COMMENTS ON SESSION 4
PENSION REFORM AND FISCAL POLICY

Geert Langenus[*]

As for the previous sessions, the three discussants for Session 4 have engaged in some market segmentation and I will focus in particular on the first two papers, the one by Carone and Eckefeldt and the one by Gonand. I have to say that I am quite happy with my share of the work: both papers are very interesting in my view and I enjoyed reading them. They are also complementary in a way: the Carone and Eckefeldt paper provides a detailed analysis of the problem while the Gonand one assesses possible solutions. If you do not mind, I will treat them in this order.

1 Comments on "Economic and Budgetary Effects of Pension Reforms in EU Member States" by Giuseppe Carone and Per Eckefeldt

Let me start with the paper by Giuseppe Carone and Per Eckefeldt. The Working group on Ageing Populations (henceforth: AWG) was created within the EU's Economic Policy Committee to analyse the macroeconomic and budgetary impact of population ageing and is currently updating its 2006 projections of the ageing costs. The paper gives us a sneak preview of the new projections concerning pension expenditure. The authors show that the ratio of pension expenditure to GDP in the EU will rise by some 2¼ percentage points by 2050/2060 but this is an average; the increase is somewhat bigger in the euro area and there is quite a lot of country dispersion. The paper then analyses the driving forces and shows that the increase can be traced back to a higher dependency ratio, which is only partly offset by higher employment and lower coverage and benefit ratios. The authors also assess the impact of reforms, that mainly work through a delayed exit of older workers from the labour market but also favourably affect benefit ratios. They also perform a number of sensitivity analyses and I was personally particularly struck by the importance of the assumptions concerning migration: using an alternative assumption of zero net migration would almost double the increase in pension expenditure! Finally, the authors compare the current projections with the 2006 vintage and it is safe to say that the picture is quite similar on average but there are a few outliers; in this connection, pension projections were revised substantially downwards for Portugal and significantly upwards for Malta and Luxembourg for example.

I would like to structure my thoughts on this paper on the basis of a few general comments and questions. The first issue to highlight is probably that the people who thought that ageing is less of a problem if one takes into account new demographic assumptions (e.g., regarding fertility and migration) and recent structural reforms were too optimistic: the projected increase in pension expenditure in the coming decades has not disappeared or become significantly smaller since the 2006 AWG update. This suggests that greater reform ambition is required and, in this respect, lessons can certainly be drawn from "successful reformers". More generally, it may also illustrate the need for greater fiscal prudence as, for a lot of countries, finding structural solutions for the impact of population ageing on future budgets does not seem to be that straightforward. We should not be overly confident that this will be much easier in the following years.

[*] National Bank of Belgium.
The views expressed here are those of the author and not necessarily those of the National Bank of Belgium.

My second comment pertains to the impact of reforms. The paper clearly highlights that a large group of countries have at least succeeded in shoring up the participation rate of older workers, mainly through downsizing early retirement schemes. However, an increased participation rate is only part of the story, as it was stressed in the paper by Ahuja and Paserman in the first session. What ultimately matters is whether the overall employment rate increases and if increased participation of older workers does not lead to higher unemployment. We would need to have the full set of AWG projections (including the macroeconomic projections and those for unemployment expenditure) to assess this. At any rate, it should be stressed that the employment rate of older workers is typically also influenced by parameters that are outside the pension system. One of those is the wage structure: many countries have wage structures that rise with age or seniority. This may give employers an incentive to lay off older workers if higher wages are not fully matched by higher productivity. Partly to compensate this phenomenon, some countries are already experimenting with targeted reductions in social contributions – or specific subsidies – for companies employing older workers. Finally, there is the issue of the availability of adequate jobs for older workers that is highlighted by Giuseppe and Per in the conclusion of their paper. All in all, it may not be sufficient to simply eradicate all kinds of early retirement schemes or, for that matter, increase the legal retirement age, a more comprehensive policy – also focusing on labour market institutions – may be needed to successfully raise the employment rate by delaying the exit of older workers. Turning to the projection models, if one assumes that the structural employment rate is unaffected by these reforms – and I am not sure if the new AWG projections are based upon more pessimistic assumptions concerning structural unemployment than the previous ones –, then obviously increased participation of older workers is entirely passed through to higher employment and, hence, automatically reduces the ageing costs. However, it is unclear to me at least if the policy environment is supportive enough for that to happen in all EU countries.

