Social Security in a Long Life Society[1]

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Outline

1. Social Security under Attack

Social security is under attack. The European welfare state is seen as a cause of its employment problems: "every extra 1% on payroll taxes causes X thousand people to lose their jobs". Critics of social protection argue that advanced economies with sizeable welfare states cannot compete in the global economy. Advocacy of flexible labour markets is translated into calls for the dismantling or privatisation of social insurance. Even supporters are posing questions. The lengthening of the life span and new life patterns are seen as challenging the validity and adequacy of existing social security programmes.

Action may be seen as imperative. In a pay-as-you-go state pension scheme, with a given replacement rate (pension as a percentage of final earnings) and a fixed retirement age, a longer life span means an increasing proportion of retired people and hence that higher contributions have to be levied on the working generation. Their real incomes are reduced by reductions in net wages or the higher labour costs cause a fall in employment. There is therefore a major problem for social and economic research. Indeed, one may ask why is *research* necessary? Surely what is required is *action*? Governments must initiate urgent policy reforms of their pension and social security systems.

The need for research becomes clear however when one asks the next question – what action should be taken? As soon as one contemplates the design of policy reform, it becomes evident that the issue is a complex one and that the policy

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conclusions are less than fully obvious. Policy inaction is often blamed on the unwillingness of governments to confront trade unions, employees, and pressure groups, but governments also hesitate because of uncertainty about the alternative to social security. It is true that some countries, such as the United Kingdom, have cut projected spending on state pensions but the alternative provision for old age has brought with it other problems. In this paper, I consider four such problems: the economics of alternative pensions, the retention of older workers in the labour market, the impact on the capital market, and the redistributive dimension.

2. The Private Pension Alternative

It is clear that scaling back of state pensions has to be accompanied by alternative provision. Before raising the state pension retirement age, and reducing the state pension replacement rate, we have to ask – what is the alternative? Those advocating the rolling-back of the Welfare State normally assume that state retirement pensions, or old age pensions, would be replaced by contributions to private pensions. Contributions to private schemes might indeed be mandatory. Even if not mandatory, there would be strong moral suasion applied to the working population by governments anxious to avoid the residual liability of preventing poverty in old age.

Would such private contributions be treated by workers as different from state social insurance contributions? Would the private system be immune to the problem of demographic change? Since I do not want to get into the issue of transition from one system to another – a highly complex subject – let us consider two parallel systems. In Bismarckland there has been a pay as you go pension scheme since time immemorial, with current contributions paying current pensions; in the United Liberaldom there are mandatory private pensions, so that people save while working to accumulate a fund that at retirement will buy them an annuity. How are these two countries affected by an increase in life expectancy? In Bismarckland, we know that in the future there will be a rise in the size of the dependent population, so that over time the rate of contribution will have to increase substantially. If, say, the dependent population will double in a generation, then by the time that the current generation retires contributions will have doubled. This is the scenario about which concerns are expressed.

But United Liberaldom does not escape the impact of increased life expectancy. The cost of an annuity depends on survival rates. As people live longer, this development is priced into the annuities. With mortality reduced, an annuity costs more. To assure the same replacement rate, a worker is going to have to increase the amount he saves. (I say "he" advisedly, since annuity rates currently vary with gender. Unlike many state pension schemes, which pay the same benefits to men and women, thus redistributing towards women because they are longer-lived, in United Liberaldom women have to pay more for their annuities.) Nor is this all. The rise in savings may have general equilibrium consequences. On the capital market, the supply of savings has increased. This may be expected to drive down the rate of return. As more savings seek productive investment opportunities, the rate of return falls. (Here I am ignoring any spillover from the capital market of United Liberaldom to that of Bismarckland.) Again the price of annuities is going to rise.

This brings us to one of the key elements in the choice between the two systems. Whether or not the state pay as you go scheme offers benefits equivalent to private savings depends, as Paul Samuelson (1958) pointed out, on the relation between the rate of *growth* of the contribution base relative to the size of the retired population and the rate of *return* on savings. In recent decades we have seen the growth of the contribution base fall, as schemes reached maturity in terms of coverage (in the past they have been able to expand contributions by bringing in new classes of workers) and it is spread over a larger retired population. Rates of return, on the other hand, have been historically high. It is therefore not surprising that the benefits from state schemes have been increasingly discounted. But the rate of return can now be expected to be lower than in the 1980s and 1990s. Whatever the immediate future of the stock market, no one expects double-digit real rates of return to be repeated over the long run. For macro-economic reasons, the balance has swung back, and the case for private provision is now less strong than in the past two decades.

