The Political Future of Social Security in Aging Societies

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The World Bank
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A new perspective on aging and pensions?

- **Conventional Wisdom**: Aging – by increasing the ratio of Retirees to Workers – may undermine the financial sustainability of PAYG systems.
Figure 2.1: Percentage of Elderly in the Total Population

- Germany
- Spain
- France
- Italy
- United Kingdom
- United States
Financial Sustainability Issues

EC and OECD’s Official Projections of Pension Spending

<table>
<thead>
<tr>
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<th>2000</th>
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Contribution to changes in spending from 2000 to 2050 of
Financial Sustainability Issues

Projections: Social Security and Health Care Spending in US

![Graph showing projections for Social Security, Medicare, and Medicaid spending over GDP from 1950 to 2050. The graph indicates a steady increase in spending over time.]

- Social security
- Medicare
- Medicaid
This book’s perspective

- Conventional Wisdom: Aging – by changing the ratio between Workers and Retirees – may undermine the financial sustainability of PAYG systems.

- Problem: Systems will have to be Reformed. Possible measures – higher contribution rates, lower pension benefits, postponing retirement, partial funding – differ in how the costs of the reform are distributed across generations.
A Look at Preferences in Europe: Do Pensions Matter?

Public Resources should be Shifted from other Policies towards Pension

DISAGREE

AGREE

Portugal
Grecia
Francia
Italia
Austria
Alemania
Bélgica
Luxemburgo
España
Dinamarca
Irlanda
Países Bajos
Suecia
Finlandia
Reino Unido
Union Europea
A Look at Preferences in Europe: Higher Taxes?

Current Pension Levels Should be Maintained even if this Means Raising Taxes or Contributions

DISAGREE AGREE

Dinamarca 70
Finlandia 80
Países Bajos 60
Reino Unido 50
Irlanda 40
Suecia 30
España 20
Francia 10
Austria 0
Luxemburgo 10
Bélgica 20
Alemania 30
Italia 40
Portugal 50
Grecia 60
Union Europea 70
A Look at Preferences in Europe: Lower Benefits?

Current Taxes or Contributions Should NOT be Increased even if this Means Lower Pension Levels

DISAGREE  AGREED

Country:
- Portugal
- Francia
- Grecia
- Bélgica
- Alemania
- Finlandia
- Dinamarca
- Italia
- Irlanda
- Austria
- Luxemburgo
- Suecia
- España
- Países Bajos
- Reino Unido
- Union Europea

Percentage: 0 - 80
A Look at Preferences in Europe: Work More?

Retirement Age should increase so people work more and enjoy less old age leisure

DISAGREE

AGREE

Irlanda
Portugal
Dinamarca
Italia
Finlandia
Austria
Francia
Reino Unido
Países Bajos
Bélgica
España
Alemania
Luxemburgo
Grecia
Suecia
Union Europea

80 70 60 50 40 30 20 10 0 10 20 30 40 50 60 70 80
This book’s perspective

- **Conventional Wisdom:** Aging – by changing the ratio between Workers and Retirees – may undermine the financial sustainability of PAYG systems.

- **Problem:** Systems will have to be Reformed. Possible measures – higher contribution rates, lower pension benefits, postponing retirement, partial funding – differ in how the costs of the reform are distributed across generations.

- **This book’s perspective:** the political process will have to reconcile the opposite interests of subsequent generations.
Literature on Political Economics of Social Security


Intergenerational Component: Browning (EI 75), Cooley and Soares (JPE 99), Galasso (RED 99)

Intragenerational Component: Tabellini (NBER 90, SJE 00), Casamatta, Cremer, Pestieau (SJE 00)

General Equilibrium Component: Meltzer and Richard (AER87), C&S (JPE 99), G (RED 99), Boldrin and Rustichini (RED 00)

Early Retirement: Gruber and Wise, Conde-Galasso, Casamatta, Pestieu et al., Disney

Implicit Contract (Sub-game Perfection): Hammond 75, Sjoblom (PC1985), C&S (JPE 99), G (RED 99), B&R (RED 00)
Key Issue: Political Sustainability

- **Political Sustainability**: Existence of a majority of the voters in favor of the existing social security system

- How do individuals (Voters) evaluate social security? They compare returns from the social security system and from alternative assets

**Voter’s Time Horizon**

- Beginning of Working Period
- Voter’s Age
- Retirement Age
- End of Life

- Sunk Cost
- Contributions
- Benefits
Determinants of Political Sustainability

- Average Return on social security
- Age: Elderly versus Young
- Degree of Redistribution of the system: Low versus High Income Workers
- Family Ties: living with the family versus alone
- Retirement Age: “Redefining Age”
Degree of Redistribution

Pension transfer as % of transfer to two-earners average couple

Low w age | Average w age | High w age

-60% | -20% | 20% | 60% | 100% | 140% | 180%

Single male | Single female | One-earner couple | Two-earners couple
Enjoying Retirement
Politico-Economic Effects of Aging

Aging induces (at least) two crucial effects:

- **Economic**: An increase in the Dependency Ratio reduces the average long run return of the system.
  → Since pensions represent a saving device, Portfolio Rebalancing: agents *reduce* the size of pension system.

