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The ‘principle of scarcity’, pension policy and growth

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Abstract

The picture one is bound to form of the whole question of pensions depends on whether one views it through the lens of the ‘principle of scarcity’ or through that of the ‘principle of the underutilisation of productive resources in a market economy.’ A generous PAYG system of the defined-benefit type is here defended as the best retirement system one can conceive of in light of the principle of underutilised resources. The nature of the main obstacles that the implementation of such a system is likely to encounter in the present set of historical conditions is outlined in the final part of the paper.

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Notes

[1]According to a 2004 official report, in the UK reductions in yield resulting from providers' charges can absorb about 20–30% of an individual's pension savings (cf. Pensions Commission, 2004, ch. 6).

[2]Overall financial liberalisation over the last 25 years has greatly increased the economic and political weight of the financial services industry, which is of course also the chief direct beneficiary of the downsizing of the traditional defined-benefit public pension schemes. Though important, I believe nevertheless that the role played by this increased influence of fund-management companies in the process of pensions privatisation is secondary, at least in Europe, to deeper changes afoot, over the same period, in the relative power of this continent's social classes and groups (more on this in Section 4, below).

[3]See, for example, Bank of International Settlements (1998), World Bank (1994) and Holzmann & Hinz (2005); see especially the innumerable contributions by Martin Feldstein on social security, starting from Feldstein (1974). This widely circulated paper expressed forcibly, for the first time, the notion that the pay-as-you-go nature of social security was bound to exert a ‘substantial depressing effect’ on the savings rate and the level of GDP. According to the empirical estimates presented in the paper, household US data showed that the social security programme approximately halved the personal savings rate, leading the author to argue that this could not fail to bring about a marked reduction in the stock of capital and the level of national income: ‘During the 1960s personal saving accounted for 60 percent of total private saving. By halving personal saving, social security reduced total private saving by 38 percent. In the long run, this decrease in the rate of private saving would also decrease the private capital stock by 38 percent’, and ‘[a] 38 percent decrease in the capital stock implies a substantial reduction in GDP’ (Feldstein, 1974, p. 922). While there are authors who point out that there is not enough solid evidence to support the expectation that substituting private retirement saving for state benefits will increase the economy's propensity to save (cf. for example Barr, 2000; Diamond & Orszag, 2005, pp. 47–54), the idea is generally accepted that the presence of such an effect, if it could be proved,

would constitute a positive feature of prefunding for future pension commitments: ‘A key issue in determining whether advance funding is advantageous is the extent to which it results in net additions to national savings’ (Holzmann & Hinz, 2005, p. 5).

[4]‘The main motivation for the [World] Bank to support pension reform has not changed. Instead it has been strengthened by the past decade of experience: most pension systems in the world … create significant distortions in the operation of market economies, and they are not financially sustainable when faced with an aging population’ (Holzmann & Hinz, 2005, p. 3).

[5]‘The design of a pension system or its reform must explicitly recognize that pension benefits are claims against future economic output. To fulfil their primary goals, pension systems must contribute to future economic output. Reforms should, therefore, be designed and implemented in a manner that supports growth and development and diminishes possible distortions in capital and labour markets. This requires the inclusion of secondary development goals, which seek to create positive developmental outcomes by minimizing the potential negative impacts that pension systems may have on labour markets and macroeconomic stability while leveraging positive impacts through increased national saving and financial market development’ (Holzmann & Hinz, 2005, p. 6).

[6]‘Uniform treatment’, as well as the principle according to which the different categories of retired dependent workers should be ensured the same standard of living to which they have become accustomed, also imply that all possibilities of opportunistic behaviours should be ruled out. Thus benefits should be so calculated that they do not take into account ‘last-minute’ promotions, nor rewards for services that are not representative of the retiree's normal activity over the last 2 or 3 years of his or her working career.

[7]It must be pointed out, however, that for several European countries no serious problem of sustainability should arise for pensions over the next 4 to 5 decades, even if output continued to grow at the low rates we have become accustomed to. In fact, owing to the expected decline in their population, income per person would in any case keep on rising over the same period (see on this also note 9, below).

[8]On the association between the worsening of economic and social conditions in Russia and the fall in both fertility rates and life expectancy, see Cabanne & Tchistiakova

(2002, ch. 2); on the shortening of life expectancy in Russia, see also Brainerd & Cutler (2005).

[9]According to the calculations used by the Ragioneria Generale dello Stato (RGS) to evaluate the behaviour of the burden of pensions over time, growth of GDP over the next 50 years or so should occur at an average rate of only 1.5% per year because of a declining labour supply (cf. Ministero dell'Economia e delle Finanze-RGS, 2001). In practice, output is not viewed as demand constrained and its rate of growth is viewed as determined by the rate of growth of the labour force and the rate of growth of labour productivity: conditions of full employment (or 'natural' unemployment) are implicitly assumed. It should be observed, in any case, that the low average rate of growth of GDP, projected on the basis of the expected decline in the size of the labour force, would still imply a very significant rise in income per person over the next four to five decades, owing to the large population decline expected to take place in Italy over the same period on the basis of current demographic trends. (Population size for Italy is expected to fall by about 12%, the largest expected decline within the EU–15 states; see Lisiankova & Wright, 2005, Table 1, p. 76.) As already pointed out in the text (Section 3), whatever implications population ageing may have on the labour force and the number of people employed, the standard of living of all the inhabitants of a country can well keep on rising as long as its income per person continues to rise. So one does not see why, in the expected conditions, population ageing should imply 'a substantial and sustained fall in the standard of living of people employed', if unaccompanied by a less generous PAYG scheme. It would seem that population ageing, unaccompanied by a downsizing of the public pension system, could lead to a fall in the standard of living of wage earners only if concomitant with a massive redistribution of available income in favour of non-wage earners.

[10]It has indeed become customary among macroeconomists over the last 20 years to identify both the 'natural' rate of growth of output and the 'natural' rate of unemployment with moving averages of the actual rates (cf. for example Mankiw, 1997, ch. 5, Fig. 5.1).

[11]On the potential 'virtues' of this new contribution-based PAYG scheme for the long-run financial equilibrium of the pension system, see Gronchi & Aprile (1998).

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