly, or we would never have ended up in the situation we find ourselves in today. To the contrary, the history of public finance (especially federal, but also state and municipal) over most of the postwar era has been based on an implicit (and sometimes explicit, as in Samuelson's case) rejection of Jefferson's basic premise.

It's high time we recalled it.

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