- **Political**: Aging Increases the Political Weight of the Elderly.
  → Generates “political pressure” to *increase* the generosity of the system.
Quantifying these Effects

- Economic effect may be measured by the dependency ratio
- Political effect by the median age among the voters

<table>
<thead>
<tr>
<th>Country</th>
<th>Old Age Dependency Ratio</th>
<th>Effective Retirement Age</th>
<th>Median Age among Voters</th>
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<td>Germany</td>
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<td>59</td>
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<td>47</td>
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Aging in the US

Median age among voters: 47 years in 2000 and 53 in 2050
US 2000: Grey Panthers

The graph shows the distribution of population and voters across different age groups. The x-axis represents age, ranging from 18 to 83 years. The y-axis represents the share, with percentages ranging from 0.0% to 2.5%. The graph indicates a general decrease in share as age increases, with peak shares occurring in the younger age groups. The line labeled "Population" shows a higher share in younger age groups compared to "Voters," who consistently have a lower share across all age groups.
Introduce a general equilibrium politico-economic model, calibrated to the economic, demographic and political aspects and to the social security systems in the six countries. Agents take:

- Economic decisions: labor supply and savings; and
- Political decisions: voting over the pension system

Simulate the expected economic, demographic and political for 2050 and assess the political sustainability of the social security systems.
Economic Environment

- 77-Generations OLG Model: Agents may Live from 18 to 95 and face age-specific probability of survival
- Agents may also differ in their education, income, longevity and working history
- CES Utility Function
- CD Production Function
- Demographic Structure:
  - Survival Probability;
  - Dependency Ratio (Growth Rate of Population)
- Social Security System
Exogenous key elements:

• Benefits’ formula (DB or DC, earning periods)
• Effective Retirement Age;
• Pension Indexation.

Endogenous key elements (to be determined in the political arena):

• Contribution Rates; and
• Replacement Rates (since we focus on the equilibrium tax rate that equalizes total contributions to total pensions)
Political System

- Every Voter Indicates her most preferred Social Security Tax Rate, given the other characteristics of the social security system:
  - retirement age,
  - pension benefits calculation (DB, DC)
  - pension benefits indexation (inflation, wage growth)
- Social Security Tax Rate determines
  - the agent’s flow of remaining contributions to the system
  - the pensions’ generosity
Calibration Strategy

- **Demographics:**
  - Survival Probability;
  - Population growth to match dependency ratio (EC AWG);

- **Economics:**
  - Employment rate by age (ECHP)
  - Capital share of income
  - Productivity growth rates (EC AWG)

- **Pensions:**
  - Effective retirement age (ECHP, ILO)
  - Equilibrium contribution rate

- **Politics:**
  - Median age among voters
France: Population Profile

- **Year 1999 Actual**
- **Year 2050 Expected**
- **Year 1999 Model**
- **Year 2050 Model**
Figure 3: Efficiency Unit Profile by Age and Education

- Low Education
- Intermediate Education
- High Education
Political Decisions and Aging

Voter’s Time Horizon

Beginning of Working Period

Voter’s Age

Retirement Age

End of Life

Sunk Cost

Contributions

Benefits

US 2000

US 2050

But the average return on social security drops!!
## US: Simulations’ Results

<table>
<thead>
<tr>
<th>Year</th>
<th>Effective Retirement Age</th>
<th>Social Security Contribution Rate</th>
<th>Replacement Rate* (Low)</th>
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Political aspect dominates: Aging induces the contribution rates and generosity (replacement rates) to increase.

Policy Implications: Higher actual retirement ages are very effective in limiting the increase of the size
### Composition of retiree’s income

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<td>Earnings</td>
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## Simulations’ Results: Direct Impact of Aging

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<th>Country</th>
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<td>18.3%</td>
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Simulations’ Results: Employment and Tax Distortion

- Political aspect still dominates: with constant retirement contribution rates increase everywhere
- Policy Implications: Higher effective retirement age may reduce the size of the system (Italy) while increasing its generosity
- Employment Rates tilts towards old age while decreasing in youth.

