Enough to live on

For now, at least

TO BE old was once to be poor. No more: governments have taken over many of the costs and risks of ageing. The burden of paying for pensions and health care therefore falls mainly on those in work. That has not seemed a problem as long as economies and the workforce have grown steadily and the old have been relatively few in number. However, within a decade that comfortable arithmetic will end. The fundamental decision about how to distribute the costs of old age between the elderly and their children will therefore become harder to resolve.

In February, Alan Greenspan, chairman of America's Federal Reserve Board, said that "we will almost surely be unable to meet" the demands on resources that the retirement of the baby-boom generation will create. Almost everywhere else, the trouble is not—or not just—the baby-boomers, but the fall in fertility. The cost of pensions and of health care for the old must eventually be paid from the output of the current generation of workers. Even if birth rates recover a bit (and there are signs that they may do), solving Europe's pensions problem will be a nightmare. If the workforce shrinks and the number of dependants grows, no amount of fancy finance can fill the gap. That is why—to repeat this survey's main message—it is vital to ensure that more older people go on working, and so make their own contribution to output.

Tackling other labour-market rigidities that keep people out of jobs also becomes urgent: Italy has insanely high youth unemployment, for instance, and Germany has Europe's highest unemployment among the unskilled. Immigration can help too, but only a bit: Germany by 2020 will be 300,000 births a year below replacement level, calculates Ralf Ulrich, a demography professor at Berlin's Humboldt University. That is one-and-a-half times the average annual level of immigration over the past 30 years. If the gap between births and deaths were to be filled entirely with immigrants, the numbers would get simply too large for such societies to digest. Besides, immigrants themselves eventually grow old, and are then disproportionately likely to be poor.

The hardest part of reform, though, will be to persuade both today's and tomorrow's pensioners that retirement will entail bigger financial risks than it has done in the past. In fact, governments everywhere are engaged in pension reform. Few have yet begun to give the same attention to health care. Yet the future burden of health-care costs could easily be at least as great as the cost of pensions.

Howard Oxley of the OECD estimates that, without change, the cost of pensions will take an extra three percentage points of the GDP of the rich countries by 2050; health care could take an extra two-and-a-half to three percentage points, of which one would be the cost of long-term care. A different sort of estimate, for the United States alone, by Jagadeesh Gokhale and Kent Smetters for the

American Enterprise Institute, puts America's total unfunded liabilities at around $44.2 trillion. But most of that—$36.6 trillion—is attributable to Medicare, not to Social Security (the state pension scheme).

However, it is harder to predict the costs of health care than of pensions. In general, says Henry Aaron, an economist at the Brookings Institution, health costs per head rise with age. But does this mean that, if the average 75-year-old has a life expectancy of a quarter of a century, he will need the same level of health care as a 75-year-old today? Or as someone today with 25 years of life ahead? On balance, he says, the years to death are likely to matter more. Moreover, one of the odd and unexplained quirks of health care today is that 90-year-olds seem to absorb less of it than 75-year-olds. Nobody knows whether this is because hospitals offer them less, or because they keel over more quickly. The answer is probably a bit of both.

However, of the disabilities that increase with advancing age, some will be particularly expensive to tackle: Alzheimer's afflicts only 3% of Americans aged between 65 and 74, but 47% of those over 85. And the sheer rise in the numbers of old people will drive up health-care costs. So no government is likely to avoid the need for reform.

In America, Boston University's Mr Kotlikoff suggests giving individuals vouchers with which to buy health insurance, and pegging the overall value of the vouchers to the growth of the economy, to make sure that the costs of health care do not outstrip real earnings. In Germany, health care costs more per head than anywhere except America and Switzerland. Axel **Börsch-Supan,** an economist at the Mannheim Research Institute for the Economics of Ageing, who has played a leading role in proposing pensions reform, argues that it is dangerous to have pay-as-you-go funding for health care when a country is ageing as rapidly as Germany is doing. However, on both sides of the Atlantic, reforming health care will be politically even more perilous than reforming pensions. Governments are likely to duck the issue for as long as they dare.

With pensions, on the other hand, most governments are now attempting reform. Some, notably Sweden, Italy and Chile, have put path-breaking reforms in place. Others, such as the United States, Britain and Germany, have set up top-level commissions to produce ideas. But there is a difference. The scale of the problem in the United States and other English-speaking countries is modest compared with that in continental Europe.

(…)

In America, by contrast, pensions are lower. The average pensioner typically receives only 45% of the income he earned before retirement; the average Austrian, 78%. In addition, America's workforce is not imploding: high rates of immigration and so high fertility rates have kept up the supply of youngsters.