I now turn to the issue of the adequacy of pensions that is also touched upon in the paper. The authors show, in particular, that the benefit and replacement ratios are set to decline (strongly) in most EU countries. This may signal potential problems in the future as the social sustainability of the reforms – especially taking into account the increased voting power of the elderly – may not be guaranteed in the longer term. However, to my mind there is also an issue of cross-country comparability of the pension projections. As those projections tend to be based upon current policies, assumptions concerning the future indexation of individual pension entitlements are not necessarily harmonised. In this connection, one can however raise the question whether current policies can be prolonged until 2060. More generally, falling benefit and replacement ratios may be an indicator of inequity in the pension system. Hence, it is important that we carefully assess intergenerational implications of structural reforms to pension and care systems. For this a broader approach is needed and this may include generational accounting exercises or methods assessing the welfare of different cohorts such as in the paper by Gonand.

One of the other interesting issues in the paper is the comparison with the 2006 AWG projections. A systematic analysis of the revisions of the AWG projections is certainly very helpful. However, if I have one small quibble with the paper, it pertains to the fact that the reader actually wants more than what the paper provides. Ideally, one would want to disentangle the impact of reforms, revised assumptions and changes in projection models but the current format based upon the expenditure drivers does not allow that. It shows that countries are moving in different directions – with respect to benefit and coverage ratios, but also as regards dependency ratios – and it is not always easy to understand why if one is not very familiar with the detailed country projections. I assume that, at least in some cases, trends may be somewhat blurred by changes in projection models. As pension expenditure is the only expenditure item for which national projection models are used by the AWG, full transparency of those projections is a key issue. Despite all the detailed information given by the AWG, many people – and some of them are even in the room today – indeed still consider the national pension projections as "black boxes". Hence, it would be particularly helpful if the authors could (roughly) quantify the impact of changes in individual assumptions and projection models but I realise that this is quite an uphill task.

Let me now switch to the issue of migration. The paper shows that for most countries, but not for all, the dependency ratio effect is now lower – and in some cases significantly so – than in the 2006 AWG exercise. I presume that this is due to the fact that higher life expectancy is more than offset by higher fertility and increased net migration. It is safe to say that all three of these projections are surrounded with significant uncertainty. With respect to the first element, for instance, Ray Barrell reminded us yesterday that people tend to underestimate their life expectancy. Let me just add to that that recent projection exercises have amply shown that demographers are indeed also people and have been known to sometimes run behind the life expectancy curve. However, I would like to focus on net migration because I know that the issue is very important for the projections in the case of some countries. First, I was wondering if the authors could elaborate on the procedure that makes these assumptions on net migration at least consistent across EU countries. My second point relates to the fact that the positive impact of net migration requires a certain policy environment. There is the basic issue of opening the borders to legal migrants but other issues such as diploma recognition and the type of migrants that countries attract are important as well. In the sensitivity analyses the importance of the assumption on net migration is highlighted very clearly. Hence, if we have doubts that the required policies are in place – and will be in place throughout the projection period – it is quite tricky to assume that a large part of the ageing cost will simply be wiped out by net migration.

The final issue relates to the macroeconomic projections. For many countries, the current and the following five years were supposed to be the last period of relatively strong growth before the decline in the population of working age starts weighing on trend growth. How is that picture changed because of the current crisis? Is the current downturn assumed to have a lasting effect on trend growth and, hence, on the ageing costs?

2 Comments on "Choosing a Pension Reform: A Framework for the Social Planner" by Frédéric Gonand

Let me now turn to the equally interesting paper by Frédéric Gonand. The paper is written against the background of unsustainable public finances in many industrialised countries, as it was illustrated for the EU Member States in the paper by Carone and Eckefeldt. Clearly, population ageing will make structural reforms desirable and the Gonand paper looks into the different options. It focuses on pension systems and compares different reform strategies to a "no reform"-scenario, although the latter is actually a "rising tax burden"-scenario. Gonand argues that the choice for a specific reform should be based upon social welfare considerations but shows that, of the reforms studied in the paper, none are Pareto-improving. Hence, the "optimal" reform crucially depends on the aggregation procedure for individuals' welfare and two parameters in particular, the society's aversion to intergenerational inequality and the extent to which welfare of future generations is discounted. As for the previous paper, I would like to make a few general and one or two more specific points.