<table>
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<tr>
<th>Country</th>
<th>Median Voter’s Age</th>
<th>Effective Retirement Age</th>
<th>Social Security Contribution Rate</th>
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<td>18.7%</td>
<td>60.0%</td>
<td>80.8%</td>
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</tbody>
</table>
The Main Lessons

- Aging affects the financial as well as the political sustainability of PAYG pension systems.

- Political effect dominates: the size of the social security system will increase in all countries, albeit with differences.

- Country specific characteristics (degree of redistribution, family ties) may matter in shaping voting coalitions, and hence the success of policy reforms.

- Policy implication: an increase in the effective retirement age decreases the size of the system while (often) increasing its generosity.

- Next Political Issue: Will voters be willing to support an increase in the effective retirement age?
A Crucial Issue: Europeans Enjoy Retirement
And are not ready it Give up!

Retirement Age should increase so people work more and enjoy less old age leisure
Addressing the Political Feasibility of Postponing Retirement

- Individuals (Voters) determine:
  - Social security contribution rate
  - Effective retirement age (for everyone!)

- Bi-dimensional Policy Space:
  - Condorcet cycles may arise
  - Median voter model may not apply

- Issue-by-issue voting (Shepsle, 1979):
  - Voting on social security contributions for a given retirement age
  - Voting on retirement age for a given social security contribution rate
  - Equilibrium at the intersection of these “reaction functions”
Determinants of Retirement Age Decision

- Voting on retirement age (for everyone!) for a given social security contribution rate depends on

  1. Individual labor-leisure trade-off due to retirement
  2. Impact of retirement age on pension benefits via dependency ratio: given the contribution rate, higher retirement age increases pension benefits
  3. General equilibrium effects on wages and returns

- Individual’s preferences cannot be ordered according to individuals’ age

- Ambiguous “reaction function”: higher contributions (and pensions) create a substitution (lowering RA) and an income effect (increasing RA)
US 2000: Determining Contributions and Retirement

Political-economic equilibria in the US

- Retirement age
- Social security contribution rate

RA (contribution) 2000
Contribution (RA) 2000
How does Aging affect individuals vote?

- Voting on social security contributions, given retirement age:
  - Economic Effect (lower IRR): lower contributions
  - Political Effect (older median voter): higher contributions
  - Overall result is ambiguous

- Voting on retirement age, given social security contribution
  - Negative Income effect: aging reduces returns from social security. Retirement Age increases
  - Negative Substitution effect: for a given contribution rate, aging reduces pension benefit. Retirement Age increases
  - Overall result: Retirement Age increases
Figure 6: Political-economic equilibria in the US
## The Political Future of Social Security and Retirement

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<tr>
<th></th>
<th>Age of the median voter over contribution rate</th>
<th>Effective retirement age</th>
<th>Social security contribution rate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>France</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>47</td>
<td>58</td>
<td>22.4%</td>
</tr>
<tr>
<td>2050</td>
<td>56</td>
<td>67</td>
<td>27.1%</td>
</tr>
<tr>
<td><strong>Italy</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>44</td>
<td>58</td>
<td>38.0%</td>
</tr>
<tr>
<td>2050</td>
<td>56</td>
<td>67</td>
<td>34.9%</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>45</td>
<td>63</td>
<td>14.5%</td>
</tr>
<tr>
<td>2050</td>
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<td>70</td>
<td>27.1%</td>
</tr>
<tr>
<td><strong>US</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>47</td>
<td>63</td>
<td>9.7%</td>
</tr>
<tr>
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<td>13.5%</td>
</tr>
<tr>
<td>2050</td>
<td>53</td>
<td>69</td>
<td>11.9%</td>
</tr>
</tbody>
</table>
Postponing retirement: the political push of aging

- When voting over Retirement Age and Social Security Contribution Rates, the political economic equilibrium is associated with
  - Higher retirement age
  - Lower contribution (than in the one-dimensional simulations)

- WHY? Aging and the large social security systems make the individuals “poorer” and hence more willing to work longer years.
The Main Lessons

- Aging affects the *political sustainability* of PAYG pension systems leading to larger systems.

- **Policy implication**: an increase in the *effective retirement age* decreases the size of the system while increasing its generosity.

- Voters will be willing to support an increase in the effective retirement age. Why? with aging and large social security systems individuals will be “poorer” and will need to work longer years.

- Hence, less increase in social security contribution and higher retirement age (in 2050 in Italy retirement at 67 and contributions only at 34.9%)
Our simulations suggest that – as population ages – politicians are less willing to undertake unpopular pension reforms.

Even “intergenerationally fair” politicians favorable to reform the system may be constraint by their political accountability.

Delegation of pension policies to a super-national institution, not directly accountable to the voters, may soften these political constraints.

A common European policy on pensions may help to shift the political cost of any reform decision onto the European institutions (EC), which may give a “voice” to future – yet to be born – generations.