The prospect of a large hole in America's Social Security fund has attracted lots of schemes for reform. But resolving America's Social Security problem is "a piece of cake", says Peter Diamond of MIT, at least in comparison with the prospective bill for health care. He has just published a book ("Saving Social Security: A Balanced Approach") with Peter Orszag, another distinguished economist, explaining how they think it could be done with only moderate pain. Fairly modest tax increases and curbs on the distribution and scale of benefits would, if made quickly enough, bring the budget under control.

Boston University's Mr Kotlikoff agrees: "I could fix it in ten minutes if I were president," he says. He, too, worries more about the billowing cost of health care than about Social Security, which could be partly squared with a new federal sales tax. That might be unpopular, but it would be a good way to ensure that the elderly carry some of the cost. One of the main challenges of reform everywhere is to persuade the retired that they must share the burden of change.

Two main issues dominate the debate: whether pensions should be financed from past savings or from current revenues; and whether the benefits they provide should be linked to past earnings or to some other predictable marker ("defined-benefit" schemes), or to savings and the return earned on them ("defined-contribution" schemes). A third issue, dealt with in a later article, is how to redesign pensions to reduce the incentive to retire early.

State pensions everywhere are largely pay-as-you-go, and entirely so in continental Europe. Several of Europe's governments are now considering switching. The problem is that one generation has to pay twice: once to finance the pensions of today's old, and once to fund its own pensions. One device, employed in recent pension reforms in Sweden and Italy, is for the government to introduce "notional defined contributions", granting credit for the years people work. The government records all contributions, and then adds a notional rate of interest. The scheme can remain pay-as-you-go.

Private-sector schemes have mostly been funded. But not in Germany: there, 58% of company pension schemes are on-balance-sheet book reserves, says Dieter Bräuninger, a senior economist at Deutsche Bank Research in Frankfurt. International investors do not like these huge unfunded liabilities, so big German companies are now struggling to set up funds.

(…)

The question of defined benefits versus defined contributions raises another core issue: that of allocating risk. Any scheme that pays defined benefits imposes risks on workers. They suffer if they leave early, or do not earn as much as they expect in the crucial, final years of working life. But the risk of low returns on their contributions is transferred to other people: taxpayers for state pensions, shareholders for company pensions. Schemes whose value is determined by the level of contributions and the return on investments, such as the 401(k) plans on which Americans increasingly depend for their pension income, or the defined-contribution schemes to which British companies are switching in droves, impose on the individual two further risks: of earning insufficient returns, and of living unexpectedly long.

In future, government schemes will probably retain some element of defined benefit, providing a guarantee against poverty in old age of which the taxpayer will carry at least part of the cost. However, pensioners, rather than current taxpayers, will carry some of the "longevity" risk of extra life expectancy. Sweden and Italy both make provision for regularly recalculating the future cost of pensions and passing on part of the longevity risk in the form of lower pension entitlements. So, as life expectancy in old age grows, benefits will rise more slowly than they would otherwise have done—or even decline.

One group is likely to escape these constraints, at least for the moment: public-sector workers. Every big country tends to reward its own servants by promising them that the taxpayer will care for them in old age. In some places (as in Germany) the public servants do not even contribute to this luxury. In Britain, where swathes of employees have been shut out of their private-sector employers' defined-benefit schemes, teachers, civil servants and police continue to enjoy such benefits. They will add vastly to public-sector payroll costs as their workforces retire.

In some developing countries this is an even more serious problem, because public servants are often the only people with formal pension arrangements. The World Bank calculates that in Malawi, where the first generation of post-colonial teachers is reaching retirement, pensions shot up from 11.6% of teachers' remuneration to 35.5% in the five years to 1999-2000. In Brazil, civil servants account for 5% of the workforce but 50% of pensioners.

For everyone else, old age will become financially riskier. To guard against that risk, individuals will have to save. They will do so mainly through tax-sheltered savings schemes. Such schemes are the right option for company pensions. Defined-benefit schemes are difficult to transfer from one employer to another, so younger, footloose employees end up subsidising older stick-in-the-muds. "A private-sector defined-benefit scheme is a surprisingly effective way of redistributing money towards the rich," observes Adair Turner, who is heading a commission on pensions policy in Britain. Such schemes also give employers an easy (if expensive) way to get rid of older workers by paying them to retire early. Such payments are harder to make, or at least to fudge, if a pension is run as a savings account.

By contrast, defined-contribution schemes allow savers to see how much capital they have accumulated, which may make them think more carefully about the money they will need in retirement. Generally, American evidence suggests, they then decide to work longer.

Den vollständigen Artikel finden Sie im Economist vom 27.03.2004.