Of course, the issue is not just economic. There is an important dose of politics. The attitude of workers towards contributions to a private scheme and to a state scheme is influenced by the perceived political risk that the state scheme cannot be sustained: the Bismarckian scheme will have been abolished by the time current workers reach pension age. Here there is an obvious circle. Expectations of benefit cuts cause people to discount future entitlements and treat social security contributions as a pure tax. This leads to adverse economic impacts, which validate the doubts about the financial security of the scheme and strengthen calls for its scaling back. As long as confidence is retained, the social security scheme may be quite viable, but once doubts have come to be held we may have embarked on a trajectory that leads to inevitable rolling back of the Welfare State. As I noted in my book (1999) on *The Economic Consequences of Rolling Back the Welfare State*, economists bear a responsibility for such a development. If economists claim that the current Welfare State is unsustainable, thus causing a fall in public confidence, then the prediction becomes self-fulfilling.

3. Carry on Working?

Longer life expectancy means that Bismarckland has to levy higher contributions and that the citizen of United Liberaldom has to accumulate a larger fund by the age of retirement. In both cases, the pressure can be alleviated by raising the retirement age. This could be achieved by tying retirement ages to life expectancy for a cohort: for example, increasing the retirement age for a cohort by a half, say, of the increase in their life expectancy. This would be a means of sharing the burden between generations (see Section 5). Or it could be achieved by doing away altogether with fixed retirement ages, as in recent EU moves towards ending age discrimination.

Superficially, the idea appears attractive, given trends in demography and the reduced physical burden of many jobs. At the same time, we have to look at the demand side. When one does so, then there are reasons for concern. Many people have argued that technological change, particularly information technology has led to a shift towards skilled and highly educated workers, and away from the unskilled. While many older workers have adapted very well to these challenges, on average older cohorts have lower levels of education and are less well placed to compete for these new jobs. Many of the jobs are in the service sector, where we have seen increasing international competition, as illustrated by the location of call centres overseas. The same does not apply to personal services such as care for the elderly or for young children, but here we encounter a different problem: the substitution of paid for unpaid work. If grandparents are no longer available to provide fee child care, because they have been required to continue in their paid jobs, then the next generation face the burden in a different form: the cost of purchasing child care.

I stress the demand side, since it highlights the role of *employers*. Much of the debate about labour market reform concentrates on the role of workers, but does not consider that there are two sides to the labour market. We have to ask what influences managers in creating jobs and conditions in which older workers can continue to work past their currently expected retirement dates. Does “being a good employer” still lead employers to reward employee loyalty by providing job security up to retirement? Is there a direct conflict between increased labour market flexibility and the employment of older workers? If, to simplify, an “old style” labour contract was for career employment, then employers bought a package of, say, 40 years labour, recognising that labour law constrained them to keep workers on even when their productivity had fallen below their pay. Employees on their side invested by producing more in their mid-career in exchange for pay in excess of productivity in early and late stages. The more that labour market reform means easing of such constraints, the more that we are likely to see employers laying off older workers. Moreover, it is worsened by the abolition of retirement ages. At present employers know that there is a definite limit to any period for which pay exceeds productivity. The prospect of unlimited employment means that they will have to bring in employment tests that, while apparently non-discriminatory, have the effect of easing out older workers.

I have noticed that the idea of raising the retirement age is particularly popular among politicians. This led me to wonder if they are setting us a good example. To test this, I took the 15 EU (of 2003) countries in January 1970, leaving out Greece, Portugal and Spain, and looked at the ages of their Prime Ministers and then asked whether the Prime Ministers at 1 January 2003 were older. It is true that the 12 Prime Ministers of 1970 were younger than I remembered. The oldest was Viscount Eyskens of Belgium, who was 64. But most were in their 50s. The median age was 54 and two-thirds were aged between 52 and 57. What about 2003? As might be expected, Southern Europe has older leaders: the Prime Ministers of Italy and Greece are both aged 66. There is 1 more over 60. But the median has shifted down, from 54 to 51. 7 of the 15 are aged under 50 (Mr Blair was just turning 50). Politicians have not been setting us a good example. Of course, politics is an odd profession, and ex-Prime Ministers go on working, if only giving lectures and writing their memoirs. But a major reason why they are getting younger is a more general one – the increased pressure on the holders of office. This is a common refrain in many occupations: that people are retiring early because they can no longer face the strain and stress of modern work.