First, Gonand shows that structural reforms typically have winners and losers. Hence, approaches illustrating the micro-implications of these reforms for different groups in the current and future population should always complement the standard macroeconomic and budgetary projections in my view. This can also shed some light on the sustainability of the reforms (as the reforms may be undone if the losers succeed in winning political support). Many governments face(d) delicate choices in the coming (past) years. Intergenerational equity would seem to be an appropriate criterion to assess different policy responses to the budgetary challenge created by population ageing. This can be analysed in different ways, including approaches using social welfare functions such as in the paper by Gonand but also on the basis of generational accounting and, e.g., the evolution of the net tax burden over different cohorts. However, any concrete operationalisation will include a normative judgment on what is equitable. In this context, it may be difficult to translate analytical results into clear policy recommendations.

Second, the comparison of utility, welfare, income and consumption levels of different cohorts is quite complicated. How do you account for economic progress? On the basis of Arrow's critique, some discounting would seem necessary. There may be a link with the choice between absolute or relative poverty measures, an issue that was already heavily debated in this workshop. While I share many of the views expressed by Carlo Cottarelli and Laurent Paul, who qualified the appropriateness of relative poverty indicators, it still is the case that all papers that look into poverty issues in this workshop, use a relative poverty definition. I would argue that, if we seem to be relatively comfortable with country-specific poverty lines, it would also be natural to opt for "cohort-specific" welfare assessments. The application of such a relative approach to the welfare of different cohorts may then be consistent with linking the discount factor to, say, per capita GDP growth or average wage growth. There is a similar issue in generational accounting exercises that look into intergenerational equity: what is more relevant, the net tax burden or the after-tax income of different cohorts? I would personally not think that young and future and generations should be punished with a higher net tax burden because they have MP3 players and flat-screen TVs while their grandfathers and grandmothers had record players and black-and-white TVs. In addition, equalising after-tax income across generations would imply a continuously rising tax rate. Hence, I would by and large support the view that the welfare of future generations should be discounted to an appropriate extent.

This brings me to a third, more technical point. In the paper a very specific procedure is followed to avoid the "old-cohort bias". The social welfare function is based upon changes in utility generated by reforms (the difference between utility levels in the different reform scenarios and under the "no reform" option). Can the author elaborate on the reasons why this is necessary? I may be illustrating my general ignorance here but, when reading through the paper, I was wondering why the bias could not be dealt with via appropriate discounting (also in the ranking of the cohorts). The specific procedure followed in the paper at least makes the interpretation of intergenerational equity rather difficult as the aversion parameter is not linked anymore to differences in absolute levels of utility. I would argue that counter-intuitive results would then be possible: most people would look differently onto a unit of utility depending on whether it is taken away from – or given to –, say, Mr. Roman Abramovich or from – or to – a single mother that has to get by on welfare cheques.

Fourth, the set-up of the model is also somewhat specific: taxes are only levied on labour income and are increased only if deficits in the pension system would otherwise occur. It may be worthwhile to consider possible extensions of the model including the introduction of a tax on consumption and a pre-funding strategy to finance the ageing costs. This may point to alternative options to make the baby-boom generations contribute more to the funding of the ageing costs.

Fifth, the empirical results presented in the paper reveal different reform preferences for different countries. In Japan, for example, a decrease in the replacement rates seems to be by and large the optimal scenario while this is much less the case for the other countries studied in the paper. Can these different preferences or model outcomes be traced back to the calibration of the country models or to characteristics of the current pension systems?

Finally, let me end with a quote from the Gonand paper: "*democratic government usually does not care much about the welfare of future generations*". I am afraid that that statement, while somewhat provocative, is not fully inaccurate. In this connection, the question can be raised whether fiscal rules can help. This is particularly relevant in the context of the medium-term objectives (MTOs) for fiscal policy that are defined for individual EU Member States in accordance with the Stability and Growth Pact. These MTOs will be revised in the course of 2009 in order to better reflect the governments' implicit liabilities against the background of population ageing. However, the current proposals imply only a very partial pre-funding of the ageing costs. This may be a missed opportunity as more ambitious MTOs than those which are currently envisaged could serve as a powerful reminder of the need to take policy action, either via more upfront fiscal consolidation or via (deeper) structural reforms. In addition, the international institutions could strongly contribute to the policy debate with further work on the intergenerational implications of different policy options. In this connection, the EC is already routinely publishing sustainability indicators. These indicators are just one – admittedly, big – methodological step away from indicators of generational imbalances. Even if the latter would require an additional set of assumptions, it would be very helpful in my view if such indicators could also be produced by international institutions in order to assess the impact of different policy responses to ageing (including the absence of any policy response).