Much of the policy debate is in terms of raising the retirement age, but the key element is surely extending the working life. Such a shift in perspective has two immediate implications. First, it means that we should seek to hasten entry into the labour force. One reason for the increased dependency ratio is the higher proportion in post-school education and delayed recruitment to employment. The UK has a relatively short first-degree period, but this has become extended by the practice of taking gap years and by the growth of postgraduate education. Other European countries have considerable scope for speeding up their degree training (as already underway in the Bologna process) and for eliminating delays in recruitment competitions. Differences across cohorts become less marked if today's pensioners retiring at 60 began paid work at 14 or younger. Secondly, focus on length of working life is fairer in terms of within-cohort equity. Those who began work at 14, or even 18, can reasonably feel aggrieved at being asked to continue work until 65, when they know that graduates started paid work up to 10 years later.

4. Pensions and the Capital Market

The pressures on employers to scale back employment of older workers originate in part from the search for "shareholder value". The labour market is in this way linked to the capital market, thus joining two sides of our discussion. The high value of the rate of return on pension funds in the past two decades has come at the expense of reduced employment opportunities.

Moreover, the growth of private pension funds has impacted on the working of the capital market. As Leslie Hannah commented some years ago, in his book on *Inventing Retirement*, "the pension industry has become a power in the land" (1986, p 64). The potential impact of pension funds on the capital market is recognised by the World Bank (1994) in its report on *Averting the Old Age Crisis*. They note that institutionalising savings may make it harder for small firms and new ventures to obtain financing. But in the case of larger corporations, they view the growth of pension funds as beneficial: "when pension funds have a big stake in corporate equities, they are in a better position than individuals to overcome `free rider' problems, demand improved accounting and auditing procedures, and get information. They are also better able to use that information to assess company managers and press for changes if management is not performing effectively" (World Bank, 1994, p 177). They argue that when pension funds have only small stakes in companies, then they will fail to monitor managerial performance, but that as holdings increase so will pension funds increase their involvement in corporate governance.

These arguments take it for granted that increased monitoring of companies moves their performance in a desired direction. On the other hand, *if* faster growth is regarded as desirable, then increased involvement by pension funds may have the reverse effect. As discussed in Atkinson (1999), firms financed on the equity market may find that they are constrained to invest less and grow more slowly than their managers would otherwise choose. The Goode Committee in the United Kingdom noted that there had been "widespread discussion of the `short-termism' of pension funds. Those who identified this as a problem saw it as making long-term investment decisions in research and development or capital projects impossible for company managements to pursue." (1993, p 159). Debate about pension reform has focused on the disincentive to employment provided by payroll taxes, but ignored the adverse effects on employment stemming from the increased role of pension funds in the capital market.

5. Pensions and Redistribution

While calls for pension reform start from concerns about efficiency and competitiveness, an essential ingredient is redistributive – between generations. Economists tend to try to avoid distributional questions, assuming them away by hypothesising that identical representative agents populate the economy. But in an intertemporal economy this is not possible. Even if everyone in the same cohort were identical, we differ in our dates of birth. There is an ineluctable distributional issue. We are in effect asking: which generation should bear the cost of increased life expectancy? That is a very reasonable question, and a number of answers can be given. One could maintain the tax rate and reduce benefits per head as the retired population grows, or one could maintain benefits per head and push up the tax rates. In his very measured analysis, Richard Musgrave (Chapter 7 in Musgrave, 1986) suggested that a "fair and practicable solution" is to share the burden of adjustment between workers and pensioners by maintaining the ratio of per capita benefits to per capita net wages. As suggested earlier, increased life expectancy of X years could be accommodated by expanding the working life by X/2 years, sharing the cost.

But redistribution is not just across generations. The reason that Britain introduced old age pensions was concern about the aged poor. In his famous study of poverty in York in 1899, Seebohm Rowntree reported how "the life of the labourer is marked by five alternating periods of want and comparative plenty" (page 170). At the end, after a period of relative prosperity when he has working children, he "sinks back into poverty" when he is too old to work. A 100 years later, the UK Government's study of Households Below Average Income showed that "pensioners in families with no working adult were three to four times as likely to be below [60% of the median] as those in families with a working adult" (Department for Work and Pensions, 2002, page 106). The overall standard of living was much higher, but the relative position of pensioners remains a concern. The situation was particularly serious for those with no occupational or personal pension: 30% of single pensioners and 46% of couples were below the low income line.

In reforming the pension system to meet new circumstances, we must not lose sight of the old circumstances that gave rise to the welfare state.

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